

NEXT GENERATION ALBANIA



**A Systematic
Country
Diagnostic**



WORLD BANK GROUP

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A Systematic Country Diagnostic

April 2015



Currency Equivalents

(Exchange Rate Effective, January 22, 2015)

Currency Unit – Albanian Lek (LEK) 1.00 = US\$ 0.00827

US\$ 1.00 = LEK 120.89998

Government's Fiscal Year

January 1 – December 31

Abbreviations and Acronyms

CPIA – Country Policy and Institutional Assessment (World Bank)

EU – European Union

EU11 – New EU Members States (Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia)

FDI – Foreign Direct Investment

GDP – Gross Domestic Product

HHI – Herfindahl-Hirschman Index

INSTAT – Institute of Statistics, Republic of Albania

LSMS – Living Standards Measurement Study

NEET – Not in Employment, Education, or Training

NPLs – Nonperforming Loans

ODA – Official Development Assistance

OECD – Organisation for Economic Co-operation and Development

PPP – Public-Private Partnership

R&D – Research and Development

RORK – Rate of Return on Capital

SCD – Systematic Country Diagnostic

SEE6 – South East European 6

VAT – Value Added Tax

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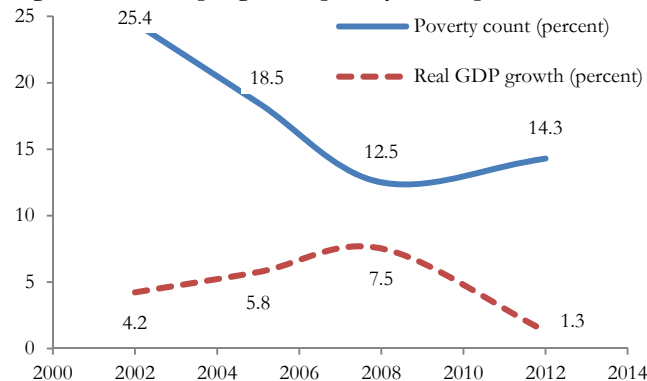
EXECUTIVE SUMMARY

Growth and Shared Prosperity

With economic growth exceeding 6 percent per annum on average, Albania was Europe's most rapidly growing economy in the decade leading up to the global financial crisis of 2008. Per capita gross domestic product (GDP) grew at an average annual rate of 6 percent in real terms, the best growth performance of any non-oil rich European country. This strong growth performance meant that Albania, which was the poorest nation in Europe in the early 1990s, reached middle-income status in 2008. The rapid pace of growth helped the country narrow the per capita income gap with the European Union (EU) from 18 percent of average EU incomes in 1998 to 30 percent in 2012.¹

The association between economic growth and poverty reduction is strong in Albania. In the boom years between 2002 and 2008, growth lifted a large number of people out of poverty, with the poverty rate declining from 25.4 percent to 12.5 percent. Economic growth was inclusive, with consumption among the bottom 40 percent of the distribution (the bottom 40) growing more quickly than the average for the country.² The drivers of economic growth during this period benefited the less well off, with poverty falling by half in both rural and urban areas.

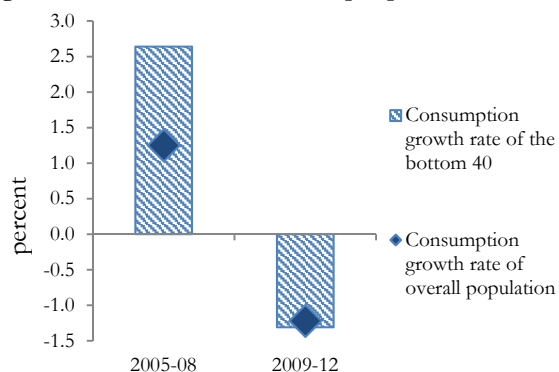
Figure 0.1: With rapid growth, poverty halved prior to 2008



Source: World Bank analysis of LSMS data.

Note: Poverty line = lek 6,407.21 per month at 2012 prices.

Figure 0.2: Economic benefits were pro-poor



Source: World Bank analysis of LSMS data.

Note: Poverty line = lek 6,407.21 per month at 2012 prices.

In the aftermath of the global crisis, the pace of economic growth decelerated, the decline in poverty halted and income convergence with the EU stalled. Albania's economic growth averaged less than 3 percent a year in real terms between 2009 and 2012, sinking to an average of only 1.7 percent a year in 2013 and 2014. The impact of the crisis resulted in a shrinking labor demand, and the poverty rate stood at 14.3

¹ The economies of the new EU member states (the EU11) grew at 3.2 percent annually in per capita terms during this period.

² Consumption expenditures are used as a proxy of household income.

percent by 2012, with poverty increases particularly in urban areas. Adjusted for purchasing power, per capita income was US\$8,123 in 2013, leaving Albania as the fourth poorest country in Europe, with 7 percent of the population living below the \$2.50-a-day poverty line.³

Given the strong association between economic growth and poverty reduction in Albania, the country needs to accelerate growth in order to reverse the recent poverty trend and increase prosperity.

Accelerating growth is essential to lift people out of poverty, but income growth will also need to continue to reach all segments of the population—that is, equitable growth—to ensure sustainable long-term gains in shared prosperity. The World Bank’s twin goals are to eliminate extreme poverty and boost shared prosperity. These goals are measured along two dimensions, namely, (1) the rate of extreme poverty and (2) the pace of income growth among the bottom 40, both of which are relevant for Albania. These goals will need to be realized in a way that is environmentally, economically and socially sustainable to ensure that welfare today is not increased at the expense of future generations.

This systematic country diagnostic (SCD) addresses the question of how to accelerate equitable growth in a sustainable manner, thereby achieving marked progress in reducing poverty and promoting shared prosperity—advancing the World Bank’s twin goals. The report suggests that Albania has the opportunity to revisit its economic strategy not only to reignite and sustain growth, but also to increase employment opportunities and raise living standards for all to ensure that growth remains equitable. What are the opportunities and constraints to reigniting equitable growth? Does Albania have the structural foundations, the enabling environment and the capacity to manage risks needed in order to accelerate economic growth, reduce poverty and build shared prosperity? The SCD employs a conceptual framework using an assets-based approach to economic gains by households, firms, and the overall economy as a way to identify the constraints to economic growth across the income distribution.⁴

Is Albania’s economic model adequate to support income growth and poverty reduction?

The SCD uses a top-down approach to investigate the patterns of growth and its distribution in order to assess whether Albania’s economic model is adequate to reduce poverty and increase shared prosperity. The SCD finds that pre-crisis drivers of growth in Albania have been exhausted and suggests that a different model is needed going forward.

The 1990s opening of the economy from communist isolation was accompanied by early liberalization and structural reforms. These reforms enabled reallocation of production factors from stagnant sectors to

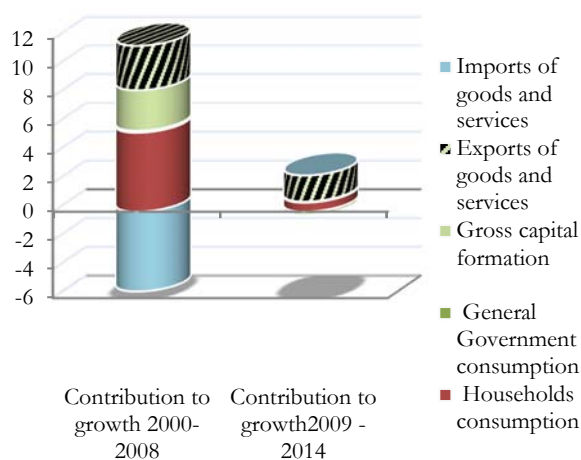
³ World Bank, ECATSD calculations using ECAPOV data. Poverty is measured using consumption at the \$2.50-a-day poverty line, circa 2012. Despite the slowdown in the economy, inequality, measured by the Gini index, remained broadly unchanged. The Gini index was 26.9 in 2012, compared with 28.2 in 2008.

⁴ The asset-based approach has been developed by Bussolo, M., and L. López-Calva, (2014) Shared Prosperity: Paving the Way in Europe and Central Asia, Washington, DC: World Bank.

more productive sectors, freed up investment and shifted labor from agriculture in rural areas to manufacturing and services in trade, transport, and communications in urban areas. The average annual real growth rate was 7 percent between 1992 and 1999, and per capita income rose from \$2,075 to \$3,262. Growth was financed by substantial foreign inflows, equivalent to a quarter of GDP, in the form of official aid and remittances from the large number of Albanians living abroad.⁵

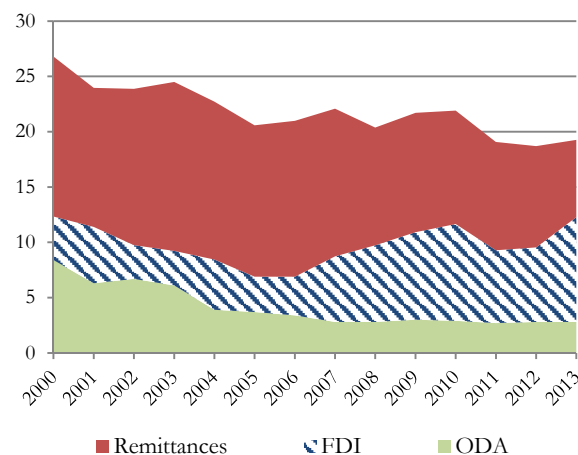
Strong growth continued in 2000-2008 at an annual average rate of 6 percent. The construction and services sectors were the drivers of economic and employment growth in 2000–2008, contributing nearly three-quarters to output growth and 32 percent to formal employment growth. The reallocation of resources from rural agriculture to rapidly growing urban sectors such as construction and services contributed close to 60 percent of real GDP growth. An economy-wide decomposition of per capita growth indicates that increases in capital stock accounted for over 85 percent of the rise in GDP per capita. However, the inter-sectoral and spatial shift away from agriculture in the 2000s did not lead to notable gains in aggregate productivity or formal employment growth in the period before the global crisis. Strong expansion of the economy prior to the global crisis was accompanied by a decline in official labor force participation as a large share of rural migrants chose inactivity and informality instead of formal employment.⁶ Formal labor force participation fell from 73 percent in 2000 to 58 percent in 2008. Despite the quick expansion of output, formal employment dropped in this period.⁷

Figure 0.3: Domestic demand drove growth precrisis
(Demand decomposition of growth, percentage point)



Source: INSTAT

Figure 0.4: Remittance flows consistently exceeded other foreign transfers, fueling domestic consumption
(Foreign inflows, percent of GDP)



Source: INSTAT

⁵ The share of emigrants rose from 3.6 percent of the population in 1990 to 24.0 percent in 2000.

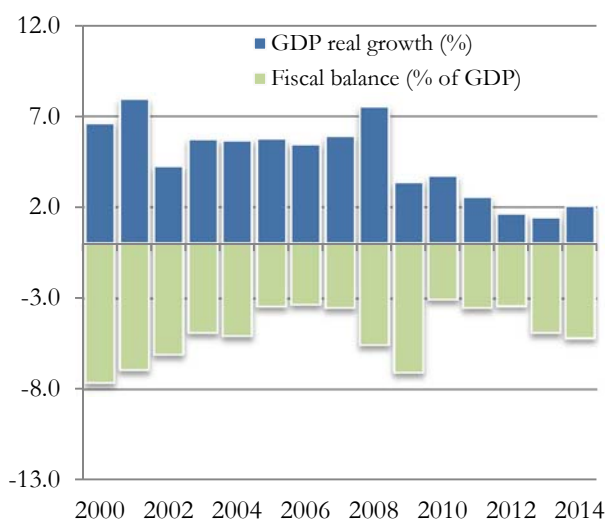
⁶ Informality has been widespread in the labor market in Albania. In the period up to 2007, labor market data was only available from administrative sources, capturing strictly formal employment. With the availability of the labor force surveys since 2008, the extent of the informal market in Albania was revealed. World Bank calculations show 47 percent in 2010 and 2011; informality per these estimates is defined as all self-employed and unpaid family workers in nonagricultural sectors, plus employees not covered by social security. This is in line with the 43 percent in 2013 reported by INSTAT.

⁷ Labor force participation rates are measured using administrative data.

In 2000–2008, growth was driven by domestic consumption. Total consumption accounted for almost 64 percent of the growth in aggregate demand. High import content of domestic consumption coupled with high rates of public investment led to not only a large trade deficit (averaging 24.5 of GDP in the period 2000–08), but also widening current account deficits. The rapid expansion of consumption was fueled by: (1) remittances (peaking at \$1.5 billion in 2008), which were consistently above the inflows of foreign direct investment (FDI) and official developmental assistance (ODA) as a share of GDP, and (2) domestic sources such as wages, other nonwage income, strong growth in credit, and the expanding fiscal deficit. Real wages grew at an average of close to 10 percent per annum, with upward pressure from the sizeable flow of remittances and unrecorded flows from undocumented activities. Domestic demand was further fueled by lax fiscal policy and a boom in credit growth. The average annual fiscal deficit stood at 5.2 percent of GDP; credit to the private sector grew an average of 180 percent a year.

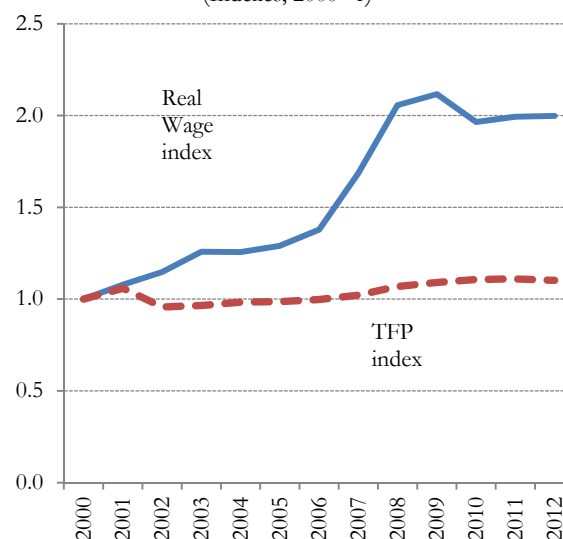
The substantial rise in wages contributed to poverty reduction before the crisis. Of the six percentage points decline in poverty in 2005–2008, household labor income was the main contributor followed by pensions, remittances, and social assistance benefits. However, the pace of the real wage increases was significantly higher (real wages doubled) than the pace of productivity gains (total factor productivity remained flat). This, along with an appreciating Albanian lek, eroded competitiveness.

Figure 0.5: Fiscal imbalances in place
(Fiscal Balance, percent of GDP and Real GDP Growth, percent)



Source: INSTAT and Ministry of Finance

Figure 0.6: Real wage growth outpaced productivity growth, harming competitiveness
(Indexes, 2000=1)



Source: World Bank calculations.

The Eurozone crisis slammed the brakes on Albania's economic expansion. GDP growth declined to around 1.4 percent by 2013. Exacerbated by Albania's close links to poorly-performing Greek and Italian

economies, Albania's export volumes, remittances, and financial flows diminished. While exports drove the limited economic expansion of the economy post-2008, they remained highly market- and product-concentrated, with significant physical capital content in non-labor intensive sectors such as minerals and unrefined oil. FDI inflows, which, in 2000–08, had accelerated at an annual average of 3.8 percent, slowed to 1.7 percent per annum between 2009 and 2013. Investment ratios (around 25 percent of GDP) remained much higher than gross national savings (just above 15 percent of GDP in 2012 and showed a declining trend). While FDI continued to finance most of the current account deficit, external debt increased since 2009, albeit remaining at a manageable 36.7 percent of GDP in 2014. Remittances fell from 10.3 percent of GDP in 2008 to 6.8 percent in 2013, and their cover of the trade deficit declined from an average of 52 percent prior to the crisis, to 42 percent in the period after.

Albania avoided recession post-2008 largely through loose fiscal policy, leading to rapidly rising public debt (from 55 percent of GDP in 2008 to 70 percent in 2014). Substantial and growing public debt increased the vulnerability of the economy because of high interest costs, rollover risks, and the potential to crowd out private sector growth. Lax fiscal policy and poor control over public financial management led government to accumulate payment arrears to businesses estimated at 5.2 percent of GDP in 2013. Government arrears contributed to deterioration in market activity and a rise in nonperforming loans (NPLs). As the crisis hit, problems of portfolio quality (stemming from easing of credit standards and overexposure towards sectors such as construction) came to the fore and the NPL ratio climbed from 6.5 percent in 2008 to almost 25 percent in late 2014. Rising government arrears, loans in foreign currency to unhedged borrowers, cumbersome judicial procedures and difficulties with collateral execution also contributed to the rise in NPLs. This undermined commercial bank earnings and restrained the ability and willingness of banks to expand credit to the private sector. Credit growth to the economy slowed from an annual average of 57 percent immediately prior to the crisis (from quarter 1 2005 to quarter 2 2008) to 10 percent in the period after (from quarter 3 2008 to quarter 1 2014).

The sharp slowdown in the economy post-2008 caused the demand for labor to fall. Employment declined across the economy, leading to contraction in household incomes and a rise in poverty. In 2009–13, employment and labor participation rates dropped, respectively, to 45 and 53 percent, and real private sector wages in non-tradables declined. The number of employed people declined by around 123,000 in only one year (2008–09), and the employment rate fell from 56 to 53 percent in 2007–10. The slowdown affected youth and women in particular. There was a 5 percentage point reduction in employment among women and an 8 percentage point drop in youth employment. The decline was 11 percentage points among women aged 15–24 years. In 2008–12, the poverty rate rose in urban areas from 10.2 to 13.6 percent and in rural areas from 14.7 to 15.3 percent, driven primarily by a shock to the labor market, particularly the contraction of low-skilled labor-intensive sectors. For example, output and employment in the construction sector contracted at an annual

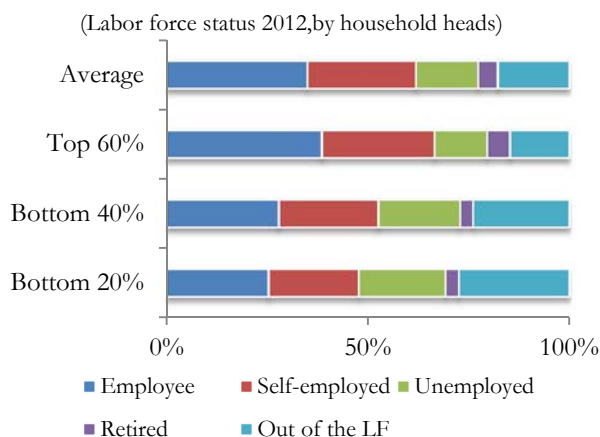
average rate of 3.5 percent and 4.4 percent, respectively, between 2008 and 2013. Inactivity rates more than doubled from 15 percent of the population in 2008 to 38 percent in 2013, and poverty rates were significantly higher among the inactive. In 2012, poverty incidence was 11 percent among households headed by the employed, 22 percent among households headed by the unemployed and 24 percent among households headed by the inactive.

The gradual loss of competitiveness, lack of productivity gains and increase in poverty reflected the inadequacy of the economic growth model to deliver sustainable gains in income. The 2008 external shock exposed the limitations of the domestic-driven growth model that depended on foreign flows to finance domestic consumption, investment, and ultimately growth. The resulting macroeconomic imbalances will continue to exert downward pressure on the economic gains of households and create disincentives for accumulation and productive use of factors of production. Restoring a sustainable macro-fiscal framework is, therefore, a high-order requirement for reigniting growth and increasing prosperity. The path to strong income growth requires a structural shift toward increased productivity among firms, a boost in the external competitiveness of the economy, and inclusiveness in the growth process while maintaining the conditions for macroeconomic stability. Long-term economic growth and employment gains require this shift in the growth model.

Figure 0.7: Large increase in post-2008 unemployment and inactivity was associated with lower socio-economic status.
(Population structure by labor status, 2008 and 2013)



Source: INSTAT



Source: World Bank analysis based on LSMS 2012 data

Does Albania have the endowments and assets needed--and the ability to use them efficiently and intensively--to reignite equitable growth?

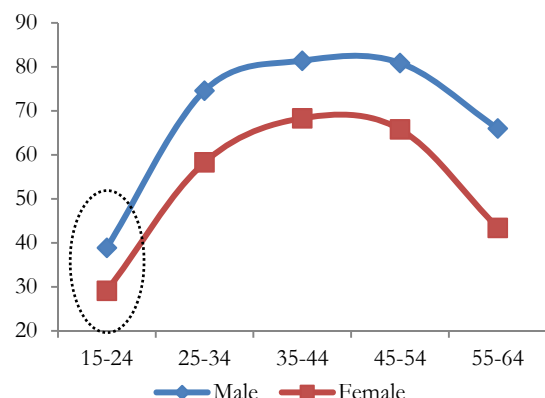
The SCD applies a bottom-up approach to examine the ways in which the stock, accumulation and distribution of human, physical, and financial capital have hindered or generated economic gains among households and firms. The SCD finds that Albania is well endowed and has accumulated a wealth of assets, but that inefficient use of these assets has undermined growth. Moreover, by excluding segments of the population from the accumulation and use of assets, the country is missing an opportunity for faster and more inclusive growth.

Albania has a relatively young population by European standards, but labor market outcomes demonstrate that this endowment is not used optimally. The quality of labor market engagement is weak and characterized by low employment rates, low labor force participation rates, significant informality, a substantial share of unpaid family workers and extremely high outmigration. These features are prevalent particularly among youth, women, minorities, and the bottom 40. For example, among youth 15 to 29 years of age, only 29 percent in this age group were employed in 2013. Among women 15 to 29 years of age, the share of employed was only 23 percent. The lower employment rates among youth and women are partly driven by higher unemployment among youth (29 percent in 2013) and lower activity rates, particularly among young women (30 percent). A 20 percentage point gender gap exists in labor force participation rates. Estimates suggest that close to half of total employment outside agriculture corresponds to informal employment, and nearly three-quarters of the labor in construction is informal. Extraordinary out-migration (cumulatively equivalent to 5 percent of the resident population in 1990, rising to 40 percent in 2010) has also affected the human capital base and the capacity of the domestic labor market to create jobs and absorb labor.⁸

With weak labor market engagement and declining remittances, it is necessary to strengthen the capacity of Albanian households to generate labor market income. This will require long-term commitment to policies such as the alignment of labor supply with the needs of the labor market for the creation of (formal) jobs and the development of the skills needed to boost firm-level productivity, attract investment, and expand access to higher productivity and better paying employment opportunities among the population. Gaps exist in our understanding of the constraints to a well-functioning labor market, but evidence suggests that among the key obstacles are disincentives and barriers to employment among women, youth, minorities, and disadvantaged groups.

⁸ Emigrants tend to be younger and more well educated than the resident population.

Figure 0.8: Notable gender gap exists among the employed
(Share of total employment, by gender, 2011)



Source: World Bank calculations on data of the LFS 2011.

Figure 0.9: Large share of employment corresponds to unpaid family workers, especially in agriculture, or to self-employed
(Share of workers, by sector and type of employment, 2011)

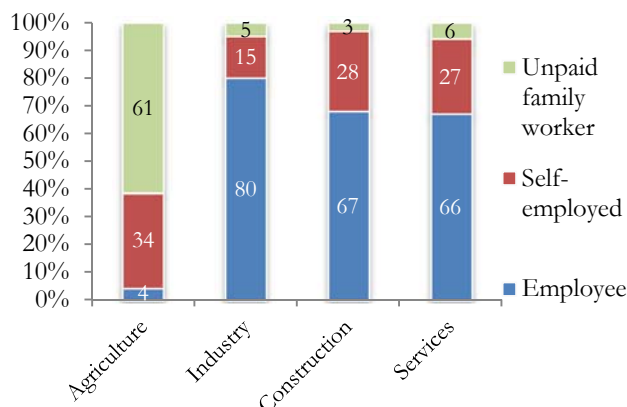
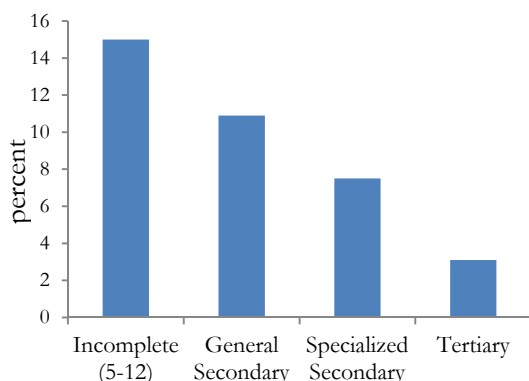


Figure 0.10: Poverty is more prevalent among the less educated

(Poverty headcount, by educational attainment, population 25 and over)



Source: 2012 LSMS data.

education is also significant. Twice as many people are enrolled in tertiary education in the highest quintiles than in the poorest quintiles. Inequalities exist in the stock of human capital, affecting the capacity available in the workforce. The share of individuals with primary education or less is substantially higher among poorer groups. Although Albanian students have consistently improved their scores in international assessments, learning outcomes remain low, with a learning gap equivalent to 2.5 years of schooling among 15-year olds relative to the Organisation for Economic Co-operation and Development countries' averages.

The population is relatively healthy with improving health outcomes in recent years, but significant inequities persist across socioeconomic groups. Life expectancy at birth reached 77 years in 2011 (80 years among women and 74 among men), higher than in neighboring Serbia (74.5) and FYR Macedonia (75) and

Access to all levels of education has increased, thus strengthening the human capital base of a new generation of workers. Nonetheless, inequalities in educational access remain. The bottom 40 and the poor show lower enrollment rates and lower educational attainment, limiting their economic opportunities and the asset base of the country as a whole. In preprimary education, for example, net enrollment is two times higher among the wealthiest quintile than the poorest quintile. In 2011, only a third of Roma children were enrolled in preschool. The socioeconomic gap in higher

only three to five years behind high-income countries such as Greece and Italy. Infant and maternal mortality rates have declined, but remain high. Infants in rural areas are twice as likely to die before age 1 as infants in urban areas, while infants in remote mountainous regions are four times more likely to die before age 1. While child malnutrition has declined steadily in the past decade, over a quarter of children in the poorest quintile were stunted (suffering from chronic malnutrition) in 2009, compared with 13 percent in the wealthiest quintile. At the same time, Albania is beginning to suffer from a non-communicable disease pattern typical of wealthy countries. Ischemic heart disease, stroke, and cancers are the leading causes of adult death. In addition, out-of-pocket health expenditures are high, particularly among the poor.

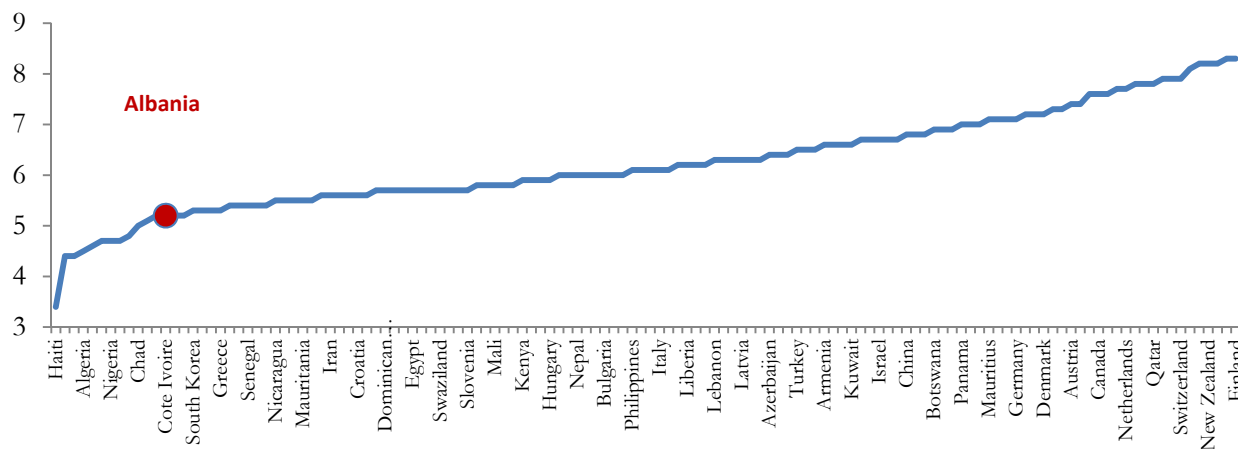
Strengthening the quality of human capital would increase the share of skilled labor in the labor force, thereby boosting productivity through the employment of a healthier and more highly skilled workforce. An increase in the quality of human capital can also contribute directly to the welfare of the poor (for example, by reducing the impact of catastrophic spending on poverty). However, efforts should be focused on narrowing the policy priorities to measures that directly contribute to raising the quality of and equity in access to education, lowering patient financial risks, enhancing the quality of health care, and improving the incentives for formal employment, including among vulnerable groups.

Insecurity in property rights undermines productive use of land endowments. Albania has one of the lowest scores (137 of 148 countries) in the world in terms of overall property rights, particularly physical property rights. The lack of a well-functioning land market is having broad negative impacts on rural development (for example, substantial farm fragmentation) and urban development (the uncontrolled growth of urban settlements). With respect to urban areas, it is estimated that between 1992 and 1996 the informal sector provided 60 percent of houses built by the private sector.⁹ This has led to inefficiencies in the allocation of land, land use and space (density). Lack of urban planning has undermined the growth potential of Albanian cities. With respect to rural areas, the initial land privatization process resulted in a large number of tiny and scattered farms, holding back the development of the agricultural sector. As of 2012, there were over 350,000 agricultural holdings in Albania averaging one hectare in size. Most farmers remain locked in low-income subsistence farming, unable to utilize their land assets to generate additional economic gains. Overall, poor enforcement of property rights represents the key obstacle preventing firms, farms and households from entering the land market. This has direct consequences not only on landownership, but also on income generation and the incidence of poverty. Some groups, such as women and the less well-off, are at an additional disadvantage because they are often excluded from landownership. The country has almost twice as many male landowners than female, and most female landowners have a property share of less than 25 percent. Comprehensive land policy reform would increase land formalization, promote inclusion, and address problems

⁹ UNECE (2002), Albania Country Profile on the Housing Sector

in land compensation and property valuation schemes. Focusing the agenda on improved national territorial planning among all governments will help foster efficiency and equity in the use of land and space. Along with ownership, the issue of sustainability of land management is also critical, especially given the importance of nature-based tourism and Albania's legacy of environmental hotspots along its beautiful coastline.

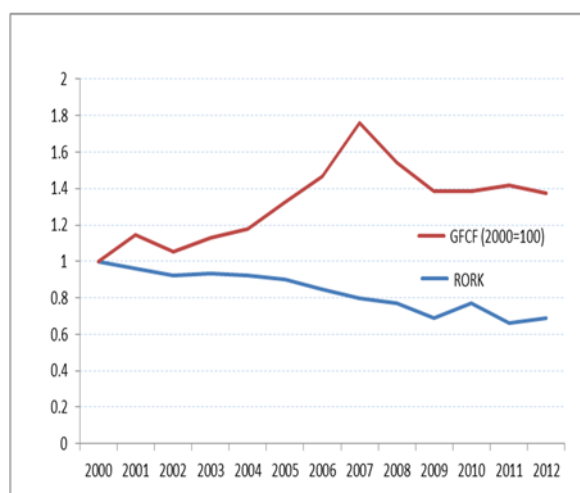
Figure 0.11: Albania is among the lowest scoring countries globally on protection of property right
(Physical Property Rights Index)



Source: International Property Rights Index, <http://propertyrightsalliance.org>.

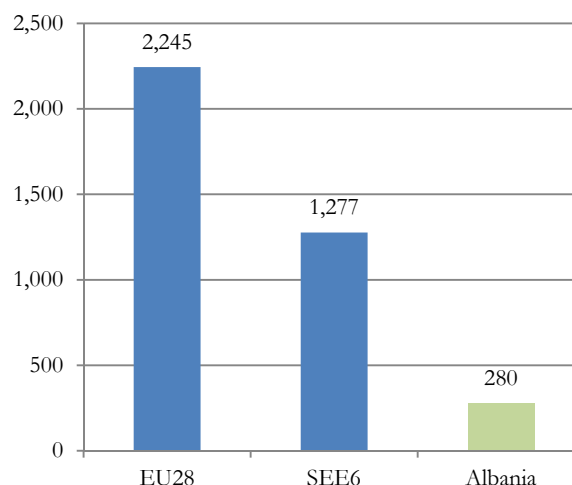
Consistently declining rates of return on capital are raising broad questions about the opportunity costs of resources. While physical capital accumulation was an important driver of precrisis economic growth (accounted for an average of 25 percent of output in the period 2000-08), returns on capital are low and have been declining for a long time. Total investment expanded, on average, by 13.3 percent in 2000–08, of which some 80 percent originated in the private sector. Private investment grew by an average of 10 percent a year, reflecting to a large extent a boom in construction. Public investment, at 17 percent of gross fixed capital formation, rose even more quickly, at a 13 percent annual average, going to the transport sector for new road construction rather than maintenance of existing infrastructure. Consistently falling returns on capital (estimated to fall by 30 percent between 2000 and 2012) discourage domestic and foreign private investment flows, place a burden on public finances, and, ultimately, reduce economic growth. Poor management of capital investment has contributed to large inefficiencies. Moreover, weaknesses in financial intermediation, including equitable access to financial markets, represent a constraint on the accumulation and use of financial assets both for households and firms. For example, Albania had 22 branches per 100,000 adults in 2012 compared with the average of 36 in the EU and only 280 deposit accounts per 1,000 adults, compared with 2,245 in the EU.

Figure 0.12: Rates of return on capital have been declining
(Gross fixed capital formation and rates of return on capital RORKs, Albania, 2000–12, Index 2000 =1)



Source: World Bank calculations based on Penn World Tables.

Figure 0.13: Access to financial services is limited
(Deposit accounts, number per 1,000 adults)



Source: International Monetary Fund

Does the enabling environment support equitable growth?

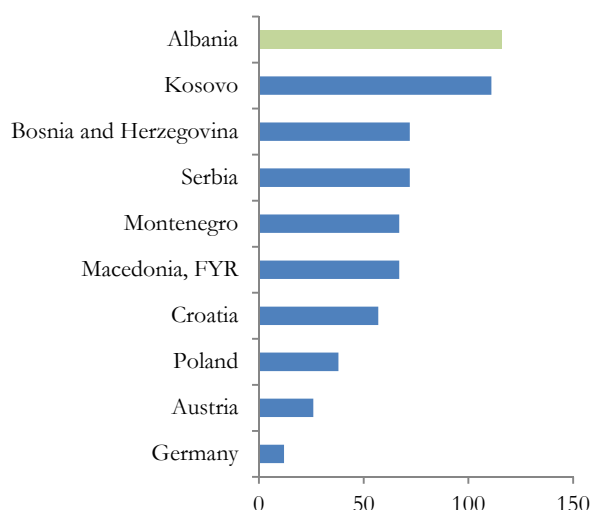
The SCD focuses on the enabling environment required for better accumulation and use of assets and endowments. The SCD finds that the quality of the institutional and business environment, the delivery of public services, and the mechanisms available to protect the poor are ineffective in supporting the buildup and use of assets by firms and households. However, all three areas have the potential to support the buildup and use of assets if governance reforms are undertaken.

Overall, weaknesses in governance and the perception of corruption have long-dominated Albania's image. The country remains in the bottom 30 percent in global rankings of corruption perception. An inefficient judicial system and inconsistent application of the rule of law, coupled with perceptions of corruption, have generated mistrust in the government among economic agents and citizens, as well as significant informality. Enhanced independence, accountability, and professionalism of the judiciary would ensure that the implementation of laws and regulations is carried out in a nondiscretionary manner. Expanding consensus building in Parliament in the adoption of reform strategies, laws, and regulations could also help overcome inconsistent application of laws and regulations by courts and executive agencies. Tackling these high-level problems in governance would contribute to restoring confidence that the legal and institutional environment can protect and enforce the property, contract, and other rights of economic agents. The EU candidacy status of Albania represents an opportunity to pursue the EU integration agenda, including an effort to raise the quality of institutions on par with Europe.

Entrepreneurs continue to face burdensome institutional and regulatory barriers. This is reflected in the poor investment environment, which is having a direct effect on firm and farm growth. Businesses are reporting

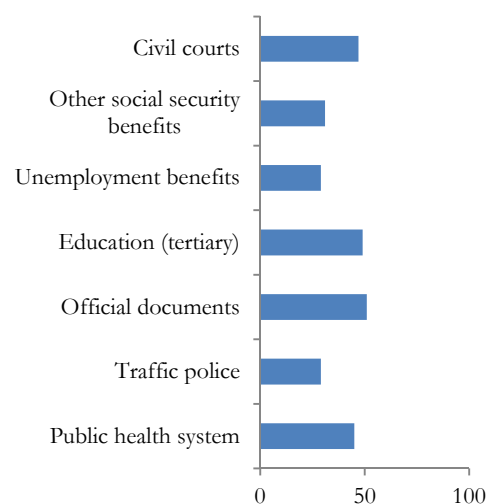
that institutional and governance barriers are negatively affecting their sales and employment growth. It is more burdensome to deal with construction permits, trade logistics, inspections, and property and land registration in Albania than in neighboring countries and in other countries around the world. Moreover, businesses and entrepreneurs have voiced strong concerns about the discriminatory implementation of regulations and the high level of complexity in rules, procedures, and reporting guidelines. Making the investment policy framework stronger and more transparent would help spur local business development, attract foreign investors, and harness spillovers from FDI. It would also help reduce informality and help foster global and regional integration. In turn, it is expected to affect incomes positively across the distribution and economic sectors through the greater employment and entrepreneurial opportunities created by a regulatory environment in which firms can thrive.

Figure 0.14: Albania is in the bottom 30 percentile globally in perceptions of corruption
(Corruption Perception Index, 2013)



Sources: Transparency International, London. Note: A lower ranking indicates that a country has better relative governance.

Figure 0.15: Albanians are relatively unsatisfied with public service delivery
(Share of satisfied respondents in total, 2010)



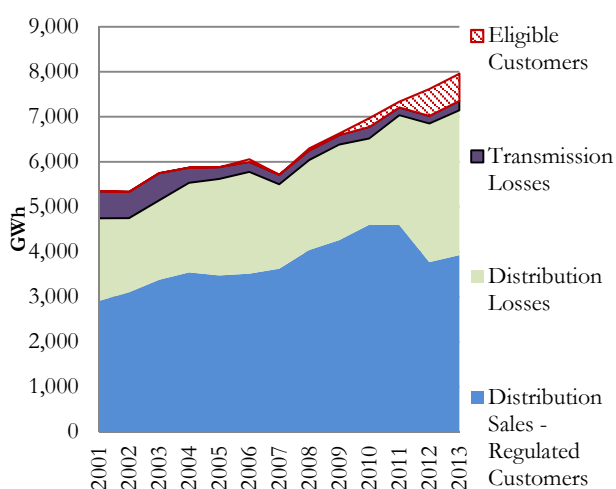
Source: LiTS 2010.

Lack of reliability in energy supply is a large burden on economic growth. High economic dependence on weather-affected hydropower resources (98 percent dependency), high distribution losses (close to half the energy supplied), low collection rates, and technical inefficiencies have made the energy sector an unreliable and financially unsound supplier. Securing energy supply is an immediate need and can be achieved through diversification in generation, strengthening regional integration, efficiency gains in distribution by reducing losses and more effective cash collection, the development of a competitive energy market that will attract private investment, and reductions in the fiscal exposure of the government.

The provision of public services must be strengthened in order to accelerate inclusive growth. Satisfaction with delivery is low across most public services, reflecting large inefficiencies, poor quality, weak

institutional capacity, limited accountability to public service users, territorial fragmentation, and socioeconomic and spatial inequalities in access. Corruption perception is high, accountability low, spatial inequality in access substantial, and the penetration of information and communication technology incomplete. In a fiscally-constrained environment, efficiency gains are the primary road to improvement in the delivery of equitable public services. With respect to public spending, key reform areas include: i) improving public investment management to ensure that a scaling-up of public investment supports long-term macroeconomic stability and growth; ii) strengthening the link between output/performance and spending; and iii) optimizing revenue mobilization (for example, expanding health insurance coverage and reducing the reliance on payroll taxes). Likewise, fostering the development of institutions and good practices to reinforce financial discipline (such as strengthening the commitment control system of the central government), reaching compliance with regulatory benchmarks (for instance, in the water and wastewater sectors), improving the public-citizen interface in the delivery of public services to enhance responsiveness and reduce the high rate of informal payments (for example, in health care), capitalizing on fiscally sound public-private partnerships (PPPs), and overcoming institutional weaknesses in the absorption of preaccession EU funds (such as in agriculture) can help improve the use of public funds in service delivery.

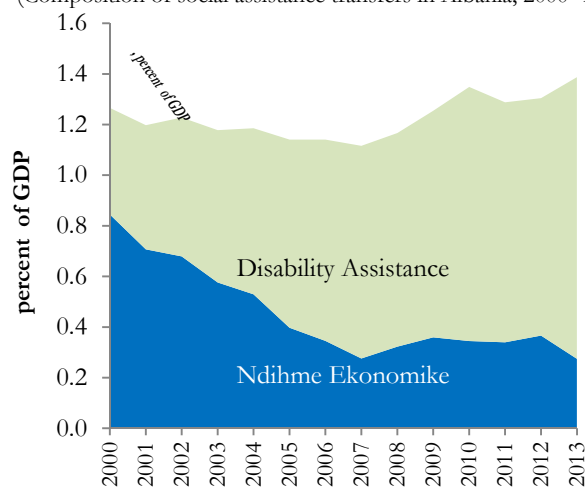
Figure 0.16: Massive losses plague distribution of electricity
(Distribution of electricity, GWh)



Source: World Bank staff calculations

Figure 0.17: Inadequately targeted disability assistance crowds out poverty-focused programs

(Composition of social assistance transfers in Albania, 2000–13)



Source: World Bank staff calculations

Note: Ndihme Ekonomike (aka Solidarity Albania Program) is the main poverty-focused program

The effectiveness of institutions to protect the poor and vulnerable needs strengthening. In the recent past, the main poverty-focused program has been poorly targeted and characterized by low coverage. Moreover, the benefits received by the poorest quintile were among the lowest in Europe. As of 2012, the share of the poor covered by the program was only 24 percent, but the share of non-poor receiving benefits had risen from

5.2 percent in 2008 to 7.4 percent of the total in 2012. Meanwhile, spending on disability assistance increased because of growth in the number of beneficiaries and the overly generous indexation and ad hoc expansion in benefits. From 2007 to 2013, the number of beneficiaries rose by 50 percent to reach 165,000. The disability assistance program does not effectively target and support the truly disabled. As a result, social safety nets do not address the needs of most poor households, and are inadequate in protecting the vulnerable and the disadvantaged from household-specific or systemic shocks.

What risks threaten the sustainability of inclusive income growth and welfare improvements?

The SCD identifies risks threatening the sustainability of rapid and inclusive growth. Albania is exposed to multiple risks, which will threaten progress toward the twin goals if not managed well. These risks are cross-cutting and affect the pattern and distribution of economic growth, the ability of economic agents to build and use assets and endowments, and the institutional environment that enables households and firms to generate income. Managing these risks is needed to ensure that the gains of shifting to a new growth model are sustainable instead of short-lived and sporadic.

The key macroeconomic risk relates to difficulties in restoring the medium-term macro-fiscal balance, which is critical for boosting the competitiveness of the economy. The earlier domestic demand-fueled remittances-financed growth model is no longer sustainable and has contributed to severe macroeconomic imbalances—characterized by high public debt, structural fiscal deficits, public sector arrears and large non-performing loans—which must now be addressed in order to reignite growth and reverse the recent increase in poverty. Fiscal consolidation is an important step toward improving macroeconomic stability. It needs to be supported by deep structural reforms aimed at reducing explicit and implicit contingent liabilities (such as in the energy sector, the pension system, and property restitution and compensation for formerly expropriated land). The risk remains that fiscal consolidation could go off the rails—perhaps due to social or political pressures—resulting in inefficient ad hoc expenditures that undermine the medium-term macro-fiscal framework needed to support growth. While the financial sector has remained largely resilient to the global crisis (with solid liquidity ratios and strong provisioning requirements) continued vigilance is needed, given the decline in banks’ profitability and potential deleveraging in a system dominated by subsidiaries of European banks. The greatest external macroeconomic risk stems from the weak European recovery and its impact on demand for Albanian goods, services and workers.

On the environmental front, the key risks include disaster risk, climate change risks, the overexploitation of natural endowments, and pollution. Managing these risks well would underpin competitiveness and growth potential in water, land, and coastal assets. Ensuring that the economy can count on natural resources is key for securing the income sources of households and firms in sectors relying on natural endowments (agriculture, energy, water, tourism, extractive industry). Moreover, Albania is prone to hydrometeorological and geological hazards. As such, its exposure to natural disasters is large and exacerbated

by climate change. In turn, this increases the vulnerability of households and the overall economy to climate shocks, which, if they materialize, can reverse the progress toward the twin goals.

Social risks are associated with the exclusion of some groups from economic opportunities. Social risks involve perceptions of inequality and corruption, as well as barriers to equitable economic participation, especially among the poor and the less well off, women, youth, and minorities. Exclusion can jeopardize progress achieved in boosting shared prosperity, but also prevents the maximization of gains from the growth process given that some groups cannot contribute in line with their potential. Promoting inclusion across socioeconomic groups (including ethnic minority, gender, gender-identity, age, and economic status) will directly guard against the erosion of living standards and incomes of marginalized groups and ensure that all groups are part of the new growth path of the economy.

What are the policy priorities for advancing the twin goals?

The SCD identifies the most important policy priorities for Albania to restore growth and make growth inclusive and sustainable for reducing poverty and boosting shared prosperity. A two-stage approach was adopted to identify priorities for overcoming the constraints to advancing the twin goals in Albania. In the first stage, the SCD identified twelve major constraints which are undermining the achievement of substantial progress toward the twin goals, and then defined a policy priority for addressing each of these twelve constraints. The Table below summarizes the twelve priorities and their key policy recommendations. In the second stage, the Albania SCD Team drew on the findings of the diagnostic and of stakeholder consultations in order to cluster the twelve priorities based on their direct impact on achieving the twin goals. Priorities were scored based on their direct impact on growth, poverty reduction and shared prosperity. Three mutually-reinforcing categories of priorities were identified, as follows:




- 1. Fundamental Priorities:** This group comprises the highest-ranking policy priorities, considered fundamental for reaching the twin goals in Albania. Unlocking these five constraints is the ***necessary and immediate prerequisite*** for the success of all policy priorities in advancing the twin goals. This group exerts direct impact both on the productivity and competitiveness of the economy and on greater inclusion. It includes: (1) restoring fiscal sustainability and financial stability; (2) establishing a high-quality business environment that promotes firm growth and job creation; (3) providing clean energy efficiently, equitably, and in a sustainable manner; (4) formalizing and enhancing the inclusiveness and sustainability of the land market; and (5) enhancing governance, transparency, and the accountability of government toward citizens.
- 2. Supporting Priorities:** A further four are viewed as supporting priorities that ***amplify the impact of the top five priorities*** over the longer run. The group includes (1) increasing the quality of labor market engagement among the bottom 40, youth, women, and minorities; (2) improving the quality and relevance

of the education system and skills training programs; (3) improving the efficiency and equity of public resource management; and (4) ensuring more inclusive access to financial markets.

3. **Sustaining Priorities:** This group—although not seen as having the strongest direct and immediate impact on growth and inclusion—is considered critical to *enhancing the economic, social, and environmental sustainability* of the top five priorities. The group includes: (1) enhancing the effectiveness and efficiency of social protection systems for the benefit of vulnerable groups, (2) ensuring the sustainable use of natural resources and the stewardship of the environment, (3) improving the quality and equity of health services and reducing health-related financial risks.

Table 0.1: Overall Impact Assessment of Policy Priorities in Achieving the Twin Goals

	Overall Impact
Restoring fiscal sustainability and maintaining financial stability	<i>Fundamental</i>
Establishing a high quality business environment	<i>Fundamental</i>
Providing clean, efficient, equitable and financially sustainable energy	<i>Fundamental</i>
Formalizing and enhancing inclusiveness and sustainability of the land market	<i>Fundamental</i>
Enhancing governance, transparency and accountability of government	<i>Fundamental</i>
Increasing the quality and inclusiveness of labor market engagement	<i>Supporting</i>
Improving quality, access and relevance of education and training systems	<i>Supporting</i>
Improving efficiency, access and quality of public services delivery	<i>Supporting</i>
Improving inclusiveness of access to financial markets	<i>Supporting</i>
Enhancing effectiveness and efficiency of social protection systems	<i>Sustaining</i>
Ensuring sustainable use of natural resources and stewardship of the environment	<i>Sustaining</i>
Improving quality, efficiency and equity of health services	<i>Sustaining</i>

Note: The impact scores are derived from the qualitative assessment of SCD experts and range between 1 (minimum) and 5 (maximum) for each policy priority as well as for the short and the medium to long term. They are consolidated in an Overall Impact Index per policy priority. Sustaining impact refers to  (yellow) cells with a medium-low impact score between 1.67 and lower than 2.5]. Supporting impact refers to  (orange) cells with a medium-high impact score (2.1 and lower than 3.3. Fundamental impact  (red) indicates high impact and comprises scores higher than 3.3. See Annex 1 for details.

Notable complementarities exist between the policies with a high impact on economic growth (such as macroeconomic stability and energy security, as well as governance and a high-quality business environment) **and the policies with a specific impact on equity** (related to the quality of labor market engagement, the protection of vulnerable groups, and building up the quality of human capital). Capturing synergies, developing proper sequencing and building institutional capacity to develop and implement reforms will be critical to maximize equitable growth in a sustainable manner.

The World Bank Group’s strategy to support Albania will be built around the top five SCD priorities. The SCD serves as the evidence base for defining the Country Partnership Framework (CPF) engagement. Within the top five priorities, the CPF will apply further selectivity by assessing political feasibility, institutional

capacity, the World Bank Group’s comparative advantage relative to other partners and our historic engagement in Albania.

Summary Table of Broad Areas, Key Constraints, Policy Priorities, and Specific Policies for Advancing the Progress toward the Twin Goals in Albania

POLICY PRIORITY: RESTORING FISCAL SUSTAINABILITY AND MAINTAINING FINANCIAL STABILITY		
Fundamental	KEY CONSTRAINTS Macroeconomic imbalances related to high public debt, structural fiscal deficits, public sector arrears, potential external imbalances, and high NPLs	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Implement sound fiscal policies by improving the efficiency of public spending, enhancing revenue measures, tackling the outstanding public arrears, addressing pension sustainability, eliminating quasi-fiscal deficits (especially in energy through a time-bound recovery plan), strengthening the management of public debt, and strengthening public financial management • Strengthen public investment decision making, reflecting improved planning and the prioritization of capital spending (for example, by rebalancing new investment in roads toward maintenance, developing financing mechanisms for infrastructure, and addressing environmental externalities such as wastewater treatment and waste management) • Maintain financial sector stability by reducing NPLs, reviving sustainable credit growth, increasing the reserves of the deposit insurance fund, safeguarding the credibility of monetary policy, and strengthening the autonomy of the financial regulatory authorities
POLICY PRIORITY: ESTABLISHING A HIGH-QUALITY BUSINESS ENVIRONMENT		
Fundamental	KEY CONSTRAINTS Large regulatory barriers to economic agents harm firm growth and job creation	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Cut the regulatory burden across the board (for example, construction permits, trade logistics, inspections, property and land registration, and so on) and ensure the nondiscriminatory implementation of regulations among all economic agents • Strengthen the policy, legal, and institutional framework to attract FDI and the entry and protection of FDI to maximize the benefits and spillovers of FDI among local economic agents (firms, farms, entrepreneurs) • Improve trade logistics and facilitation and deepen international and regional integration • Improve corporate governance and the financial reporting practices of banks and firms through streamlined rules, procedures, disclosure practices, the role of boards of directors, and financial reporting and auditing standards

POLICY PRIORITY: PROVIDING CLEAN, EFFICIENT, EQUITABLE, AND FINANCIALLY SUSTAINABLE ENERGY		
Fundamental	KEY CONSTRAINTS High economic dependence on hydro resources for energy provision, resulting in vulnerability to weather patterns; pervasive waste of energy resources; and high reliance on imports	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Reduce waste and increase energy efficiency through reduction in distribution losses and improved collection from consumers • Reduce weather vulnerability through preparation and implementation of Risk Management Strategy, including among others, diversification of generation sources, regional integration and insurance instruments. • Improve the management of hydro resources through integrated water basin approaches
POLICY PRIORITY: FORMALIZING AND ENHANCING INCLUSIVENESS AND SUSTAINABILITY OF THE LAND MARKET		
Fundamental	KEY CONSTRAINTS Widespread informality and weak enforcement of property rights in land markets in both rural and urban areas Lack of urban planning and enforcement leading to an inefficient allocation of land, land uses and space (density)	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Increase land formalization and promote inclusionary practices through streamlined and transparent administrative procedures of land legalization (including for b40 and women), land and property valuation following international standards, digital land cadaster registration lined to a fiscal cadaster • Address land restitution/compensation scheme in fiscally sound and fair manner in line with best international practices; • Develop a land and farm consolidation program to help increase farm productivity and improve land management • Improve land planning and management to protect the endowment and foster agglomeration economies
POLICY PRIORITY@ ENHANCING GOVERNANCE, TRANSPARENCY AND ACCOUNTABILITY OF GOVERNMENT		
Fundamental	KEY CONSTRAINT Institutional weaknesses, inefficient judicial system and application of the rule of law, perceptions of corruption leading to high informality	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Increase transparency and accountability of decision-making, including through an integrated e-Government system, strengthened the independence and depoliticization of public institutions • Enhance the independence, accountability, professionalism of the judiciary/courts and executive agencies to ensure non-discretionary and consistent implementation of laws and regulations • Expand consensus building in Parliament in the adoption of reform strategies, laws and regulations
POLICY PRIORITY: INCREASING THE QUALITY AND INCLUSIVENESS OF LABOR MARKET ENGAGEMENT		
Supporting	KEY CONSTRAINTS High overall informal employment and high joblessness (from both inactivity and unemployment) among bottom 40, women, youth, minorities	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Improve policy incentives and remove barriers for formal employment, particularly for the b40, youth and women, including by strengthening the evidence base • Strengthen active labor market programs to promote activation of particular groups (e.g. youth, women, minorities) • Enhance labor market information systems to improve education, training, and job matching, including through enhanced coordination between government and private sector, strengthened linkages with active labor market measures, and regular collection and use of labor market information • Promote formal sector firm registration by reducing barriers to registration and reducing personal income tax disincentives to formal sector employment

POLICY PRIORITY: IMPROVING QUALITY, ACCESS AND RELEVANCE OF EDUCATION AND TRAINING SYSTEMS		
Supporting	KEY CONSTRAINTS Inequitable access to quality preprimary and higher education; overall poor learning outcomes stemming from weak quality of the education system; weak links of education and training systems with labor demand.	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Improve access and equity in access to pre-primary and higher education, by targeting b40 children and youth • Improve quality of formal education system in an equitable manner from preprimary to higher education, by ensuring that graduates at each level acquire requisite cognitive, non-cognitive, and technical skills • Enhanced management, efficiency, and quality of higher education system through targeted scholarships and institutional performance based/competitive grants • Strengthened management and governance of education system, including resource allocation and decentralized autonomy and accountability
POLICY PRIORITY: IMPROVING EFFICIENCY, ACCESS AND QUALITY OF PUBLIC SERVICES DELIVERY		
Supporting	KEY CONSTRAINTS Socio-economic and spatial inequalities in public services provision; Significant inefficiencies in public spending; Low quality provision of public services	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Strengthen institutions and build human capacity for reinforcing financial discipline, improving governance/management/accountability and combatting corruption in service delivery • Strengthen the efficiency and equity in managing public resources (e.g. in health, education, water, transport, sanitation, etc) to improve access to, quality of and equity in public services • Improve the legal and regulatory framework for public services delivery, including through enhanced level of accountability and management as well as fiscally-sound PPPs
POLICY PRIORITY: IMPROVING INCLUSIVENESS OF ACCESS TO FINANCIAL MARKETS		
Supporting	KEY CONSTRAINTS Limited access to finance and savings, given low penetration of financial services, and low financial inclusion especially for some groups and rural areas	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Encourage development of non-bank financial institutions (SCAs, insurance, leasing, investment funds and asset management companies, etc.) • Strengthen financial infrastructure (deposit insurance, payment system, collateral registries, the insolvency regime, etc.) as well as the availability of long-term debt and equity financing (e.g. domestic capital market activities) • Improve financial inclusion, particularly for b40 and women, by providing new saving, lending and money payment opportunities to the unbanked population through both banks and non-bank financial sector channels (e.g. through SCAs, MFIs, Albanian Post, mobile money providers, etc.)
POLICY PRIORITY: ENHANCING EFFECTIVENESS AND EFFICIENCY OF SOCIAL PROTECTION SYSTEMS		
Sustaining	KEY CONSTRAINTS Poor targeting, coverage and low benefit levels of the main poverty-focused program; Poor targeting of truly-disabled people and inefficient spending of the disability assistance program	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Continue the reform agenda to improve the poverty targeting of Solidarity Albania Program and the targeting of the disability program on the disabled, rebalance spending between programs, and modernize the administration of benefits, while consolidating social assistance by channeling various benefits through the Solidarity Albania Program • Continue the agenda to reform the pension system and focus on the implementation of the recent pension law • Link social assistance to human capital and economic activation measures and improve the institutional capacity to implement economic activation measures so as to promote the inclusion of marginalized groups within the growth process

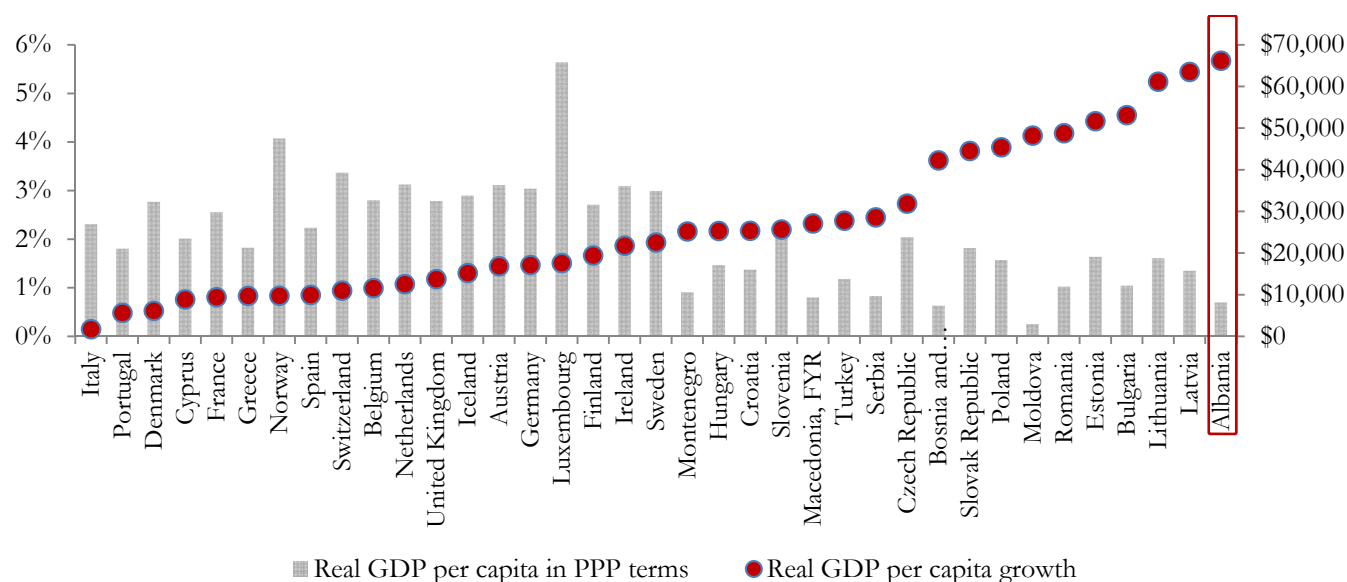
POLICY PRIORITY: ENSURING SUSTAINABLE USE OF NATURAL RESOURCES AND STEWARDSHIP OF THE ENVIRONMENT		
Sustaining	KEY CONSTRAINT Non-sustainable use of natural resources, on which livelihoods and key economic sectors (energy, agriculture, tourism) depend Growing pressure on environmental assets and climate risks in water resources	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Improve capacities and the governance framework for managing natural, environment and climate risks, and protecting valuable ecological resources and natural assets • Increase the value of ecosystem services from land and forest management, focusing on upland rural areas • Improve management of hydro resources through integrated water basin approaches, including regional cooperation • Shift to a more sustainable production trajectory by focusing on climate smart farm practices, and improvements in the irrigation infrastructure
	POLICY PRIORITY: REFORM HEALTH FINANCING TO LOWER PATIENT RISKS AND IMPROVE QUALITY OF HEALTH CARE	
Sustaining	KEY CONSTRAINTS Inequitable access to quality health services; inequities in health outcomes for poor, bottom 40%, and ethnic minorities; increasing burden of non-communicable diseases; very high out of pocket expenditures; and high informal payments, particularly for poor and b40	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Strengthen preventive medicine and primary care to provide equitable access and quality services, particularly for poor and b40, including through provider training, payment reforms, and upgraded equipment and infrastructure • Reform hospital services and enhance critical support services to improve quality of care and efficiency, including through rationalization of the hospital network, payment reforms, increased autonomy and accountability, improved monitoring of quality and efficiency, and selective upgrades in infrastructure and equipment, as well as improved health management information systems, laboratories, emergency services. • Strengthen pharmaceutical policies and accountability mechanisms to reduce costs, informal payments, and out-of pocket spending • Increase coverage of health insurance, particularly for the b40, while ensuring sustainability of the public health insurance benefits package

INTRODUCTION: GROWTH AND SHARED PROSPERITY IN ALBANIA

Albania is a small European country. It has a population of 2.8 million (2011 census). It is located in Southeastern Europe, bordering Greece to the south and Kosovo and Montenegro to the north. Its coastline of 476 kilometers extends along the Adriatic and Ionian seas. Seventy percent of the country is mountainous. In 1991, Albania emerged from nearly 50 years of harsh communist rule with widespread poverty and a nearly devastated economy. At the time, Albania was the most isolated country in Europe with virtually no ties or cooperation with any other nation and dependent solely on its own crippled industry and agriculture.

With economic growth exceeding 6 percent per annum on average, Albania was Europe's most rapidly growing economy in the decade leading up to the global financial crisis of 2008 (Figure 1). Albania has experienced extraordinary growth. Since 1998, the country's real gross domestic product (GDP) per capita has grown at an average annual rate of 6 percent, the best growth performance of any European country that is not oil rich. Because of strong growth performance, Albania grew from the poorest nation in Europe in the early 1990s to middle-income status in 2008. In 2013, income per capita was \$8,123 (adjusted for purchasing power parity). The rapid pace of growth helped the country narrow its per capita income gap with the European Union (EU) from 18 percent of the average EU income in 1998 to 30 percent in 2012.¹

Figure 1: Real GDP per capita, 2000–08, percent

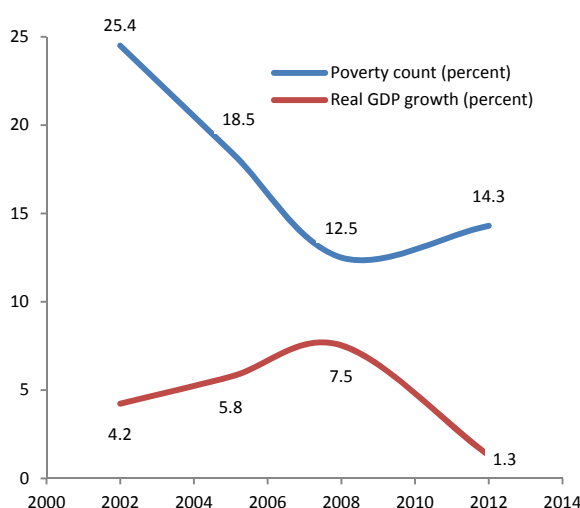


Sources: World Bank; INSTAT.

¹ The new EU member states grew at 3.2 percent annually in per capita terms during this period.

There has been a strong association between economic growth and poverty reduction in Albania. In the boom years between 2002 and 2008, growth lifted a large number of people out of poverty; the poverty rate declined from 25.4 percent to 12.5 percent (Figure 2). In the years prior to the financial crisis, economic growth was inclusive, and consumption among the bottom 40 percent of the income distribution (the bottom 40) grew more rapidly than the country's average growth in consumption (Figure 3). Growth incidence curves depicting the consumption growth rate for each percentile of the population show that, in 2002–08, the positive consumption growth disproportionately benefited the less well off (Figure 4). Poverty halved in both rural and urban areas.

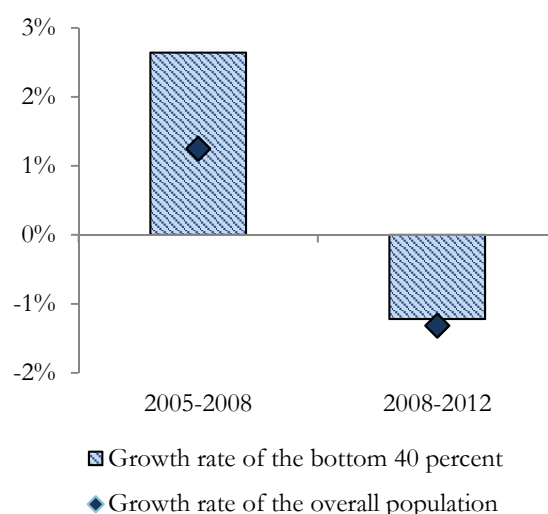
Figure 2: Poverty headcount, Albania, 2002–12, percent



Source: World Bank analysis on LSMS data.

Note: Poverty line = lek 6,407.21 per month at 2012 prices.

Figure 3: Consumption growth rate, Albania, 2005–12, percent



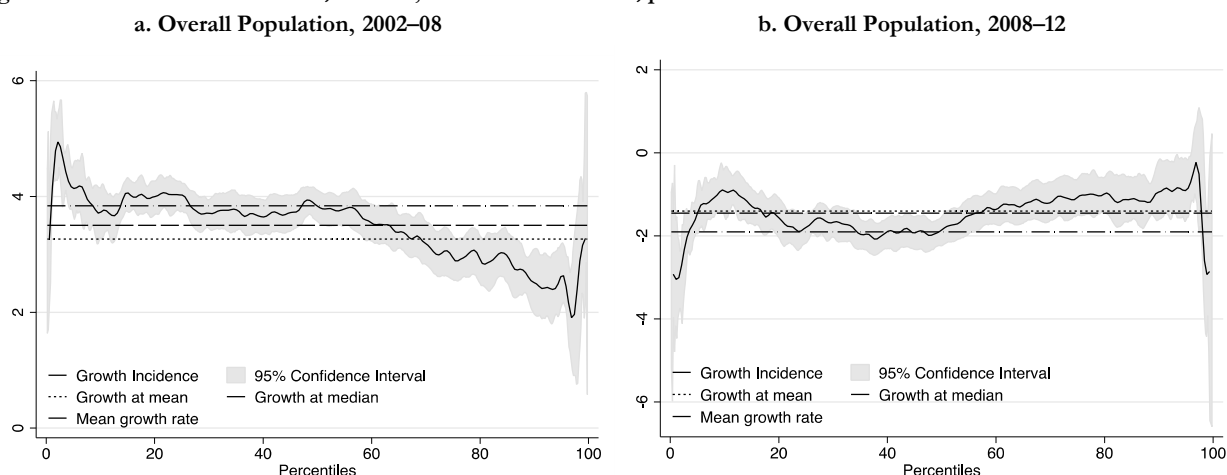
Source: World Bank analysis on LSMS data.

Note: Poverty line = lek 6,407.21 per month at 2012 prices.

With the decelerating pace of economic growth post-2008, poverty rose, and income convergence with the EU stalled. Albania's growth averaged less than 3 percent per annum in real terms between 2009 and 2012. Growth slowed further in 2013 and 2014 to an average 1.7 percent per annum. Poverty reached 14.3 percent by 2012 and particularly affected urban areas. Consumption growth among the bottom 40 and among the overall population also fell between 2008 and 2012, by 1.2 and 1.3 percent, respectively. At the end of 2014, Albania's income per capita was roughly a third of the average EU income per capita, making Albania the fourth poorest country in Europe, with 7 percent of the population living below the \$2.50-a-day poverty line.²

² World Bank, ECATSD calculations using ECAPOV data. Poverty measured using consumption at the \$2.50-a-day poverty line, circa 2012. Despite the slowdown in the economy, inequality measured by the Gini index remained broadly unchanged. The Gini index was 26.9 in 2012, compared with 28.2 in 2008.

Figure 4: Growth incidence curves, Albania, 2002–08 and 2008–12, percent



Source: World Bank calculations based on LSMS data.

Given the historically strong link between economic growth and poverty reduction, going forward, Albania needs to find ways to *(re)accelerate growth* to increase prosperity. A shift in the growth trajectory of the economy is required to achieve Albania's aspirations for a European standard of living. Assuming that average growth rates among the EU countries reach historical levels (that is, the EU at 1 percent and the new EU member states [EU11] at 3.5 percent annually), a growth path maintaining the current average annual growth rate of 2 percent would mean that Albania's convergence with the EU average income levels would occur several generations in the future (Figure 5).³ However, returning to a scenario of an average growth of 6 percent a year would boost income per capita significantly and allow the country to reach the average EU income in 25 years (Figure 6). Convergence to the income of the EU11 could become a reality in only 10 years.

While growth acceleration is necessary to lift people out of poverty in Albania, income growth will need to reach all segments of the population—that is, *make growth equitable*—to ensure durable gains in boosting shared prosperity, the twin goals of the World Bank. These goals are measured along two dimensions, namely, (1) the rate of extreme poverty and (2) the pace of income growth among the bottom 40, both of which are relevant in Albania. These measures can contribute to guiding and monitoring the progress toward improvements in the standard of living by using the potential of the people, their endowments, and their institutions more effectively. These goals will need to be realized in a way that is environmentally, economically, and socially sustainable to ensure that the welfare of the population is not expanded at the expense of future generations or specific groups in society.

³ The EU11 are Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia.

Figure 5: Convergence Path Scenarios for Albania, Economic growth rates, percent

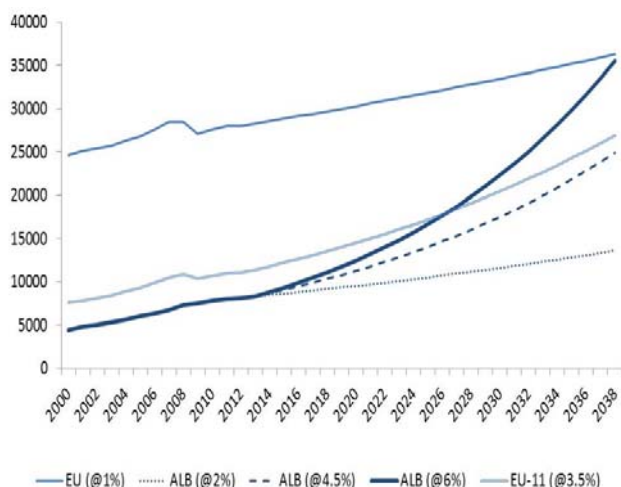
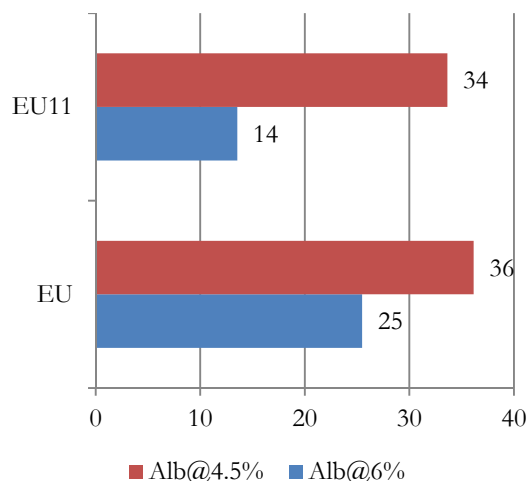


Figure 6: Years Required for convergence to EU and EU11 Average Incomes, Albania



Source: World Bank calculations.

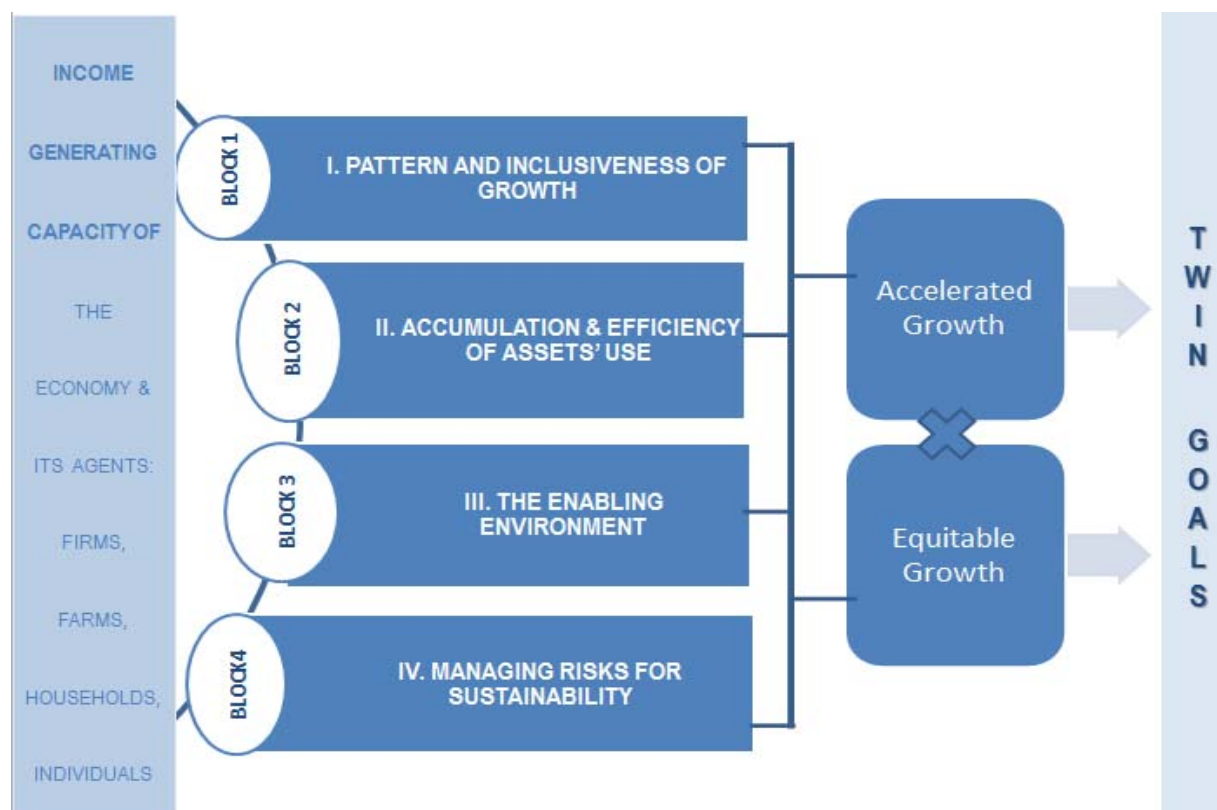
This systematic country diagnostic (SCD) addresses the question of *how* to accelerate equitable growth in a sustainable manner in Albania and, thus, make marked progress toward reducing poverty and promoting shared prosperity in the country. The report argues that Albania has the opportunity to revisit its economic strategy not only to accelerate and sustain growth, but also to increase employment opportunities and raise living standards, that is, ensure that growth remains equitable.

What are the opportunities for and the constraints to reigniting equitable growth in Albania? Does Albania have the enabling environment, the capacity to manage risks to sustainability, and the structural foundations needed to embark on a shift toward economic growth, poverty reduction, and shared prosperity? The SCD approaches these questions through the following structure (Figure 7):

- The next section outlines the **conceptual framework** of the report, which is centered on an assets-based approach to economic gains by households, firms, and the overall economy as a way to identify and tackle the constraints to income growth across the distribution.
- **Block 1** poses the question: is the economic model adequate to support income growth and poverty reduction? The SCD investigates the patterns of growth and its distribution to assess the adequacy of the economic model to deliver results on poverty reduction and shared prosperity. It applies a top-down approach to investigate the patterns of economic growth and its distribution.
- **Block 2** poses the question: does Albania have the needed endowments and assets to reignite growth in an equitable manner through their efficient and intensive use? The SCD applies a bottom-up approach to look at ways in which the current stock and accumulation of assets, the distribution and use of assets, and the returns to assets have hindered or led to economic gains across households and firms.

- **Block 3** poses the question: is the environment able to support equitable growth? The SCD focuses on the enabling environment required to promote the accumulation and use of assets and endowments in Albania, including the quality of the institutional and business environment, the delivery of public services, and the institutional mechanisms available to protect the poor.
- **Block 4** poses the question: are there risks to the sustainability of incomes of economic agents? The SCD identifies the risks threatening the sustainability of growth and inclusion. It looks at the macroeconomic, social, and environmental risks that may hinder the country's progress toward the twin goals.
- Based on a thorough diagnosis of the drivers of and constraints to recent growth and poverty reduction, the SCD derives the policy **priorities** for reigniting equitable growth in a sustainable manner with the aim of reducing poverty and boosting shared prosperity. The SCD is candid about the areas in which additional analytical work is needed.

Figure 7. The SCD Organizational Framework, Albania



CONCEPTUAL FRAMEWORK

The SCD's conceptual framework rests on the premise that, to advance the twin goals in Albania, the economy needs to accelerate the pace of growth, but also to make growth equitable. Economic growth directly contributes to achieving the twin goals by expanding the size of the pie. Without growth, progress in poverty reduction cannot last. The pattern and distribution of economic growth also matter in ensuring that growth is equitable. Effectively managing risks (macroeconomic, environmental, and social) ensures sustainability and guards against vulnerabilities and the erosion of living standards and incomes.

The framework of the SCD includes a top-down approach and a bottom-up approach to identify patterns in the capture of economic gains across households, firms, sectors, and the overall economy and, thus, the constraints to maximizing and sustaining the gains, including across the distribution. The framework relies on, but also expands on the assets-based approach to shared prosperity explicitly to include firms and the overall economy.⁴ Specifically, it looks at the capacity of the country to generate economic gains by promoting economic growth, jobs, and sustainability at the macro level (top-down) and the ways in which this capacity interacts with the productive capacity of households and firms (bottom-up)—that is, income at the household level and among firms—to benefit households and firms and contribute to the economic growth process.

The top-down analysis looks at the historical patterns of economic growth and evaluates the ability of the economy to deliver lasting gains in living standards. The issues relate to the drivers of growth, the distribution of the benefits of growth, and whether these are able to deliver lasting poverty reduction and shared prosperity.

The bottom-up analysis is centered on building the stock of assets and endowments that households and firms possess. The analysis assesses the extent to which these endowments and assets can be employed to bring sustainable gains in poverty reduction and shared prosperity. The endowments and assets include factors of production such as human capital, physical capital, financial assets, land, and natural resources. The accumulation and use of assets and endowments and the relevant returns are a function of interactions with institutions and markets. Efficiency of use is evaluated from the angle of markets and the institutional characteristics of markets that enable or restrain resource reallocation. Inclusiveness relates to the ability of households and firms to access, participate in, and benefit from economic growth. Along these dimensions and relative to the goal of generating growth for poverty reduction and shared prosperity, the economic gains and the distribution of these gains across households, firms, and sectors matter, as follows:

⁴ The asset based-approach is developed by Bussolo, Maurizio, and Luis-Felipe López-Calva (2014) *Shared Prosperity: Paving the Way in Europe and Central Asia*, Washington, DC: World Bank.

- The long-term productive capacity of **households** depends on the level and distribution of (1) the stock of assets and endowments owned by each individual and household, (2) the intensity of use of the assets to produce income, and (3) the prices of and returns to assets. Public and private transfers also boost household income. Understanding how these dimensions change across a population and over time allows a dynamic view of income generation and distribution to be captured.
- By enabling productive employment through the generation of jobs, **firms** play a central role in creating opportunities for inclusive growth. The economic contribution of firms is a function of the use of factors of production (assets and endowments) and the respective productivity (the returns). The prices of the products of firms are mainly determined by factor costs and the extent of competition and, as such, are directly affected by the institutional characteristics of product and factor markets.

Among households and firms, certain factors can enable or limit the capacity to accumulate, efficiently use, access, and benefit from assets and endowments. Social safety nets can have an impact on household incomes and provide critical protection from vulnerability and shocks, but can also impact the capacity of and incentives available to households to build up the stock of assets (for example, by providing disincentives to invest in human capital or participate in labor markets). Regulations that shape the environment in which firms do business may also add to price determinants through a direct effect on the competition enterprises face. The coverage and quality of public infrastructure and public services—such as health care, education, water, sanitation, and electricity—also play a crucial role in facilitating asset accumulation, use, and returns among households and firms and can enhance productivity and equality of opportunity.

The analytical framework focuses on sustainability by assessing the ability of economic agents to mitigate risks and increase the resilience to shocks. To ensure that economic gains are not either short-lived or achieved at the expense of future generations, the framework highlights the importance of addressing economic, environmental, and social risks. It also accounts for the time horizons of policy actions. For instance, the stock and distribution of household human capital (for example, educational attainment) cannot be altered in the short term. However, improvements in the business climate or access to public services are amenable to changes within a shorter time span, while delivering positive longer-term results. Thus, sustainability is treated as a cross-cutting theme affecting the ability of economic agents to guard against risks to their welfare.

Overall, the framework is used to set priorities for relieving the constraints to achieving lasting and inclusive growth. The constraints are identified through the core diagnosis of this SCD. Unlocking the constraints on reducing poverty and enhancing shared prosperity is the key determinant in formulating policy priorities with the greatest impact on equity and growth in Albania.

BLOCK 1: A TOP-DOWN LENS: HISTORICAL PATTERNS AND DRIVERS OF ECONOMIC GAINS

How can Albania strengthen the foundations of growth and increase employment opportunities, while ensuring that the benefits of growth accrue to all Albanians? This section investigates the patterns of economic growth in Albania over the past decade and a half and the beneficiaries of these gains. It assesses whether the current growth model is conducive to high and sustainable economic growth in the short and medium terms to generate lasting improvement in living standards, including among the bottom 40 and the poor. The section demonstrates that the global financial crisis of 2008 exposed four key vulnerabilities of the pre-2008 domestic demand-driven model: large fiscal and debt imbalances, financial sector weaknesses, external vulnerabilities, and erosion in poverty reduction. This indicates a pressing need for structural reforms to raise productivity and competitiveness in the economy, create more and better formal employment opportunities, and include the poor and the less well off in the growth process.

The Economic Model of the Past

Albania experienced extraordinary growth after the opening of the economy in the early 1990s, albeit from a very low base. The opening of the economy in the 1990s from the isolation of the communist era was accompanied by early liberalization reforms such as price and exchange rate liberalization, privatizations, and the introduction of market-based institutions. These first-generation structural reforms enabled the reallocation of production factors from stagnant areas to more productive areas, freed up investment, and boosted productivity in key sectors, including manufacturing and services in trade, transport, and communications. Between 1992 and 1996, the economy grew at more than 9 percent a year in real terms (**Figure 8**). Income per capita rose from \$2,075 to \$3,262.⁵ Inflation was in single digits (**Figure 9**). The country enjoyed substantial foreign inflows, at 24.3 percent of GDP, originating from government aid (official foreign transfers averaged 17.7 percent of GDP) and from remittances from the large number of Albanians living abroad.⁶

⁵ Values are in current international purchasing power parity U.S. dollars (IMF World Economic Outlook Database).

⁶ For detail, see IMF (International Monetary Fund). 1999. “Albania: Recent Economic Developments and Statistical Appendix.” IMF Staff Country Report 99/69, IMF, Washington, DC. By year 2000, the number of Albanians emigrating out of the country had risen to 24.0 percent of the population, from 3.6 percent in 1990.

Figure 8: GDP growth, percent, and current account deficit, percent of GDP, Albania, 1992–2008

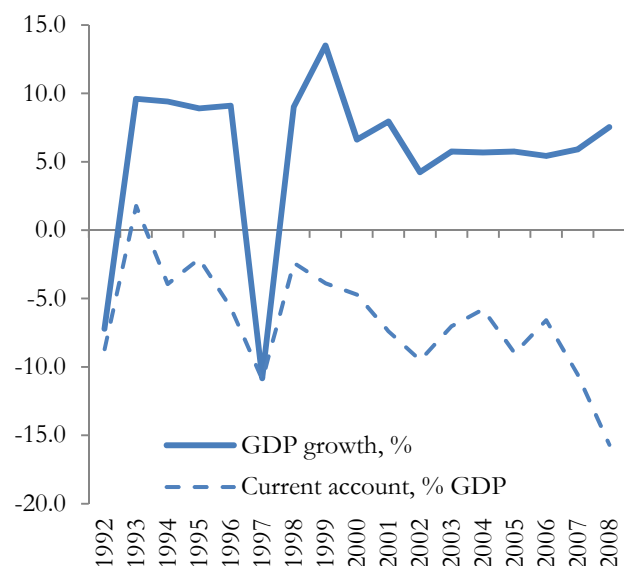
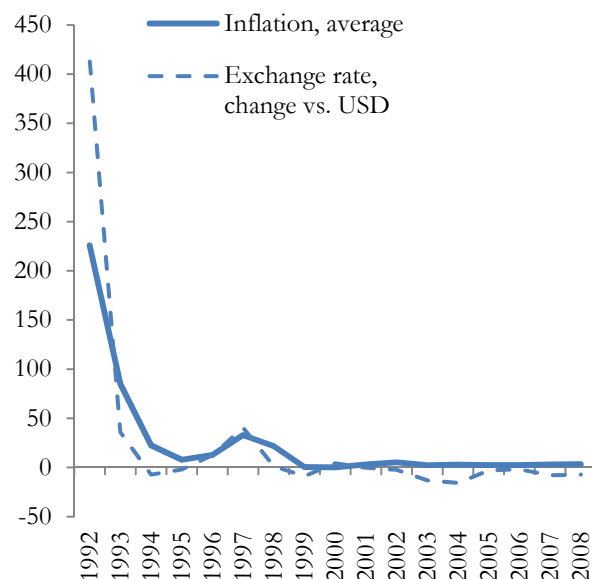


Figure 9: Inflation and exchange rate, Albania, 1992–2008, percent



Sources: IMF, Bank of Albania, Ministry of Finance, INSTAT.

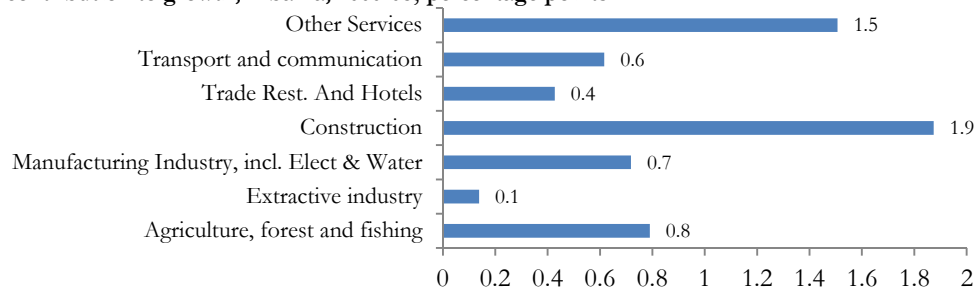
However, poor market regulatory mechanisms, the small size of the private banking sector, which was unable to satisfy the private sector’s demand for credit, and low economic literacy led to the emergence of usury markets (pyramid schemes) in 1997. The failure of the pyramid schemes generated sharp economic contraction in 1997 and bouts of civil disorder (Figure 8). It damaged the public trust in economic, social, and political institutions. The economy rebounded in 1998. The Kosovo crisis of 1999 triggered a large influx of Albanians from Kosovo (estimated at over 430,000 people), which also contributed to boosting growth on the back of the increased domestic demand among immigrants, particularly for transportation and services.⁷

The economy grew at an annual average of around 6 percent from 2000 until the onset of the 2008 financial crisis on the back of nontradables. The construction and services sectors were the drivers of economic and employment growth in 2000–08, contributing nearly three-quarters to output growth and 32 percent to employment growth (Figure 10). Construction and other services grew close to 14 and 10 percent in real terms, respectively, in 2000–08.⁸

⁷ See “Historical Overview: NATO’s Role in Relation to the Conflict in Kosovo,” North Atlantic Treaty Organization, Brussels, July 15, 1999, <http://www.nato.int/kosovo/history.htm>.

⁸ Trade in services is strong in Albania. Per capita service exports have been above the projections based on per capita income.

Figure 10: Sectoral contribution to growth, Albania, 2000-08, percentage points

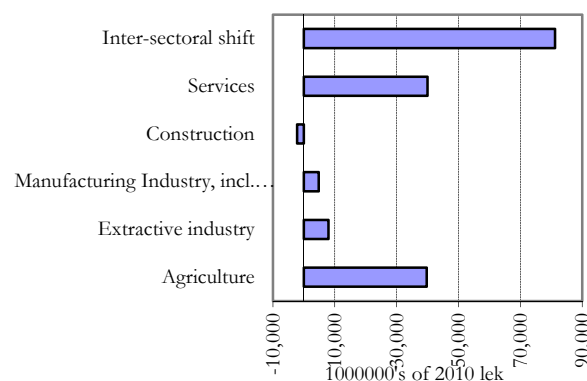


Sources: INSTAT; World Bank calculations.

The reallocation of labor from agriculture to rapidly growing sectors such as construction and services helped support growth by raising output per worker. Indeed, this intersectoral shift contributed close to 60 percent of real GDP growth in 2000–08 (Figure 11). In 2000–08, increases in output per worker stemmed primarily from the climb in the value of the physical capital available to workers.⁹ An economy-wide decomposition of per capita growth indicates that increases in capital stock accounted for over 85 percent of the rise in GDP per capita in 2000–08 (Figure 13). Investment originated primarily in the private sector, although public sector investment grew at a faster pace (13 percent annually) than private investment (10 percent annually).

Figure 11: Within-Sector and Intersectoral Shifts, Albania

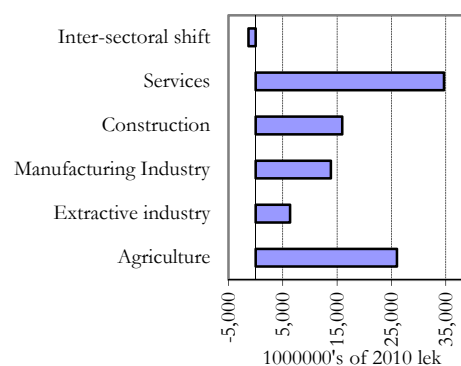
a. 2000–08



Sources: INSTAT; World Bank calculations.

Note: The bars represent the contribution of within-sector output per worker changes and intersectoral shifts to change in value added per capita.

b. 2009–13



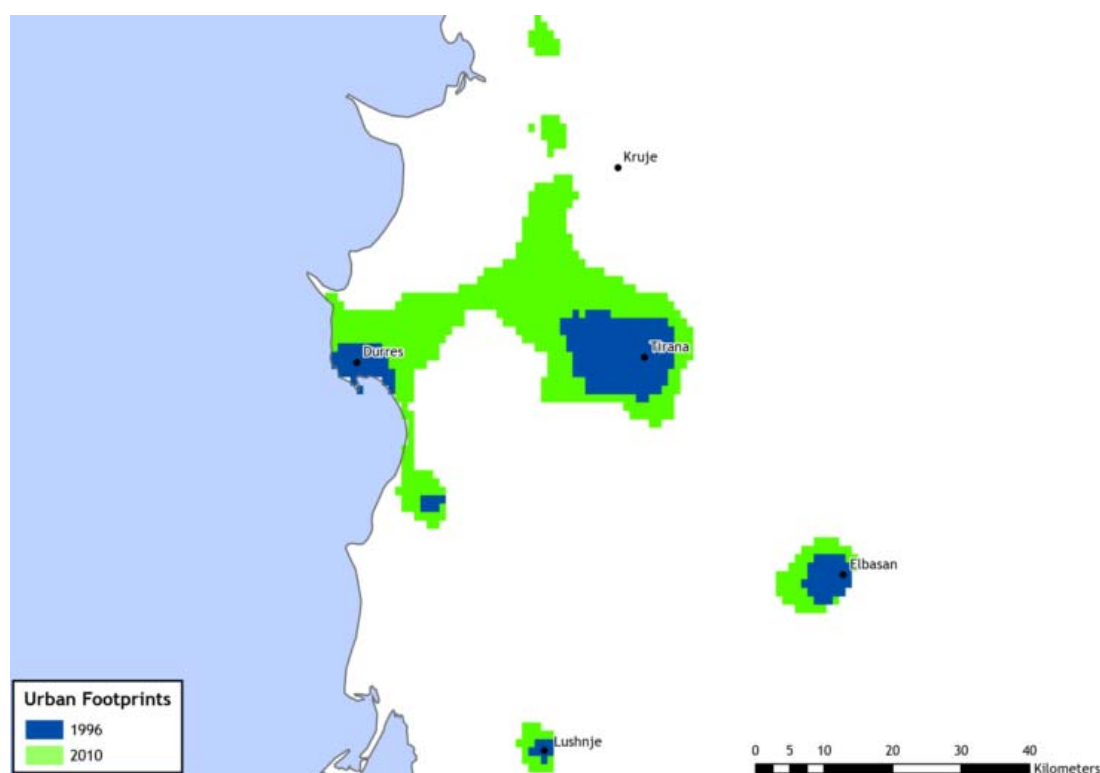
Sources: INSTAT; World Bank calculations.

Note: The bars represent the contribution of within-sector output per worker changes and intersectoral shifts to change in value added per capita

⁹ With a practically null contribution of total factor productivity to output per capita growth, these results are not at odds with the results produced when output per worker grew at 3.7 percent between 1996 and 2008. While total factor productivity is a residual of changes in output per capita from a hypothetical aggregate production function, this represents the scale contribution to output once all included factor inputs have been accounted for. The average productivity of labor picks up changes that have not been accounted for by variations in factor inputs other than employment.

Large internal migration of Albanians from rural to urban zones in the late 1990s and the first decade of the 2000s accompanied the sectoral shifts in labor (Figure 12). Employment in agriculture declined by 16 percent between 2000 and 2008.¹⁰ A part of the low-skilled labor from rural areas filled the labor market demand in the rapidly growing nontradable sectors. Employment in construction more than doubled (albeit from a low base), while employment in services rose by 10 percent.

Figure 12: Urban Footprint, Albania, 1996 and 2010



Source: World Bank (ITSQS).

Note: Urban footprints were derived from 1996 and 2010 nighttime lights data provided by the National Geophysical Data Center.

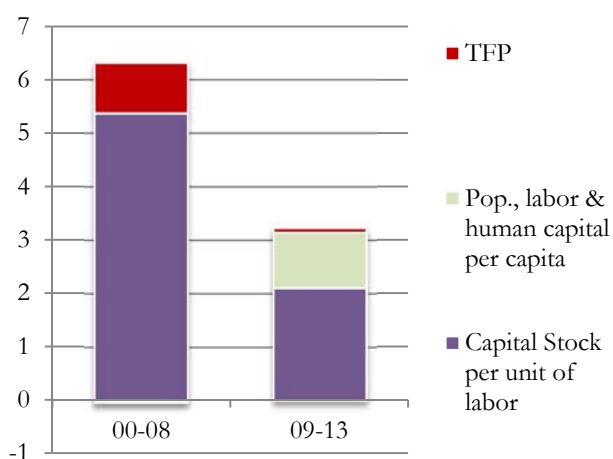
The intersectoral shift away from agriculture in the 2000s did not bring notable gains in aggregate productivity. In many countries, the sectoral shifts (from agriculture to manufacturing and services) and special shifts (from rural to urban areas) are associated with large productivity gains as resources shift from lower-productivity rural activities to more-productive urban-based sectors. Despite the massive reallocation of labor across space and sectors in Albania in the 1990s and 2000s, the actual gains in total factor productivity from

¹⁰ Analysis based on administrative data from INSTAT. Employment in agriculture as measured by INSTAT until 2013 included working-age individuals who owned land and engaged in production for their own consumption. The inclusion of subsistence farming as employment severely distorted the picture provided by labor market indicators. In 2013, the new Labor Force Survey methodology shifted the output focus from consumption to income generation, thereby reducing the likelihood of such distortions.

this process were small in 2000–08 (Figure 13). Indeed, aggregate total factor productivity increases stemmed from hikes in productivity in the agricultural sector, where sectoral output grew despite lower labor input, thereby offering a strong indication of the excess labor in agriculture prior to migration to urban areas.

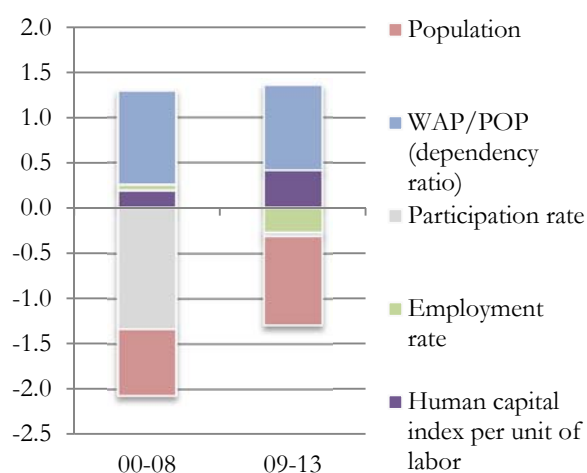
Employment growth contributed negligibly to GDP growth in the precrisis period. The strong expansion of the economy prior to the crisis was accompanied by a decline in labor force participation.¹¹ A large part of rural labor migrants went into inactivity and informality, and labor force participation fell from 73 percent in 2000 to 58 percent in 2008. In aggregate, despite the rapid expansion of output, formal employment actually dropped without creating incentives for labor productivity increases (Figure 14). The employment rate, as measured by the change in employment as a share of the working-age population, contributed less than 1 percent of the increase in GDP in 2000–08 (Figure 14). The unemployment rate fell from 18 to 13 percent, and wages went up. The decline in the labor force was thus unlikely to have been driven by a rise in the share of discouraged workers.

Figure 13: Decomposition of contributions to GDP per capita, Albania, 2000–08 and 2009–13, percentage points



Sources: INSTAT; World Bank calculations.

Figure 14: Decomposition of the human capital component to GDP per capita, Albania, 2000–08 and 2009–13, percentage points



Sources: INSTAT; World Bank calculations.

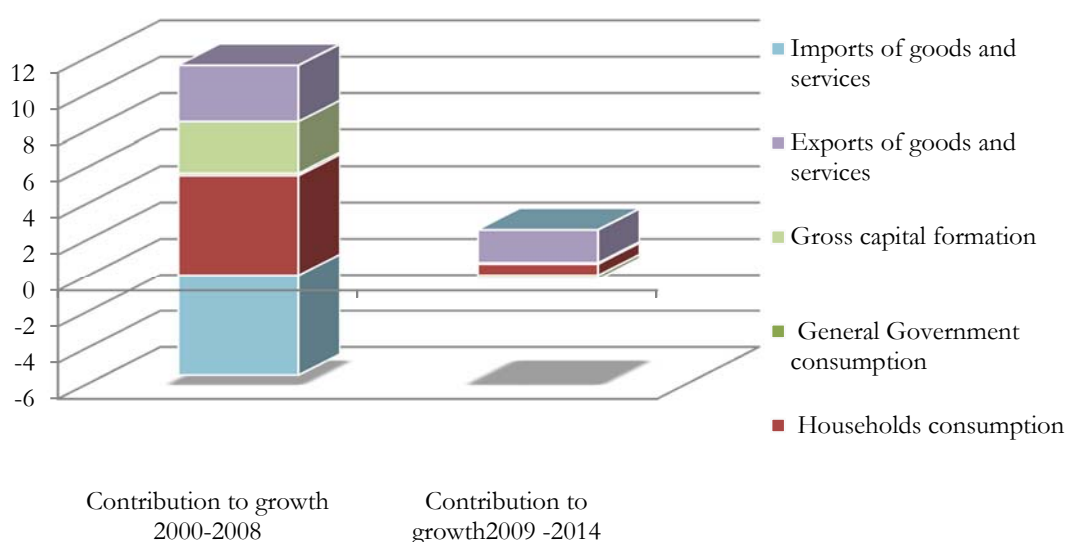
Note: The dependency ratio is defined as the share of the population under 15 and over 64 years of age in the population aged 15 to 64.

¹¹ These results are likely affected to some extent by data problems related to the shift of many Albanians to self-employment. They should be interpreted with caution. In addition, the size of the informal labor as well as outmigration flows is large in Albania, as discussed in Block 2.

From the expenditure side, strong domestic demand drove economic growth in the 2000s (Figure 15).

In 2000–08, total consumption (public and private) grew by an annual average of 6 percent and accounted for almost 64 percent of the growth in total aggregate demand. High import content of domestic consumption coupled with high rates of public investment led to not only a large trade deficit averaging 24.5 of GDP 2000–08, but also widening current account deficits in the same period. The rapid expansion of consumption was financed by (1) remittances, which, in the precrisis period, were consistently above the inflows of foreign direct investment (FDI) and official developmental assistance (ODA) as a share of GDP (Figure 16); and (2) domestic sources such as wages, other nonwage income, strong growth in credit as well as expanding fiscal deficit. Between 2000 and 2008, the average annual fiscal deficit stood at 5.2 percent of GDP; credit to the private sector grew an average of 180 percent a year, and foreign inflows averaged over 20 percent of GDP.

Figure 15: Demand contribution to growth before and after the global financial crisis, Albania, percentage points



Sources: INSTAT; World Bank calculations.

Sizable remittances and unrecorded flows from illicit activities not only fueled the growth in household consumption, but also put upward pressure on real wages in the formal sector. At their peak in 2008, remittances reached almost \$1.5 billion. Because around 40 percent of the population lives abroad (predominantly in Greece and Italy), Albania has been among the top remittance-receiving nations in the world. Along with the inflow of remittances, unrecorded income from informal activities also put upward pressure on wages.¹² Real wages grew rapidly (according to administrative data), at an annual average of close to 10 percent in 2000–08, thereby further boosting private consumption. Real wages in trade and construction, sectors fueled

¹² Michaletos estimates that up to 70–80 percent of the traffic in the heroin distributed in Europe is transported through Albania by Albanian groups. See Michaletos, I. (2010). Shape of the Albanian Organized Crime. Research Institute for European and American Studies http://ricas.gr/index.php?Itemid=42&id=332&option=com_content&task=view.

by remittances, rose at the most rapid pace prior to 2008 (Figure 17). Public sector salaries kept up with the increase in incomes in the rest of the economy, increasing by an average of 9 percent a year in 2001–08.¹³ Because around 19 percent of employment was in the public sector (2000–08 average, based on administrative sources), these wage increases translated into real income gains among a large part of the population.¹⁴

Figure 16: Remittances, FDI and ODA, Albania, percent of GDP

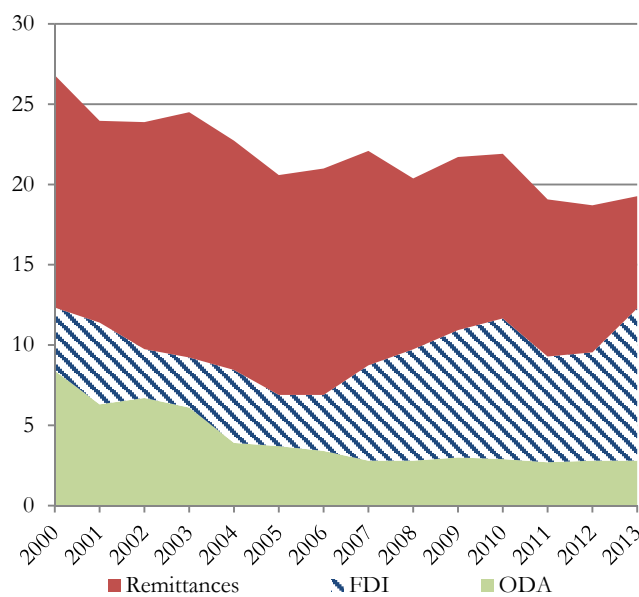
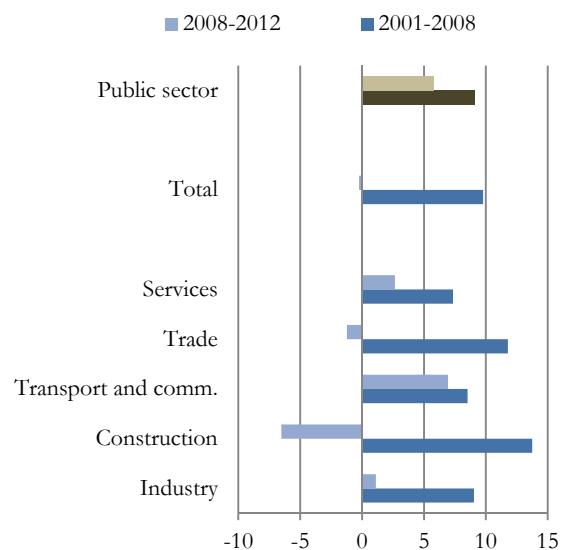


Figure 17: Real Wage Growth Rate, Albania, percent



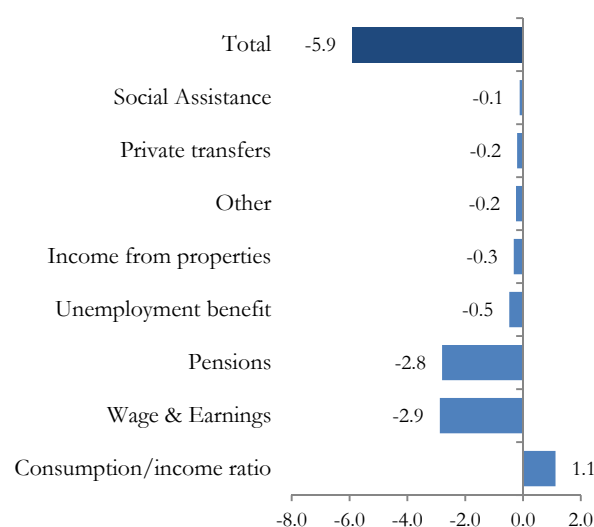
Source: INSTAT.

At the household level, strong domestic demand translated into real income gains. The rise in wages contributed to the reduction in poverty observed prior to the crisis. Of the 6 percentage point decline in poverty in 2005–08, household labor income was the main contributor, followed by pensions (Figure 18). Among the bottom 40, a large share of household income growth was explained by labor income growth (Figure 19). Other sources of income, such as remittances and social assistance benefits, contributed to household income growth, but with less impact on the poor.

¹³ While public sector salaries rose prior to 2008, they were still at a lower level compared with salaries elsewhere in Southeastern Europe, except Montenegro.

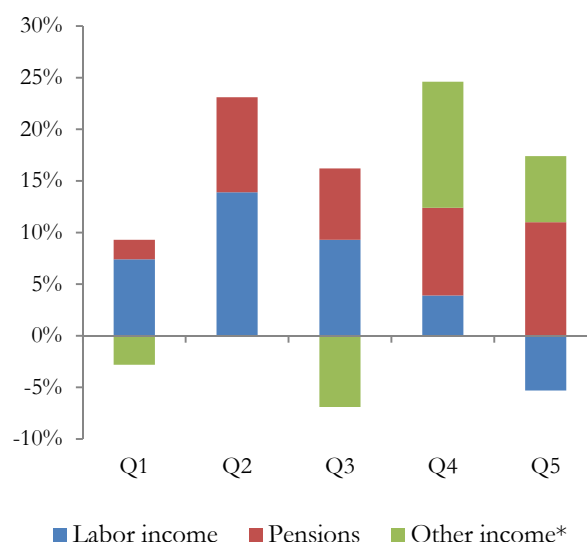
¹⁴ Labor Force Surveys, starting in 2007, indicate that public sector employment was at around 36 percent in 2011.

Figure 18: Contribution of household income sources to poverty reduction, Albania, percentage points



Source: World Bank calculations, using LSMS 2005 and 2008.

Figure 19: Household income growth by source of income and consumption quintile, Albania, percent

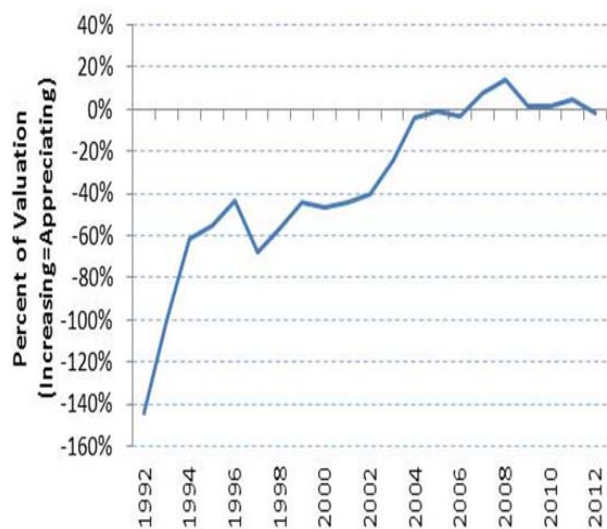


Source: World Bank calculations, using LSMS 2005 and 2008. Note: Other income includes social assistance, private transfers, unemployment benefits, income from properties, and other.

The pace of the increase in real wages was significantly higher than the pace of productivity gains, which, along with an appreciating Albanian lek, harmed competitiveness. Average real wages largely outgrew productivity (Figure 20). Real wages nearly doubled in 2000–08. Productivity remained essentially unchanged (Figure 21).¹⁵ Real wage growth in excess of productivity growth negatively affected competitiveness. Moreover, the real appreciation of the lek over 2000–08 only occurred at the expense of competitiveness (Figure 20).

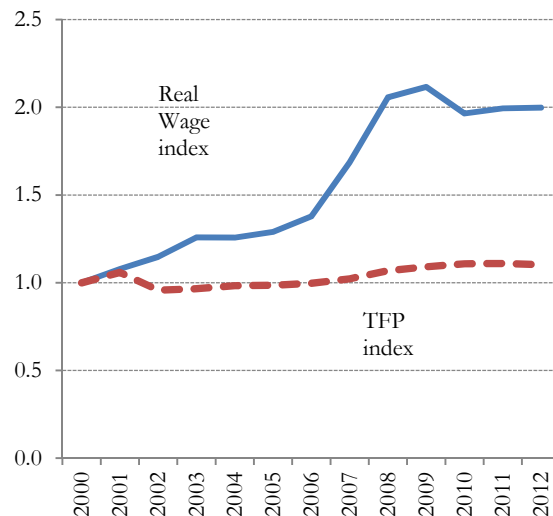
¹⁵ Real wages also rose faster than labor productivity, with the gap between the two due to higher capital share per unit of labor employed.

Figure 20: Real Effective Exchange Rate Valuation, Albania, 1992–2012, percent



Source: IMF.

Figure 21: Real Wage Growth and Productivity Growth Index, Albania, 2000–12



Source: World Bank calculations.

With no gains in productivity, rising wages, and appreciating currency, Albania lost competitiveness.

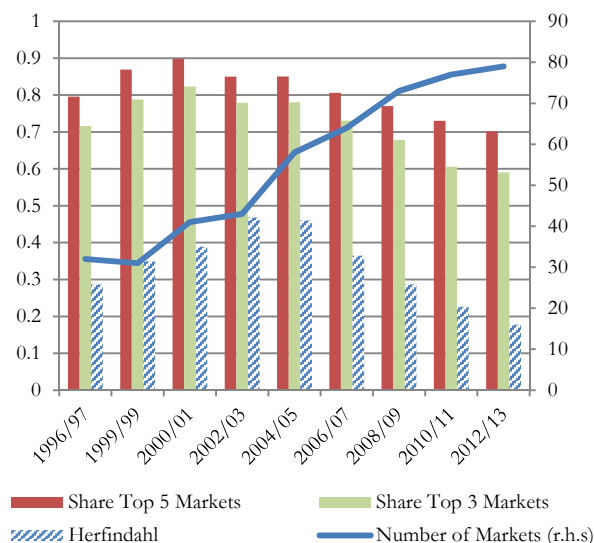
Net exports contributed negatively to growth because of the rapid consumption-induced growth in import demand, far exceeding the growth in exports (Figure 15). The underlying reasons for the persistent trade deficit reflect a combination of strong import demand due to unsustainably high growth rates as well as weaknesses in exports, indicating a lack of competitiveness.

Exports were highly concentrated in the first decade of the 2000s. Exports were dominated by footwear and textiles-clothing, which accounted for nearly half of exports prior to 2008, followed by minerals and metals, which accounted for another third of the export structure (Box 1). Exports of minerals, fuels, and electricity grew steadily throughout the period.¹⁶ But Albania's export basket remained relatively unsophisticated with respect to embedded human capital and was relatively capital intensive. Moreover, the destinations of export were highly concentrated relative to international standards (Figure 22). The share of the top 5 markets in total exports was over 80 percent; Italy was the key export destination (Figure 23). In 2000–08, the Herfindahl-Hirschman Index (HHI) was five times higher in Albania than in comparators (economies of a similar size or income per capita) such as Bulgaria or Hungary and more than double the HHI in Armenia, Jordan, the neighboring former Yugoslav Republic of Macedonia, and Moldova.¹⁷ Prior to 2008, export growth was driven by the same products to the same markets (see Box 1).

¹⁶ While exports of electricity grew in the 2000s, imports have been consistently higher than exports.

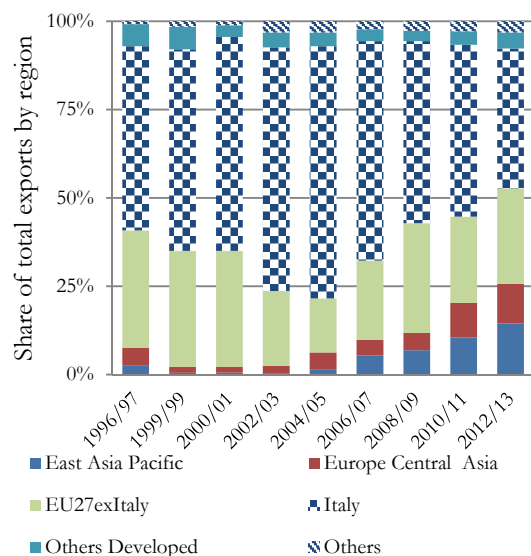
¹⁷ The HHI product (market) indicator is a measure of the dispersion of trade value across an exporter's products (exporter's partners). A country with a preponderance of trade value concentrated in a few products (few markets) will have an index value close

Figure 22: The Geographic Concentration of exports, Albania, two-year average



Source: World Bank calculations based on UN Comtrade (United Nations Commodity Trade Statistics Database), Statistics Division, Department of Economic and Social Affairs, United Nations, New York

Figure 23: Share of total exports, by region, Albania, two-year average



Source: World Bank calculations based on UN Comtrade (United Nations Commodity Trade Statistics Database), Statistics Division, Department of Economic and Social Affairs, United Nations, New York

The Economy post-2008

Despite the significant gains in income, by the time the global financial crisis hit in 2008, it was apparent that the domestic-demand-driven, foreign-financed model of growth was built on unstable ground. Flat productivity, declining competitiveness in external markets, and fiscal and financial sector imbalances reflected the prevalent weaknesses in the growth patterns of the economy. The global crisis only exacerbated these vulnerabilities as declining remittances and capital inflows were no longer able to support domestic demand.

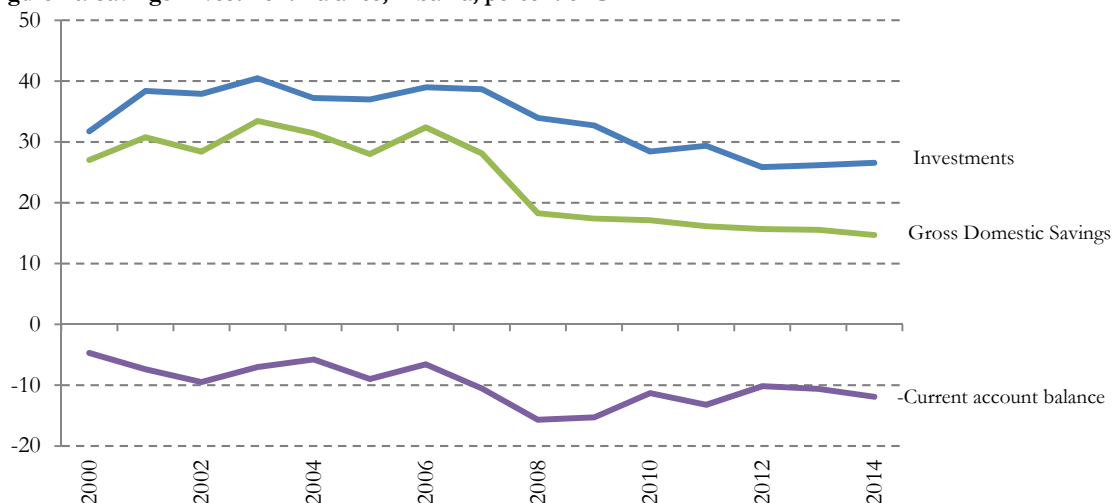
The eurozone crisis slammed the brakes on Albania's economic expansion: economic growth started to slow in 2009 and hit bottom in 2012–13. In 2009–12, GDP growth halved to less than 3 percent, declining to around 1.4 percent in 2013. Because of Albania's close links to the Greek and Italian economies, which were among the most affected in Europe, exports, remittances, and financial flows declined. Remittances declined from 10.3 percent of GDP in 2008 to 6.8 percent in 2013. FDI inflows, which, in 2000–08, accelerated at an annual average of 3.8 percent, slowed post-crisis to 1.7 percent per annum between 2009 and 2013.¹⁸ Current

to 1. Thus, it is an indicator of the exporter's vulnerability to trade shocks (the exporter's dependency on its trading partners and the danger it could face should its partners increase trade barriers). Measured over time, a fall in the index may be an indication of diversification in the exporter's trade profile (trading partnerships).

¹⁸ Albania has one of the lowest stocks of FDI in Europe relative to the size of the economy. At the end of 2013, the FDI stock per capita was five times smaller than the average in the EU11.

investment ratios remained much higher than gross national savings; the latter represented slightly more than 15 percent of GDP in 2012 and is on a declining trend, given the observed fall in the inflow of remittances (Figure 24). The excess of investment over savings has determined the size of the negative current account balance, which—at double digits over the last decade—is evidence of external vulnerabilities (Figure 24). While FDI continued to finance most of the current account deficit, external debt increased since 2009, albeit remaining at a manageable 36.7 percent of GDP in 2014.

Figure 24: Savings-Investment Balance, Albania, percent of GDP



Sources: Bank of Albania and ISTAT

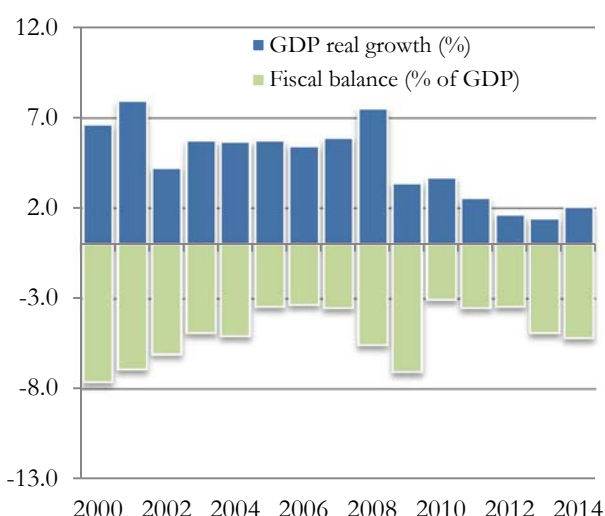
Albania was able to avoid recession post-2008 largely because of loose fiscal policy. As economic growth slowed after 2008, fiscal deficits and public debt increased (Figure 25 and Figure 26). The inability to boost fiscal revenues because of low tax revenue collection and large tax evasion on the one side and the structural burdens on public expenditures on the other side led to an increase in the fiscal deficit. Loose fiscal policy, combined with a depreciation of the lek, brought public debt levels up to about 60 percent of GDP in 2011, the legal limit set in 2008. The energy shortage in 2012 and the need for government support for the power generation utility in the form of guarantees led the government to ask Parliament to remove the 60 percent debt ceiling from the organic budget law. In December 2012, the Parliament did this, but without proposing any other fiscal or debt anchor. The public and publically guaranteed debt kept rising, from 55.1 percent of GDP in 2008 to 70.0 percent in 2014.

Lax fiscal policy, combined with poor control over public financial management, eventually led to the government's inability to pay on its contracts with private businesses. Even as revenues were declining and public investment budgets were reduced in the wake of the 2008 crisis, many public works continued at the same pace as initially planned, and contractors continued to carry out public works, often by drawing on commercial loans. With fiscal space running out, this translated into a buildup of payment arrears for public

works and value added tax (VAT) refunds estimated at 5.2 percent of GDP in 2013. These arrears led to a liquidity crunch, which further deteriorated market activity and contributed to the rise in nonperforming loans (NPLs).

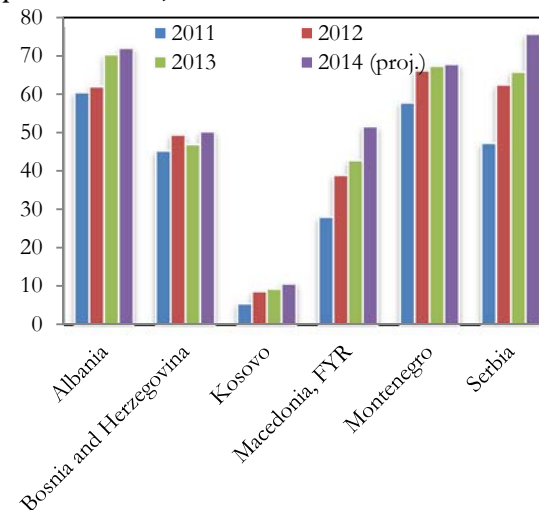
Substantial and growing public debt raised vulnerabilities because of the high interest costs, the rollover risks, and the potential for harm to growth prospects. Interest expenditures, at about 3.2 percent of GDP in 2013, crowded out more productive spending and represented a major source of vulnerability in the budget.¹⁹ Over 55 percent of domestic debt (almost 30 percent of GDP) needed to be rolled over within a year, exposing the government to changes in market conditions.

Figure 25: Fiscal Balance, percent of GDP, and Real GDP Growth, Albania, percent



Sources: Ministry of Finance; INSTAT.

Figure 26: Public and Publicly Guaranteed Debt, percent of GDP, Albania

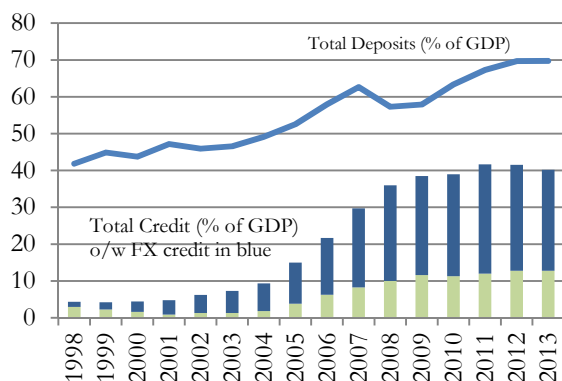


Sources: Ministry of Finance; INSTAT.

The financial sector reacted to the shock by reducing the supply of credit to the economy. Credit growth slowed significantly, thereby suppressing economic growth. Credit to the corporate sector decelerated on the back of large volatility of growth of key sectors such as constructions, trade, hotels and restaurants. Household credit reflected a large share of mortgages. (Figure 27 and Figure 28). Increased financial intermediation in the pre-crisis period, coupled by an easing of credit standards, and overexposure towards some sectors such as construction led to a buildup of vulnerabilities in the balance sheets of the commercial banks. As the crisis hit, problems of portfolio quality came to the fore and the NPL ratio climbed from 6.5 percent in 2008 to almost 25 percent in late-2014. The high level of NPLs also undermined the earnings of commercial banks and their ability to lend.

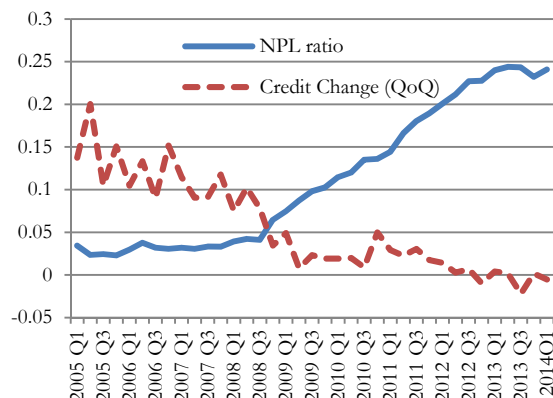
¹⁹ Interest expenditure as a share of GDP is higher in Albania than in other SEE6 countries.

Figure 27: Credit and Deposits, Albania, percent of GDP



Source: Bank of Albania

Figure 28: Pace of Credit Growth, percent, and NPLs, percent of total loans, Albania



The post-2008 slowdown and resulting contraction in domestic demand were accompanied by a rise in the relative contribution of exports to growth. The decline in imports contributed the most to the growth post-2008 as import demand, particularly from households, fell. Still, exports remained at 30 percent of GDP, significantly lower than in other middle-income countries, but their relative contribution to growth increased (Figure 29).

While exports drove the limited economic growth post-2008 (Figure 15), this was not a reflection of an improvement in Albania's external competitiveness, as revealed by the emerging patterns of exports:

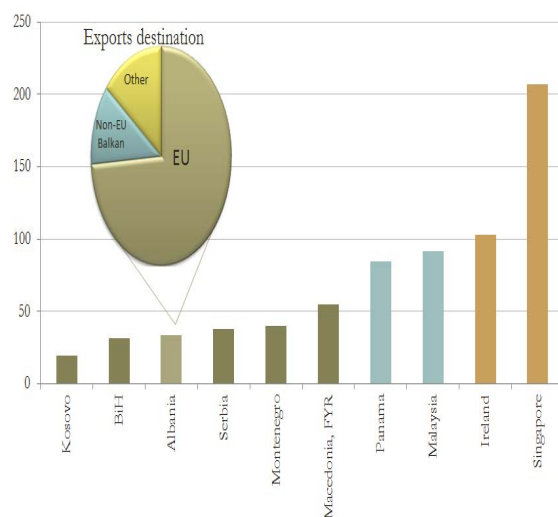
- **The export concentration in market destinations remained high by international standards.** In 2008–13, 77 percent of exports went to the EU countries hit hardest by the global crisis (on average, 54 percent of total exports went to Italy) (Figure 29). The EU economies are projected to remain vulnerable from lower growth in the medium term, limiting the expansion of exports from Albania to these markets.
- **The export concentration in products was not only high, but was also increasing.** Measured by the share of the top 3 or top 5 products or by the HHI, the concentration of export products expanded after the 2008 crisis (Figure 30).
- **Albania has a strong revealed comparative advantage in footwear, clothing-textiles, minerals (including crude oil), hides and skins (including leather), and metals, but these remain underutilized in exports (Box 1).** The export structure shifted from footwear and textiles prior to 2008 to minerals after 2008. At the more refined HS-4 level, crude oil and chromium ores and concentrates are now the top 2 exports, accounting for 34 percent and 8 percent of exports in 2013, respectively (table B1.1). The expanding role of crude oil in the export basket partly explains the increase in the export product concentration (see above). Exports of minerals and electricity also grew steadily throughout the 2000s.

- **Albania's comparative advantage is limited to exports of a few goods that are not connected to other products produced domestically.** The product space (Figure 31) assumes that a country can more easily export a new product if its factors of production are already used in the production of other goods.²⁰ Albania's export basket remains undeveloped in the core of the product space. It is mostly scattered in the periphery, especially compared with successful exporters such as Germany, where more-sophisticated products are located in a densely connected core. Moreover, Albania has been losing comparative advantage in traditional goods (Box 1). Only a limited number of new goods are emerging, few of which require production capabilities that could enable Albania to expand its export profile.
- **Albanian exports to the world continued to exhibit increasing physical capital content,** but little progress with respect to median wage, skill, or human capital content (Figure 32). As a result, the export basket is relatively unsophisticated with respect to embedded human capital.²¹ The share of skilled workers associated with the products that Albania exports did not vary significantly by destination market or over time in terms of labor sophistication, although exports to Eastern Europe and Central Asia seemed to embody a lower skill content and a higher level of physical capital. Albanian exports to the EU and the Russian Federation were characterized by relatively low wages and low value added per worker compared with exports to Eastern Europe and Central Asia.
- **Albania has underutilized its trade potential for exporting services.** Service exports have exhibited a striking pace of growth since 2000. Albeit from a low base, service exports have increased fivefold since 2000 (from \$447.8 million in 2000 to \$2,034.8 million in 2013). Growth in service exports can be mainly attributed to tourism-related and modern services (including financial service exports). However, the growth also dropped off (from 30 percent a year in 2002–07 to 5 percent a year in 2008–13).

²⁰ See Hausmann, Klinger, and Lawrence (2003). The authors measure the distance between two products as the conditional probability that an exporter with a revealed comparative advantage in product *x* also has a revealed comparative advantage in product *y*. Empirically, countries climb the product space by developing goods close to those they currently produce. It has been shown empirically that countries tend to diversify into export products close to those in which they are already specialized. It follows that countries specialized in products that are closer to each other and the production of which requires capabilities that are used for the production of other goods are able to upgrade their export basket more readily.

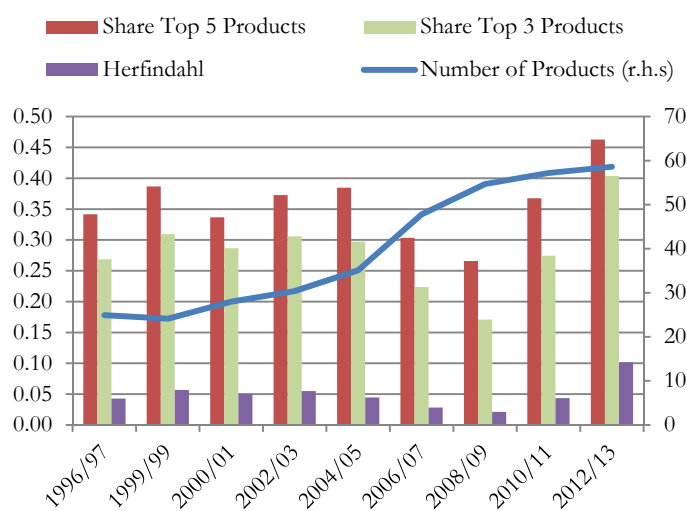
²¹ Export composition and destination markets matter, given that what and where a country exports affect the level and structure of labor demand in the exporting country. The structure of a country's exports—that is, the types of products it exports, in which sectors, and at what levels of value added—affects the types of labor needed to produce these exports. Export structure tends to vary according to the destination market. Exporting to high-income countries, where consumers have a relatively high preference for quality, stimulates the production of high-quality goods and increases the domestic demand for skilled labor (see Brambilla, I., Lederman, Guido Porto. 2012. "Exports, Export Destinations, and Skills." *American Economic Review* 102 (7): 3406–38). There is also empirical evidence that the types of products countries export matter for economic growth (see Hausmann, R., J. Hwang, and D. Rodrik. 2007. "What You Export Matters." *Journal of Economic Growth* 12 (1): 1–25; Verhoogen, E. A. 2008. "Trade, Quality Upgrading, and Wage Inequality in the Mexican Manufacturing Sector." *Quarterly Journal of Economics* 123 (2): 489–530). The latter author shows that more-productive plants produce and export higher-quality goods than less-productive plants and pay higher wages to maintain a higher-quality workforce.

Figure 29: Exports, Albania and other countries, 2013, percent of GDP



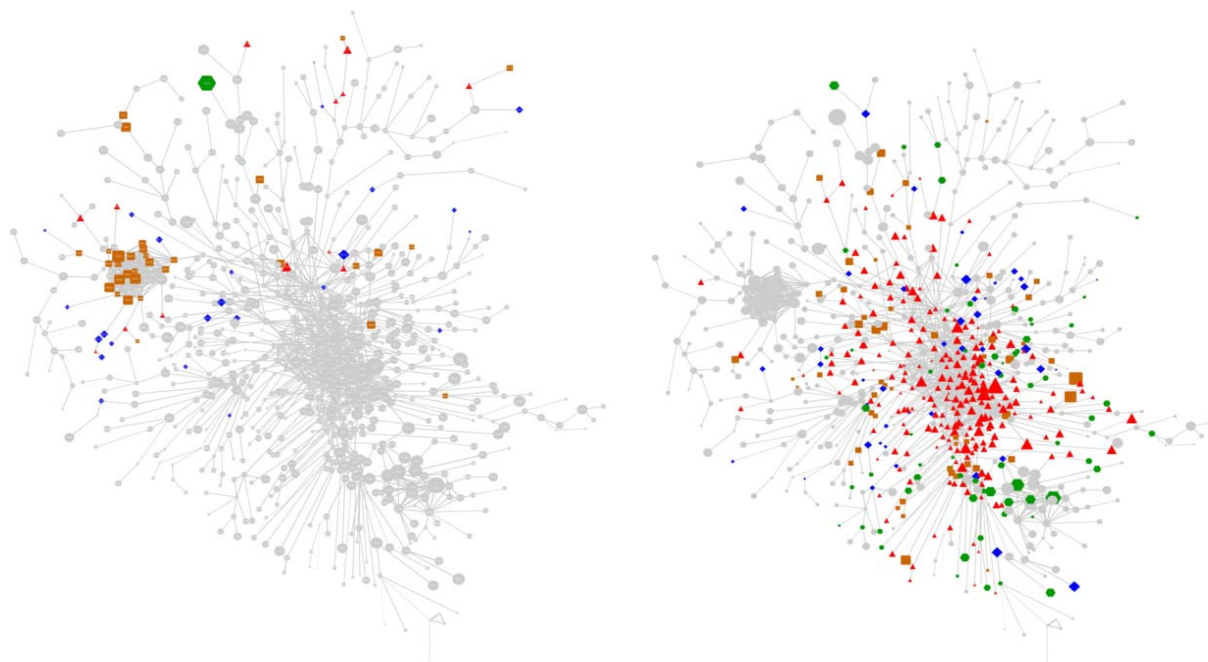
Source: World Bank calculations.

Figure 30: Product concentration, Albania



Source: World Bank calculations based on UN Comtrade (United Nations Commodity Trade Statistics Database), Statistics Division, Department of Economic and Social Affairs, United Nations, New York.

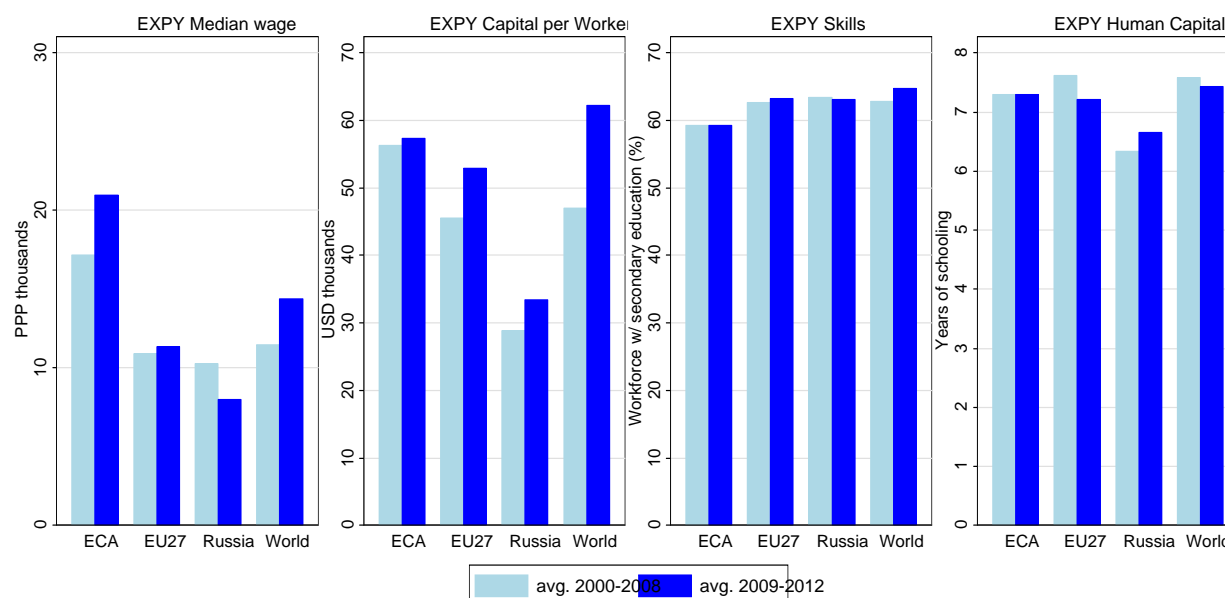
Figure 31: Revealed Comparative Advantage in the Product Space, Albania (top) and Germany (bottom)



Source: World Bank calculations.

Note: Red triangles denote classic products; blue diamonds denote emerging products; brown squares denote disappearing products; green hexagons denote marginal products.

Figure 32: Labor sophistication of the export basket by destination market and over time, Albania



Source: World Bank calculations based on UN Comtrade (United Nations Commodity Trade Statistics Database), Statistics Division, Department of Economic and Social Affairs, United Nations, New York, <http://comtrade.un.org/db/>.

Box 1. Albania's Exports

Albania's key export categories comprise raw materials or low-value added, labor-intensive products. Exports of minerals, fuels, and electricity have been growing steadily since 2005, emerging in 2012–13 as the largest category of exports. Exports of wood and paper products have also grown moderately. After a major expansion in the late 1990s and early 2000s, the growth of exports of textiles and footwear has been moderate post-2008.

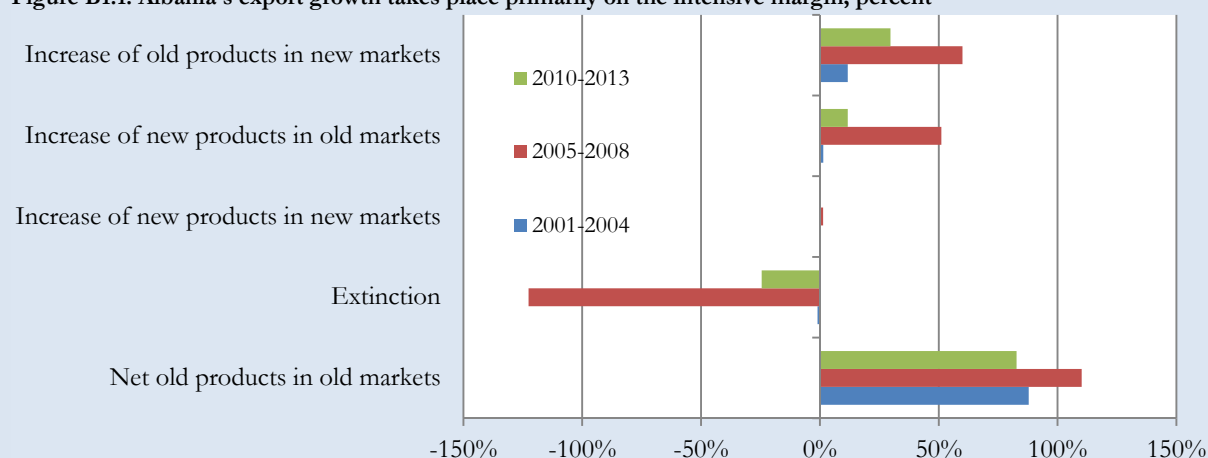
Albania can enhance its trade in goods and services. It has a strong revealed comparative advantage in footwear, clothing-textiles, minerals (including crude oil), hides and skins (including leather), metals, tourism, and modern services (communications). Exports of goods and services need to regain ground to exploit these advantages (table B1.1).

Export growth takes place primarily on the intensive margin, which means that growth was mostly driven by more exports of the same (old) products to the same (old) markets (figure B1.1). In the immediate precrisis period (2005–08), Albania's growth on the extensive margins was relatively high, including new products in old markets (for example, Italy), and old products in new markets. This suggests that Albania's established links with Italy and other EU markets could be an important strength of its exporting firms. Indeed, 60 percent and 40 percent of the exports of products to Italy, on average, survive for the first and second year, respectively, compared with an average survival rate of 42 percent and 24 percent for the first and second year, respectively, for exports to the EU. However, Albania's overall export relationships have a far lower survival rate than those of comparator countries. Only 42 percent of export flows remain active after the first year in Albania, and only 11 percent after four years. This compares with survival rates for Hungary—the peer country with the strongest survival performance—of 60 percent after year 1 and 29 percent after year 4. Albania's export survival rate is lower than that of any of its peers except Armenia and Jordan, suggesting that exporting firms have difficulty expanding their product lines, or entering into new markets, or both.

Table B1.1: The Albanian export basket

Type	Exports 2007	Share 2007	RCA 2007	Exports 2013	Share 2013	RCA 2013	CAGR 2007-2013
Animal	\$ 8,579	0.8%	0.51	\$ 18,746	0.9%	0.76	14%
Chemicals	\$ 7,249	0.7%	0.09	\$ 14,824	0.7%	0.16	13%
Foodstuffs	\$ 25,730	2.5%	1.13	\$ 46,761	2.3%	0.71	10%
Footwear	\$ 224,583	21.7%	28.39	\$ 247,679	12.2%	14.85	2%
Hides, Skins	\$ 23,845	2.3%	4.07	\$ 28,834	1.4%	2.27	3%
Mach/Elec	\$ 42,294	4.1%	0.2	\$ 58,398	2.9%	0.16	6%
Metals	\$ 130,324	12.6%	1.59	\$ 166,614	8.2%	1.7	4%
Minerals	\$ 210,457	20.3%	1.05	\$ 976,179	47.9%	1.98	29%
Miscellaneous	\$ 21,511	2.1%	0.42	\$ 22,664	1.1%	0.25	1%
Plastic	\$ 8,489	0.8%	0.21	\$ 12,675	0.6%	0.15	7%
Stone/Glass	\$ 10,802	1.0%	0.35	\$ 11,571	0.6%	0.18	1%
Textiles Clothing	\$ 251,590	24.3%	5.37	\$ 319,474	15.7%	4	4%
Transportation	\$ 6,564	0.6%	0.08	\$ 13,037	0.6%	0.1	12%
Vegetable	\$ 27,879	2.7%	1.07	\$ 55,421	2.7%	0.85	12%
Wood	\$ 35,620	3.4%	1.14	\$ 45,339	2.2%	1.02	4%

Figure B1.1: Albania's export growth takes place primarily on the intensive margin, percent



Source: World Bank calculations based on UN Comtrade (United Nations Commodity Trade Statistics Database), Statistics Division, Department of Economic and Social Affairs, United Nations, New York, <http://comtrade.un.org/db/>.

Albania's current export structure and characteristics suggest the country could exploit notable advantages in expanding exports. A review of selected export categories reveals specific sectoral constraints to exports as follows:

- **Agribusiness.** Agri-food value chain integration and market participation are still limited, but present significant income and job generation potential. Despite Albania's favorable climate and geographical position, agricultural exports make up only around 5.4 percent of total exports (Q1 2014), the lowest in the region. Albania has a large negative trade balance in agricultural products (the value of imports is more than five times the value of exports). At the end of 2013, of the active 1,690 food enterprises, the majority were registered natural persons (78 percent) relying entirely on domestic capital (97 percent). Collectively, the industry provides jobs to only some 12,000 people.

The main challenge of the sector is low competitiveness. The fragmented and subsistence-oriented supply base, legislative gaps, and poor enforcement of food safety standards, infrastructure deficiencies (power outages, poor transport networks, and so on), and the current business environment (to include high levels of informality) are all factors that have limited a much greater development of the food industry. As a result, Albania has not yet succeeded in taking advantage of both domestic and external (subregional and EU) market opportunities.

- **Apparel and footwear.** Albania has a small textile and shoe industry that relies on low-labor cost assembly operations and competes with lower-cost Asian producers who are also becoming more productive. Upgrading to higher-value added exports (that is, moving up the production chain to full product and branding) would allow Albania to maintain a niche in this sector for relatively small-scale, high-quality, and quick-turnaround production (especially for the well-established Italian market).
- **Mining.** Given Albania's endowments in mineral resources, a balanced development of the mining sector by attracting foreign investors could contribute significantly to increasing exports. However, the governance framework needs to be strengthened to reinforce a competitive, transparent, stable, nondiscretionary regulatory regime that also accounts for environmental risk and sustainability.
- **Tourism and tourism-related services** are key channels through which Albania can achieve sustainable long-term growth while safeguarding the environment. For Albania to improve tourism offerings and penetrate international markets, it must stimulate more foreign interest and investment (which will require substantial improvements in the investment climate and the provision of public services such as access to good-quality infrastructure, an adequate water supply, better sanitation, adequate waste treatment services, and good land management practices) and, by doing so, increase its integration in the global tourism market. Growing the tourism sector will likely require a shift away from traditional and regional markets toward the EU and other high-income countries.

With the slowdown of the economy post-2008, the demand for labor declined across the board.

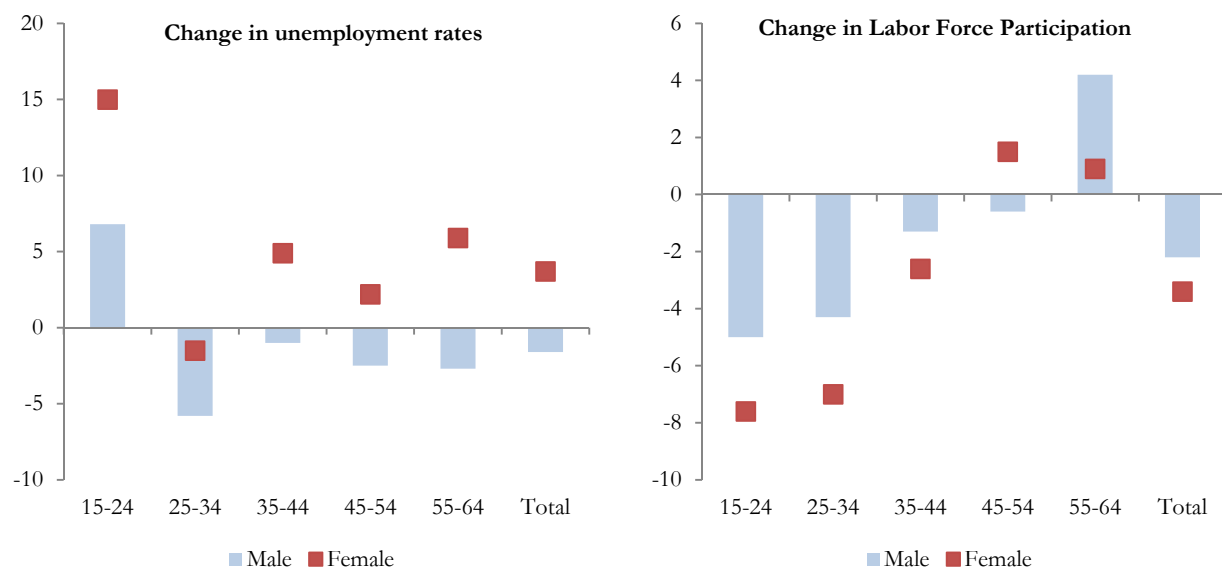
Construction and services suffered, including service exports, which had been the engines of employment growth prior to the global financial crisis. Employment declined across all sectors, leading to contraction in household incomes. In 2009–13, employment and labor participation rates fell, reaching 44.5 and 52.7 percent, respectively; real private sector wages plummeted, especially in construction (see **Figure 17**). There were no gains in total factor productivity post-2008. However, output per worker grew, primarily thanks to increasing capital spending under a loose fiscal policy and, to a small extent, improving dependency ratios and human capital increases.²²

The global economic crisis weakened labor markets. The number of employed people declined by around 123,000 in just one year (2008–09), and the employment rate fell from 56.4 to 53.4 percent in 2007–10. The slowdown affected youth and women in particular. There was a 5 percentage point reduction in female

²² Albania experienced the last stages of a demographic transition in the 2000s that allowed for a more rapid rise in the working-age population relative to the total population. In turn, the population had higher human capital content as proxied by the average education among adults.

employment and an 8.4 percentage point fall in youth employment. The decline was 10.5 percentage point among women aged 15–24 years (Figure 33).

Figure 33: Change in unemployment rates and labor force participation, by age and gender, Albania, 2007–10, percentage points

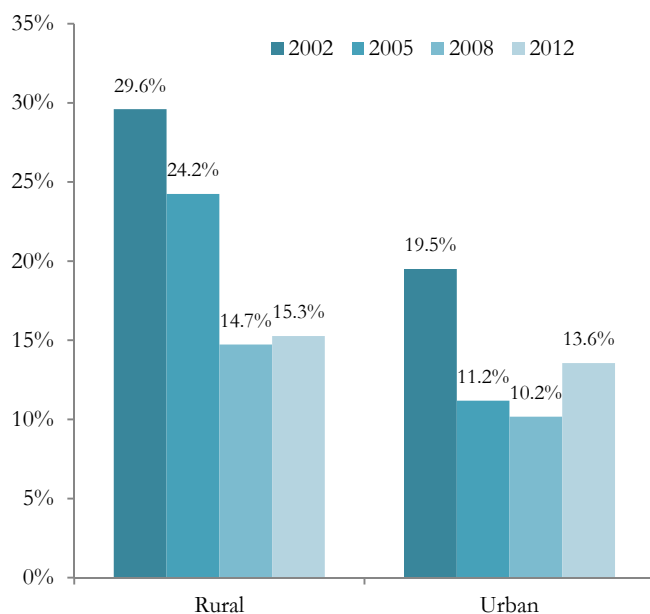


Source: World Bank calculations using Labor Force Surveys.

With the decelerating pace of economic growth post-2008, accompanied by a contraction of the demand for labor, poverty increased. Following a decrease in poverty of 13 percentage points (from 25.4 percent in 2002 to 12.5 percent in 2008), poverty levels rose in 2008–12 (Figure 2). Poverty increased from 10.2 to 13.6 percent in urban areas in 2008–12 (Figure 34), driven primarily by a shock to the labor market and, in particular, the contraction of labor-intensive sectors such as construction. A disaggregation of prefectures by rural and urban residence highlights sharp inequalities in welfare across the country: urban poverty ranged from 5.6 percent in Kukes to 17.5 percent in Lezhe; rural poverty ranged from 9.7 percent in Elbasan to 29.5 percent in Kukes (Figure 35).²³

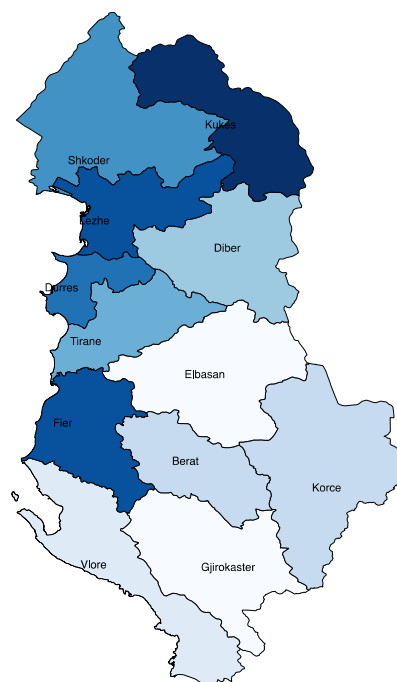
²³ Poverty maps drawn up using the 2011 census and the 2012 Living Standards Measurement Study (LSMS) allow the disaggregation of poverty and welfare across municipalities.

Figure 34: Poverty headcount, urban and rural areas, Albania, percent, 2002–12



Source: World Bank analysis based on LSMS data.
Note: Poverty line = lek 6,407.21 per month at 2012 prices.

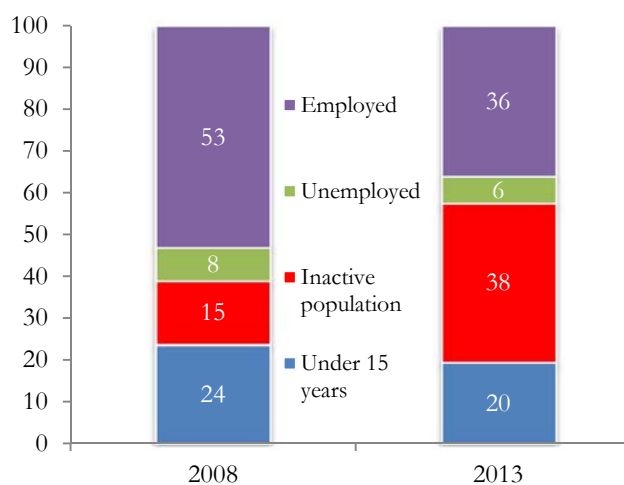
Figure 35: Incidence of poverty, by prefecture, Albania, 2012



Source: World Bank analysis of LSMS 2012 data.
Note: Lower poverty = lighter blue; higher poverty = darker blue.

Post-2008, unemployment and economic inactivity were also associated with lower socioeconomic status. Not only did inactivity rates double post-2008, but poverty rates were also significantly higher among the inactive. From 15 percent in 2008, inactivity rates were 38 percent in 2013 (**Figure 36**). Individuals living in households in which the heads were active (either employed or self-employed) or retired were less likely to be poor than individuals living in households in which the heads were unemployed or inactive. Among households in the bottom 40, for instance, 20 percent of working-age members were in unemployment, and 24 percent were out of the labor force, compared with 13 percent and 15 percent, respectively, in the top 60 percent of the income distribution (the top 60). In 2012, the incidence of poverty was 11 percent among households headed by employed persons, 13 percent among households headed by retired persons, 22 percent among households headed by unemployed persons, and 24 percent among households headed by inactive persons. The profile of the less well off thus shows a higher share of household heads in unemployment and inactivity among the bottom 20 and bottom 40 (**Figure 37**).

Figure 36: Population structure by labor status, percent, Albania, 2008 and 2013



Source: INSTAT

Figure 37: Labor force status, household heads, Albania, 2012



Source: World Bank analysis based on LSMS 2012 data

Emerging issues

Persistent loss of competitiveness, lack of productivity gains, and increases in poverty reflect the inadequacy of the economic growth model to deliver sustainable gains in income. Albania's inability to recover fully from the external shock of 2008 exposed the limitation of the domestic-driven growth model that depended on foreign flows to finance consumption, investment, and growth. This led to a deepening of macroeconomic imbalances post-2008, a marked slowdown of economic growth, and a rise in poverty. If unaddressed, these macroeconomic imbalances will continue to exert downward pressure on the economic gains of households and discourage the accumulation and productive use of factors of production. For example, the accumulation of arrears has contributed to the buildup of NPLs, which, in turn, has limited the ability of productive firms to raise financing. High public debt constrains the government's ability to open sufficient fiscal space to strengthen social programs for the poor and, if unaddressed, could lead to a crowding out of productive government spending.

Reducing macro-fiscal and financial sector vulnerabilities is a prerequisite for accelerating growth.

Albania suffers currently from macroeconomic imbalances related to high public debt, high structural-fiscal deficits, public sector arrears, and a chronically high volume of NPLs in the financial sector that constrains credit to the private sector. A competitive and inclusive economic model will require restoring and sustaining macroeconomic stability to boost the confidence of investors with respect to the predictability of the economic environment and, ultimately, support growth and protect incomes. Growth-friendly fiscal consolidation, supported by improvements in public financial and debt management, is key to fiscal sustainability to ensure

that current fiscal policies are not implemented at the expense of future generations. Guarding financial sector stability by reducing NPLs, reviving credit growth, and strengthening bank and nonbank prudential authorities is essential for spurring growth and protecting the income of economic agents.

Restoring and maintaining the credibility of the government's macro-fiscal framework is a high-order necessity for propelling growth and prosperity. In the short term, exogenous factors such as the recovery of the European economy will support better economic outcomes. However, the prospects for recovery in Europe are subdued. Even if external demand fully recovers to precrisis levels, the Albanian economy can be expected to grow at no more than 3 percent annually in the absence of reform. Such a growth rate is likely to lead only to moderate and diminishing gains in poverty reduction (all else being equal). Therefore, the path of successful convergence to EU incomes requires a structural shift toward increased productivity among Albanian firms, a boost in the external competitiveness of the economy, and inclusion in the growth process within an environment of macroeconomic stability. This type of quality growth is likely to generate long-term economic and employment gains.

BLOCK 2: A BOTTOM-UP LENS: HOUSEHOLD AND FIRM ENDOWMENTS FOR GENERATING ECONOMIC GAINS

Do households and firms have the endowments base to contribute to and benefit from the new economic growth model? The capacity to generate economic gains from markets depends on the endowments and assets economic agents possess and their distribution, their efficiency and intensity of use, and the returns economic agents receive from them. This section explores the stock and distribution of endowments and the use of endowments in terms of human capital (demographics, health and education, and use in the labor market), land and natural resources, and physical capital and financial assets. The efficient use of these endowments is essential to the effort to boost growth, reduce poverty, and promote shared prosperity. The section also explores the functioning of labor markets, given their importance in the generation of income among economic agents.

The main finding is that Albania is endowed and has accumulated a wealth of assets in many areas, but the use of these endowments and assets has not been efficient. Overall, Albania has the endowment base to reap large economic benefits, although critical deficiencies exist in education and skills. The country has not used its endowments efficiently to maximize economic gains in markets and engender sustained poverty reduction and shared prosperity. By excluding parts of the population from the accumulation and use of assets, it is forgoing an opportunity to realize growth potential.

Human Capital and Labor Markets²⁴

Workers need to be prepared to contribute to and benefit from the growth process. They need to have the skills, the incentives, and the opportunities required to participate in and respond to labor markets. Because labor is the main source of income in most households, improving the quality of labor market engagement among households can have a significant impact on living standards.

However, there are challenges in accumulating and making better use of human capital endowments, particularly in improving employment opportunities. Labor market engagement is deteriorating, especially in the quality of employment, among some population groups such as youth, women and minorities.

²⁴ There are several challenges to including more extensive labor market analysis. First, Labor Force Survey microdata are available for 2007–11, but have been collected up to 2013. Before 2007, only administrative data on labor markets exist. Moreover, comparability issues arise in terms of analyzing trends from 2011 onward. This analysis therefore discusses trends in 2007–10 and provides additional in-depth exercises with the 2011 data only. For more recent labor market outcomes, it relies on published INSTAT data for 2013. Second, other in-depth analytical work is limited, partly because of the lack of engagement by the World Bank in this area.

Employment rates are low. Although employment rates are higher than in neighboring countries, only half the working-age population had jobs in 2013.²⁵ Unemployment stood at 16.1 percent in 2013, and only 60 percent of the working-age population was active in that year. Overall, youth and women are systematically more disengaged from labor market activity (**Figure 38**); joblessness is staggeringly high among young women. Among youth 15 to 29 years of age, only 29 percent were employed in 2013, and, among women 15 to 29 years of age, the share was only 23 percent.²⁶ The lower employment rates among youth and women are partly driven by higher unemployment among youth (29 percent in 2013) and lower activity rates, particularly among young women (30 percent). Overall, there is a 20 percentage point gender gap in labor force participation rates.

A large share of young women are not in employment, education, or training (NEET). Overall, the share of NEETs reaches 18 percent among young people in the 20–24 age-group (**Figure 39**), comparable with the rate in the EU.²⁷ A closer look reveals that almost one in four women in the age-group is NEET, around twice as high as the rate among young men in the age-group. The rate peaks at 29 percent among the 30–34 age-group. Similarly, around 29 percent of youth 20–24 years of age who have a primary-school education are NEETs.

Figure 38: Employment rates across age and gender groups, percent, 2011

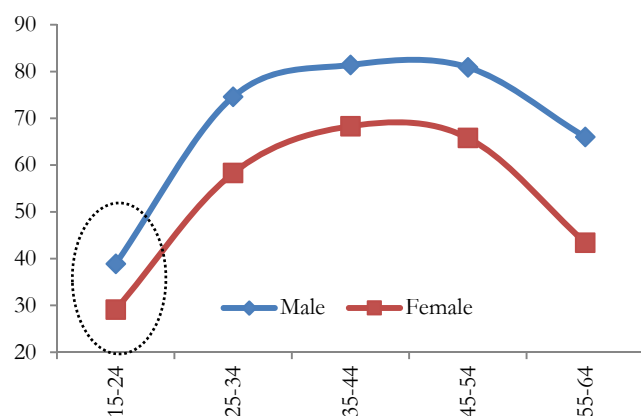
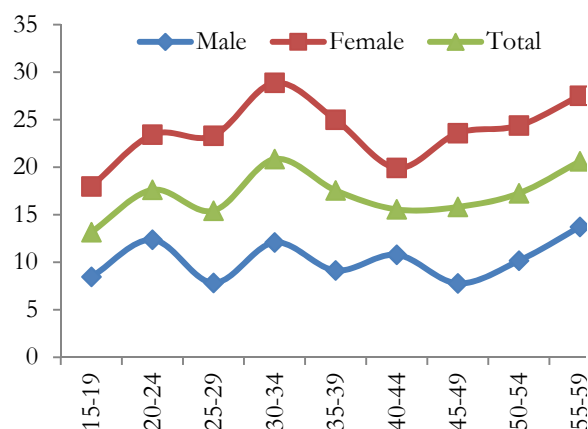


Figure 39: NEETs, percent



Source: World Bank calculations with LFS 2011.

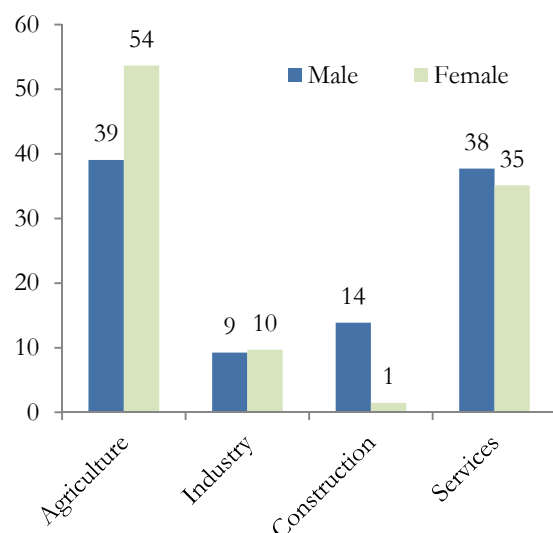
²⁵ INSTAT.

²⁶ INSTAT.

²⁷ Eurofound (2012) reports that the average NEET rate in 2011 was 6.9 percent among 15- to 19-year-olds and 18.2 percent among 20- to 24-year-olds. (See Mascherini, Massimiliano, Lidia Salvatore, Anja Meierkord, and Jean-Marie Jungblut (2012) *NEETs: Young People Not in Employment, Education, or Training: Characteristics, Costs, and Policy Responses in Europe*. Luxembourg: Eurofound.)

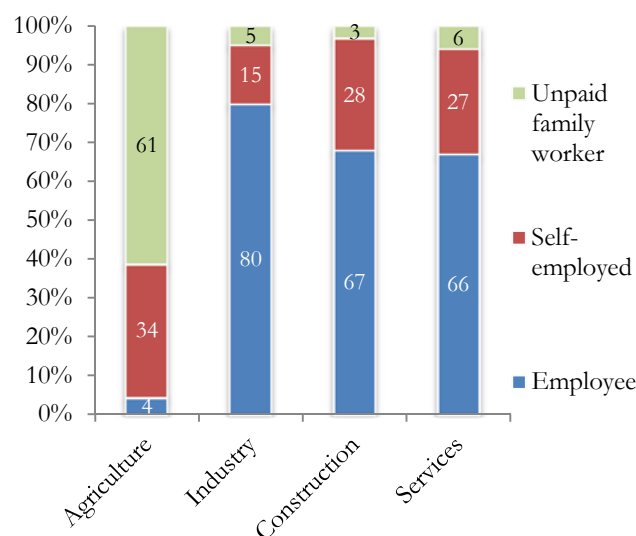
The quality of employment is also low. Close to half the employed work in agriculture, particularly women (Figure 40). Among these, almost three-quarters have primary-school education or less, and almost all (98 percent) have secondary education or less. The services sector, accounting for over one-third of employment, captures the majority (82 percent) of more highly educated workers.²⁸ However, only 12 percent of the workforce has tertiary education, in contrast to slightly more than half with only primary education or less. Furthermore, among the employed, a large share corresponds to either unpaid family workers (31 percent), the vast majority of whom work in agriculture (91 percent) and are women (71 percent), or to the self-employed (29 percent).²⁹ Thus, the agricultural sector accounts for a large share of employment, particularly among the low skilled, but most workers are either in self-employment or unpaid family workers (Figure 40).

Figure 40: Share of total employment by sectors and gender, 2011



Source: World Bank calculations based on Labor Force Surveys.

Figure 41: Share of workers by sectors and type of employment, percent, 2011



Source: World Bank calculations based on Labor Force Surveys.

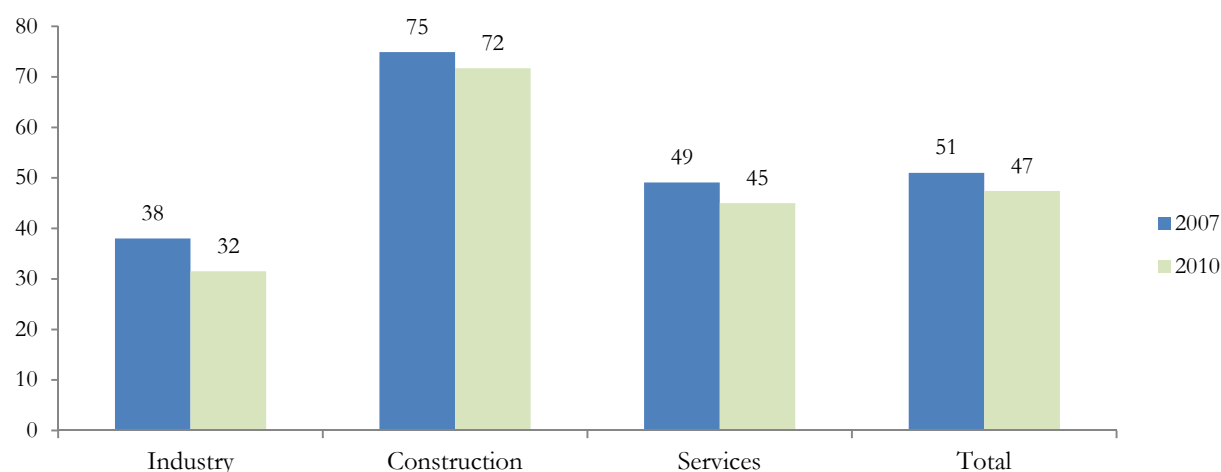
Informality is widespread in the labor market. Estimates suggest that close to half of total employment outside agriculture corresponds to informal employment, and nearly three-quarters of the labor in construction is informal (Figure 42, Box 2).³⁰ Although trends point to a slight decline, informality remains substantial.

²⁸ Capturing, in large part, workers in retail (22 percent), public administration (15 percent), education (13 percent), the hospitality industry (12 percent), transport (8 percent), and health care (7 percent).

²⁹ Data for 2011.

³⁰ World Bank calculations show 47 percent in 2010 and 2011; informality is defined there as all self-employed and unpaid family workers in nonagricultural sectors, plus employees not covered by social security. This is in line with the 43 percent in 2013 reported by INSTAT.

Figure 42: Informality in the nonagricultural sectors, percent, 2007 and 2010



Source: World Bank calculations based on Labor Force Surveys.

Note: Informality is defined as all self-employed and unpaid family workers in nonagricultural sectors, plus employees not covered by social security.

Box 2. Informality in the construction sector

Key findings of an International Labour Organization survey of 200 male construction workers in Albania on the topic of informality are as follows:^a

- 84 percent of the respondents said they worked informally, and about half said they would prefer their incomes to be declared
- 72 percent of the respondents nonetheless generally support the concept of informal employment
- Respondents favored informal services because of lower prices (40 percent) and more rapid delivery (22 percent)
- 43 percent of the respondents were regularly employed informally

Respondents attributed the widespread informality in the sector to limited employment opportunities, high taxes and social contributions that provide incentives for informality among employers and employees, and issues with the legal system.

a. ILO (2011). Another survey conducted among street vendors (7 percent of the total were interviewed) found that around 80 percent of all vendors work without a license, and 90 percent do not pay taxes.

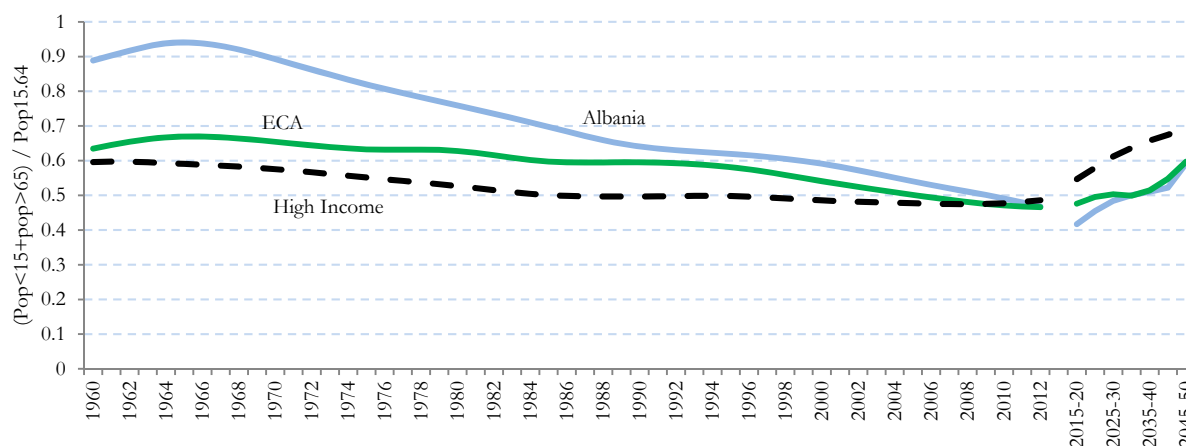
Several constraints to a more vibrant and inclusive labor market seem to limit the accumulation and efficient use of human capital. Beyond the need to boost labor demand, these constraints affect the accumulation and stock of human capital assets, particularly in education, but lead overall to poor utilization of assets as a means to obtain labor income. First, although the workforce is moderately young and health outcomes have improved, important gaps exist in access to basic education and in the quality and labor market relevance of education and training systems (see below). Second, as in neighboring countries, disincentives and barriers to formal employment contribute to substantial informality and reduction in fiscal revenues, especially among some population groups. Third, the dynamics of the labor market are deeply affected by geographical

mobility, particularly international migration. Nonetheless, there is a significant knowledge gap about labor markets in Albania. This should be addressed to clarify the constraints and policy options for higher-quality labor market engagement.

Demographic characteristics and health care

While Albania has a moderately young population, labor market outcomes suggest that this endowment is not being used optimally. In 2010, the share of the 65+ age-group in the population was 9.7 percent, well below the average in Eastern Europe and Central Asia (12.1 percent), and 21.3 percent of the population is 15 years of age or less, compared with the regional average of 17.5 and an average of 16.8 percent among countries of the Organisation for Economic Co-operation and Development (OECD). This relatively young age structure represents a potential source of economic growth, provided that this pool of human capital can be used intensively and effectively. The evidence represented by the labor market engagement of youth suggests, however, that this is currently the case. Challenges will emerge as the demographic dividend begins to disappear and as the dependency ratio rises when, later on, these larger cohorts entering the workforce today retire (by 2050), causing a significant expansion in the population share of the elderly (**Figure 43**).³¹ Another issue that could affect the human capital endowment (and on which more research is needed) is the high ratio of births of boys relative to girls, estimated at around 111.7, one of the highest ratios in the region.³²

Figure 43: Total Dependency Ratio, 1960–2010, and Projections, 2015–50, percent



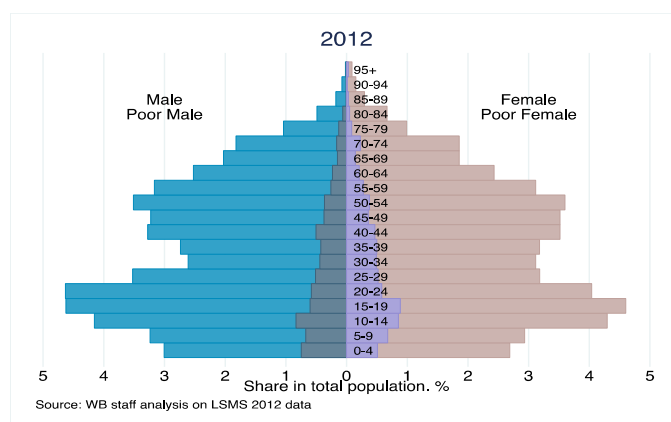
Source: World Bank calculations based on data in World Population Prospects: The 2012 Revision (database), Population Division, Department of Economic and Social Affairs, United Nations, New York.

³¹ By 2050, 25 percent of Albania's population is likely to be aged 65 and older, which puts it well over the 2050 average of 23.1 percent in Eastern Europe and Central Asia.

³² These sex imbalances at birth arise because of the missing girls problem also identified in some Asian countries and in the south Caucasus, which usually reflects a combination of factors, including son preference, declining fertility rates, and sex-selective abortions. (See World Vision and UNFPA (2012) "Sex Imbalances at Birth in Albania" for details on Albania.)

Larger households with children are overrepresented among the poor and bottom 40. The age-gender pyramid (Figure 44), which also presents the share of poor across age-groups, shows that poverty is more prevalent among households with younger children (often minorities). Among households in the bottom 40, 28 percent of the members are under 15 years of age, compared with 16 percent among the top 60. Controlling for other factors, having an infant in the household increased the probably of being poor by over 60 percent, and each additional child was associated with a 50 percent increased probability of being poor, compared to a one-third average increase in probability of being poor for each additional elderly person.³³

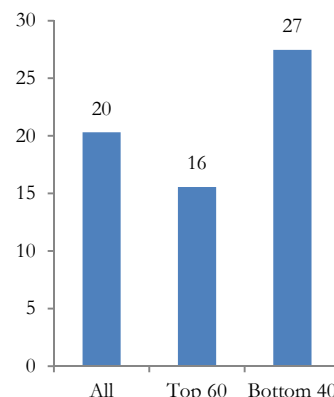
Figure 44: Age-gender pyramids, percent of total population and share of poor



Source: World Bank analysis on LSMS 2012 data.

Note: In the pyramid, the left (right)-hand side shows the share of males (female) and poor males (poor females) in each age-bracket as shares of the total population. The distance from the middle to each side in blue and pink denotes the total population share in the relevant age-group for males and females. The distance in light gray and purple is the proportion of poor people in that age-group among the total number of the poor for each gender.

Figure 45: Share of under 15 year olds in households, percent



Albania has a relatively healthy population and workforce because of improvements in health outcomes in recent years, but significant inequities persist among socioeconomic groups. Life expectancy at birth reached 77 years in 2011 (80 among women and 74 among men), higher than in neighboring Serbia (74.5) and FYR Macedonia (75) and only three to five years behind high-income countries such as Greece and Italy. Infant and maternal mortality rates have declined, but remain high. Children in rural areas are twice as likely to die before age 1 as children born in urban areas, while children in mountainous regions are four times more likely to die before age 1.³⁴ While child malnutrition has declined steadily in the past decade, over a quarter of children in the poorest quintile were stunted (suffering from chronic malnutrition) in 2009, compared

³³ World Bank analysis using LSMS data from 2005, 2008, and 2012.

³⁴ The infant mortality rate fell from 18.1 per 1,000 live births in 2007 to 15 in 2012, and the maternal mortality rate fell from 31 per 1,000 women in 2005 to 27 in 2010. Still, both the infant and maternal mortality rates are high compared with the EU 2011 averages of 4.1 per 1,000 live births and 5.8 per 1,000 women, respectively. Neonatal mortality, an important indicator of the quality of health care, needs particular attention. Infant mortality per 1,000 live births was 12 in urban areas, 24 in rural areas, and 42 in mountainous regions (based on INSTAT data and the 2010 Demographic and Health Survey). No data are available on adult mortality disaggregated by income.

with 13 percent in the wealthiest quintile. Child malnutrition has lifelong consequences for cognitive development and productivity.

The growing risk of premature mortality and morbidity because of noncommunicable diseases threaten future household well-being and productivity and disproportionately affect the poor and the bottom 40. Noncommunicable diseases are responsible for 89 percent of adult deaths. Ischemic heart disease, stroke, and cancers are the leading causes of death. While the Mediterranean diet is said to be a likely explanation for the relatively good adult health (despite the significant shortcomings in the quality and equity of the health care system), eating habits are changing, and other risk factors are increasing. Smoking rates have risen in the past decade, and currently half of all men smoke. In 2012, 10 percent of adults (age 16-64) and 46 percent of those over 65 reported having a chronic illness. The contribution of diabetes to the disease burden grew by 90 percent in 1990–2010. Hypertension has emerged as a major risk factor and disproportionately affects the poor. In 2009, one-third of men in the poorest quintile were hypertensive, compared with 20 percent in the upper quintile.³⁵ An analysis of household data found that chronic disease was significantly associated with a 44 percent increase in the increased likelihood of poverty in 2005, controlling for other factors. This declined to a 23 percent increase in 2012, which suggests some progress in providing protection against the impoverishing effects of illness, but remains high.

Out-of-pocket health care expenditures are high, particular among the poor, thereby increasing consumption poverty. In the case of health care, households often bypass lower-cost primary care services to seek care in hospitals or the private sector and pay too much for medicines because of weaknesses in pharmaceutical pricing and regulation. In 2012, out-of-pocket spending on health care represented 10 percent of total consumption expenditures among the poor, compared with 5 percent among the wealthiest quintile.³⁶ This is more than in comparator countries, and the average health care spending of the poor exceeds a common threshold for catastrophic health spending.³⁷ An estimated 6 percent of Albanians have been driven into poverty by health care spending.³⁸ This is high by EU standards, and the situation has deteriorated among the poor in recent years (such as a rise of 7 percent in out-of-pocket health care spending in 2008), despite a modest expansion in health insurance coverage (a growth in coverage from one-third to one-half of the poorest in 2008–12). Controlling for other factors, health insurance coverage was associated with a one-third decrease in the likelihood of being poor in 2012.

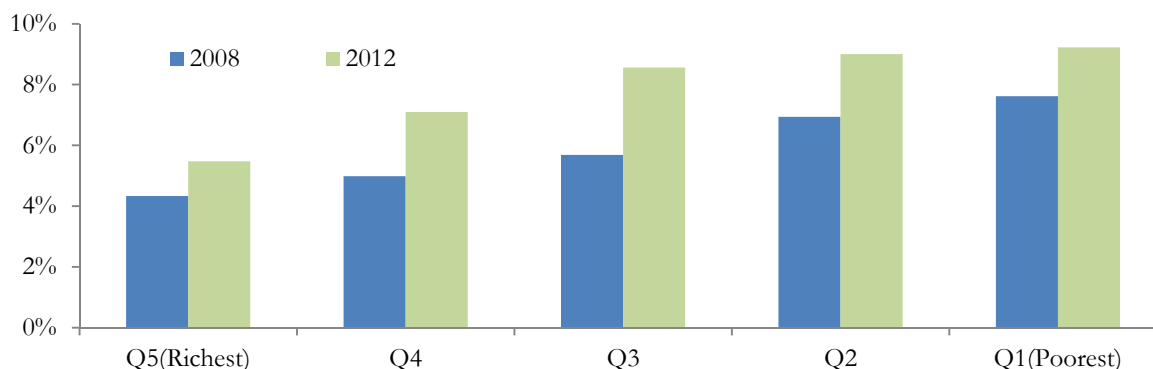
³⁵ *Albania Demographic and Health Survey*. 2009. Based on the same survey, 26 percent of poor women were hypertensive, compared with 12.4 percent in the highest income quintile.

³⁶ World Bank analysis based on 2008 and 2012 LSMS.

³⁷ Catastrophic expenditure is typically defined as spending more than 10 to 25 percent of total household consumption on health care. In Western Europe, the average out-of-pocket health care expenditure is about 3 percent of household consumption, with an average of about 5 percent in comparable countries in Eastern Europe and Central Asia (Smith, Owen, and Son Nguyen. 2013. *Getting Better*. Washington, DC: World Bank.)

³⁸ See World Bank. 2014. *Albania Public Finance Review*, Vol 2.

Figure 46: Out-of-Pocket Health Spending, percentage of total consumption



Source: World Bank analysis based on 2008 and 2012 LSMS.

Poor quality and inequality in access to health care further affect the opportunities to the efficient accumulation and use of human capital of disadvantaged groups. While the health care system performs well on some measures of access to basic services, there are significant shortcomings in quality and equity. While child vaccination coverage is high, and nearly all women deliver in health facilities, only a third of poor women were informed by their health providers of signs of complications in pregnancy, compared with 73 percent among more well off women. Ninety-eight percent of poor women reported barriers to access, compared with two-thirds among the wealthiest quintile. Among poor women, the major barriers to access are the cost of treatment (80 percent), distance and transportation (about 60 percent), concerns that no medicines or providers would be available (65 percent), and concerns about inadequate supplies and equipment (75 percent).³⁹ In 2011, 59 percent of Roma reported not being able to afford essential drugs prescribed to them in the previous year, compared to 31 percent of their non-Roma neighbors (Figure 47).⁴⁰ In terms of quality, a recent survey found that Albanian doctors gave correct diagnosis and recommended treatment only half the time when they were presented with hypothetical patient vignettes. Among male adults (15–49) with hypertension, 90 percent were not aware of their condition; 6 percent were aware, but not under treatment: 3 percent were under treatment, but not successfully; and only 1 percent were receiving treatment and had their hypertension under control.⁴¹ Sexual minorities face a lack of access to and quality of health services, especially

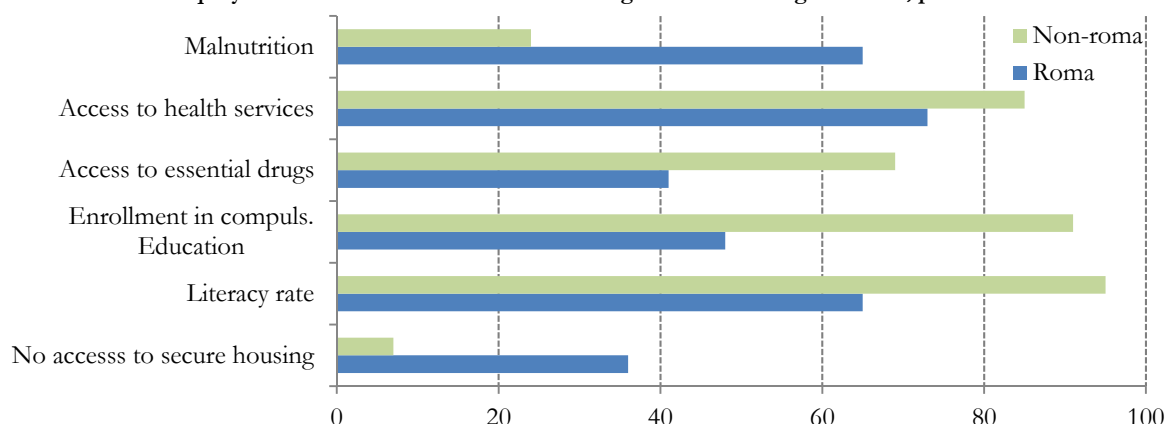
³⁹ In 2009, 10 percent of poor women delivered babies at home, while over 98 percent of all other quintiles delivered at a public facility. *Albania Demographic and Health Survey*. 2009.

⁴⁰ UNDP/EC/WB Regional Roma Survey, 2011. www.eurasia.undp.org

⁴¹ Albania Demographic and Health Survey. 2009.

on specific/needs – based care of information.⁴² Only 27 percent of respondents answered that they would feel comfortable sharing their sexual orientation, gender identity or same-sex experiences with their doctor.

Figure 47: Health and equity of access: Roma and non-Roma living in the same neighborhood, percent



Source: UNDP/EC/WB Regional Roma Survey, 2011.

Skills

Albania has raised the access to all levels of education, thus strengthening the human capital base of the new generation of workers. Half the working-age population has only primary education or less (see above). The level of education of the flow of workers that will enter the labor market in the future is showing improvement: primary and lower-secondary enrollments are nearly universal, and, in 2009–13, preprimary net enrollment shot up from 47 to 79 percent, while upper-secondary gross enrollment climbed from 76 percent to 92 percent. Gross enrollment ratios compare favorably with regional peers and the OECD average, and gender gaps have disappeared. This expansion in access has been augmented by the growing provision of private education. In 2007–13, the share of private school enrollments in basic education (primary and lower secondary) increased from 4.1 percent of students to 5.4 percent; in upper secondary from 7.5 percent to 11.2 percent; and in higher education from 6.6 to 19.0 percent, almost tripling. However, the large gap between gross and net enrollment rates suggests that there is poor internal efficiency. Many students are falling behind the appropriate grade for their age-group. In upper-secondary education, the gap is about 20 percent, meaning that about a quarter of upper-secondary students are older than the official age-for-grade. In terms of enrollment, girls have parity with boys at early ages; gaps in favor of girls emerge starting at age 12.

Nonetheless, inequalities remain. The bottom 40 and the poor show lower enrollment rates and lower educational attainment, limiting the access of these groups to economic opportunities and, thus, the potential asset-base of the country (Table 1). In preprimary education, for example, net enrollment is twice as high among

⁴² Voko, Kristina, *Access to Health Services and Quality of Care for LGBT Persons in Albania, Technical Report*, December, 2013, the Ombudsman and ‘Alliance against LGBT discrimination’, supported by the Council of Europe Office in Tirana.

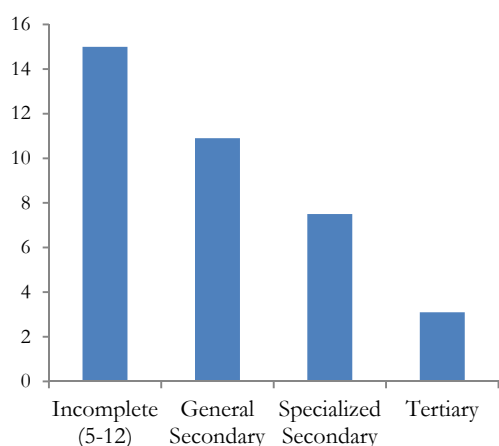
the wealthiest quintile as among the poorest quintile. In 2011, only a third of Roma children were enrolled in preschool, perpetuating the cycle of poverty.⁴³ Studies have demonstrated the importance of early childhood development for overall cognitive development and for lifetime earnings potential, particularly among poor and marginalized populations.⁴⁴ The incidence of poverty is highest in households in which individuals have not completed primary education, at 15 percent (capturing around 66 percent of the total poor) (Figure 48). The socioeconomic gap in higher education is significantly wider. More than two times more people in the highest quintiles are enrolled in tertiary education relative to the poorest quintiles. Inequalities also exist in the stock of human capital, thus affecting the opportunities available to the workforce of today (Figure 49). The share of individuals with primary education or less is significantly higher among the poorer groups.

Table 1. Lower-income groups have lower net enrollment rates in preprimary, upper-secondary, and tertiary education, percent

	Preprimary			Basic			Upper secondary			Higher education	
Quintile	Male	Female	Total	Male	Female	Total	Male	Female	Total	Male	Female
1 (poorest)	20.5	27.1	23.4	84.8	85.2	85.0	53.7	58.6	56.5	9.0	14.5
2	35.9	41.3	38.3	88.8	90.5	89.7	66.3	74.1	70.2	17.5	29.1
3	32.5	33.8	33.2	88.1	94.3	91.4	68.7	82.2	75.1	23.6	34.6
4	38.3	36.7	37.5	92.3	86.1	89.2	77.0	81.1	79.0	30.5	45.2
5 (richest)	42.1	59.9	48.4	94.0	93.8	93.9	86.9	88.0	87.4	44.0	62.9
Total	31.1	35.7	33.2	88.7	89.4	89.1	69.8	74.9	72.3	24.6	37.1

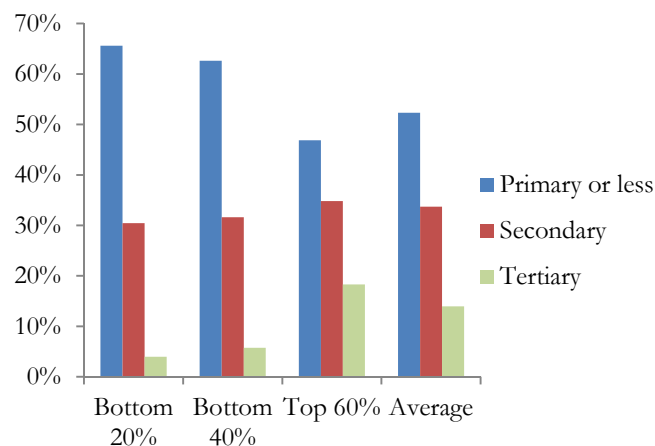
Source: Living Standards Measurement Survey (2012).

Figure 48: Poverty headcount, by educational attainment, population 25 and over, percent



Source: 2012 LSMS data

Figure 49: Educational attainment (ages 25+) by economic status, percent



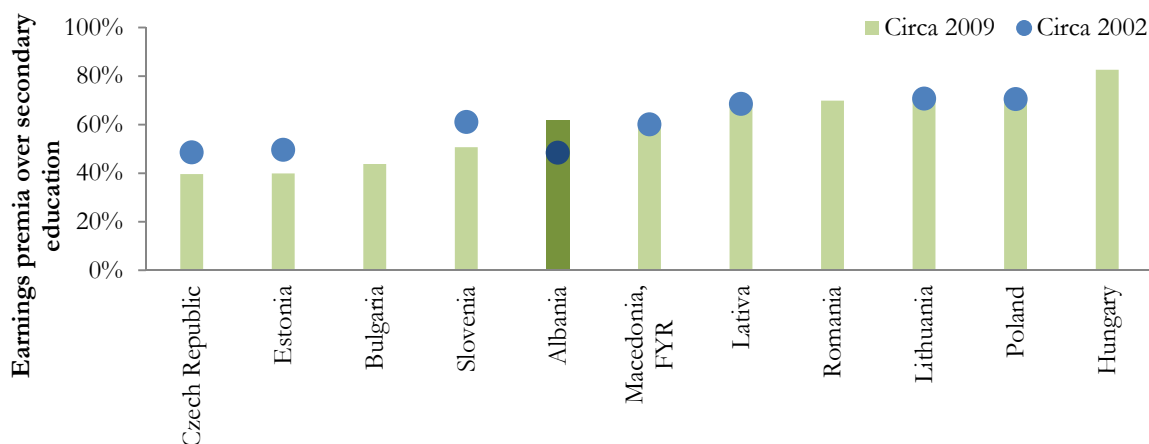
Source: 2012 LSMS data

⁴³ UNDP/EC/WB Regional Roma Survey, 2011. www.eurasia.undp.org

⁴⁴ For example, see Shady, N. 2006. "Early Childhood Development in Latin America and the Caribbean." Policy Research Working Paper 3869, World Bank, Washington, DC.

Returns to higher education are high, but, relative to primary education, there seem to be, on average, no wage incentives for individuals and households to invest in secondary education. The wage premium for tertiary educational attainment relative to secondary education increased only over the past decade (as in other countries in the region), rising from 48 percent in 2002 to around 62 percent in 2008 (Figure 50). More recent analysis based on the Labor Force Survey (2011) suggests that returns remain high (at 50 percent relative to primary educational attainment), but that there is no wage premium for secondary schooling.⁴⁵ This zero average wage premium for secondary education (relative to primary), the underlying factors of which should be explored, likely affects the incentive to continue the formal education path past primary school, especially among a large part of the labor force in the informal sector.⁴⁶ Moreover, the high returns to tertiary education are out of reach of a large share of the poor and the bottom 40 given the lower levels of educational attainment among these groups. Evidence in the region also suggests that, even among individuals with tertiary education, the average returns mask significant disparities, and the returns may not be equally available to all, particular to the poor.⁴⁷

Figure 50: Average returns to tertiary education in the 2000s, salaried workers ages 25-64, relative to secondary education, percent



Source: Arias et al. (2014), World Bank estimates from the Labor Force and Household Surveys, latest years available. Data for Albania use the 2002 and 2008 LSMS.

Returns to education also differ by gender. It is estimated that women who are wage employed earn around 20 percent less than men with similar characteristics in terms of age and education even after one has accounted for the sector and type of employment. The gap widens in younger cohorts (aged 40 or less), reaching around 24 percent.

⁴⁵ World Bank calculations based on LFS 2011. The Mincerian wage regressions control for age, gender, and educational level.

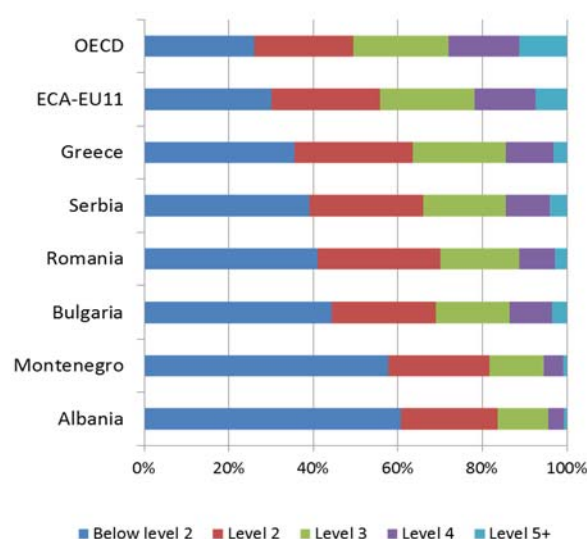
⁴⁶ World Bank calculations based on LFS 2011.

⁴⁷ Arias, Omar S., Carolina Sánchez-Páramo, María E. Dávalos, Indhira Santos, Erwin R. Tiongson, Carola Gruen, Natasha de Andrade Falcão, Gady Saiovici, and Cesar A. Cancho. 2014. *Back to Work: Growing with Jobs in Europe and Central Asia*. Washington, DC: World Bank.

The quality of education at all levels is inadequate to equip students with the basic skills the labor market requires. Although students in Albania have consistently improved their scores in international assessments, learning outcomes are stubbornly low even relative to neighboring countries with similar levels of income. More than 60 percent of 15-year-olds are functionally illiterate in mathematics, while about 50 percent are deficient in reading. These are among the highest shares of functional illiteracy among youth in countries participating in the OECD Programme for International Student Assessment. The learning gap between the OECD average and Albania is equivalent to 2.5 years of schooling (Figure 51 and Figure 52). A data gap needs to be filled on socioemotional skills, an assessment of which should start in preschools.

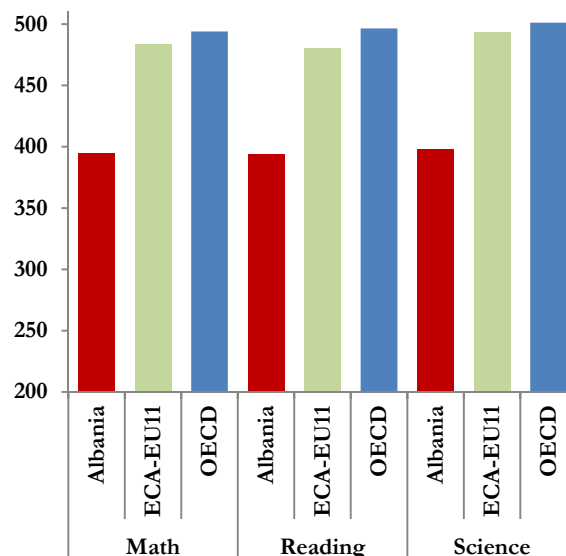
Firms cite inadequate skills as a constraint to business development, signaling labor market demands inconsistency with education and training outcomes. There are no internationally comparable data on the quality and relevance of upper-secondary and tertiary education in Albania; however, among the South East European 6 (SEE6) countries (Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, and Serbia), Albania has the largest share (36 percent) of firms reporting that the workforce does not possess the skills they require, highlighting a potentially important skills mismatch in the country. A general trend in the region is a shift from jobs that require unskilled (routine and manual) to skilled (nonroutine cognitive) labor. Such a trend is also necessary in Albania if the new growth model is to succeed. This calls for a thorough assessment of the education and training systems in the country and their links to labor demand.

Figure 51: Distribution of students by mathematics proficiency level, 2012, percent



Source: PISA International Database, Programme for International Student Assessment, Organisation for Economic Co-operation and Development, Paris.

Figure 52: Average student assessment scores, Albania and comparator countries, 2012



Source: PISA International Database, Programme for International Student Assessment, Organisation for Economic Co-operation and Development, Paris.

Moreover, given that Albania still faces severe quality challenges throughout the formal education system, training systems and adult learning programs, although important, might not be the immediate area of focus given the limited analytical base. Nonetheless, progress can be made in improving these by prioritizing the establishment of a multistakeholder skills task force, promoting autonomy among training institutions, and promoting training, along with job placement support for the jobless. Steps in the right direction include the decision to transfer technical and vocational education and training from the Ministry of Education and Sports to the Ministry of Labor and Social Welfare to ensure closer ties between labor policies and training provision; coordination with higher education institutions and training providers outside of the formal education system remains a challenge.

The capacity of the economy to innovate is limited. The economy continues to be a source of low-technology and low-value added exports partly because of limited capacity for research and development (R&D) and innovation, which constrain firms from achieving smarter, more rapid growth. Albania lags substantially behind other countries in the EU and the SEE6 countries in research capabilities and innovation. It does not have a critical mass of specialized researchers, nor does it have sufficient infrastructure and funding for research excellence. According to United Nations Educational, Scientific, and Cultural Organization estimates based on partial data, gross expenditures on R&D in Albania represented only 0.15 percent of GDP (compared to 1.9 percent European average) in 2008, funded almost exclusively by the public sector and by foreign sources. While public financing for R&D will remain constrained in the current fiscal environment in Albania, efficiency gains can be achieved by strengthening the institutional framework to ensure the effective targeting of scarce R&D and innovation funds to the best potential firms and research projects (box 3).

Labor regulations

Labor regulations influence the cost firms face in hiring and firing workers and can also affect employment decisions regarding the type of labor market engagement individuals and firms pursue.

The impact of labor regulations on aggregate employment or unemployment is ambiguous, but work across countries shows that it is likely to be limited if it is within a certain range of flexibility or rigidity.⁴⁸ Nonetheless, some groups, particularly outsiders such as youth and women might be more affected by stringent labor market regulations. Research is needed to establish the extent to which labor market regulations affect labor outcomes in Albania, as the country fares differently across various available indicators. For instance, in terms of flexibility in setting wages, the country ranks particularly poorly at 123rd in 148 countries (the worst position among Southeast European countries).⁴⁹ Similarly, cross-country regional data for 2010 placed Albania as one of the

⁴⁸ At a plateau, in the language of the World Bank's *World Development Report 2013* on jobs. See also Arias et al. (2014).

⁴⁹ Schwab, K. ed. 2013. *Insight Report: The Global Competitiveness Report 2013–2014*. Geneva: World Economic Forum.

countries with the highest minimum wage (as a percentage of the average wage).⁵⁰ Conversely, the country ranks well worldwide in the flexibility in hiring and firing workers (position 29 in 148 countries). Few firms report labor regulations as an obstacle in operations.⁵¹

Disincentives to (formal) work

Firms and workers may face disincentives to work that keep them out of the labor market or out of formal employment. In the case of Albania, it is particularly important to understand the factors that result in such high levels of informality outside the agricultural sector. Disincentives, as in other countries, could be linked to the levels or structure of labor taxation and social protection benefits.⁵²

Evidence on work disincentives from taxes and social protection systems is, however, scarce for Albania. Labor taxation in Albania is higher than in non-European OECD countries, although it is slightly lower than the regional average (**Figure 53**). Compared with neighboring countries, Albania lies in the middle in terms the extent to which labor taxation gives rise to work disincentives. Beyond the level of taxation, the structure of taxation also matters. The progressivity of labor taxation recently improved in Albania, which, in January 2014, went from a flat taxation system that treated all workers the same regardless of earnings, thus penalizing low-wage earners, to a progressive taxation system.⁵³ Evidence on the potential impact of this measure on employment is not yet available.

Even if labor taxation is not particularly high in Albania and has an improved structure, other factors could affect the willingness of Albanians to contribute.⁵⁴ One potential source of disincentives to (formal) work related to labor taxation is the perception of governance issues, inefficiencies in the provision of public services and government spending (see below), and disincentives to pay social security, given the recently addressed delinks between benefits and contributions.⁵⁵

⁵⁰ Arias et al. (2014).

⁵¹ BEEPS (Business Environment and Enterprise Performance Survey) (database), European Bank for Reconstruction and Development and World Bank, London, <http://ebrd-beeps.com/data/>.

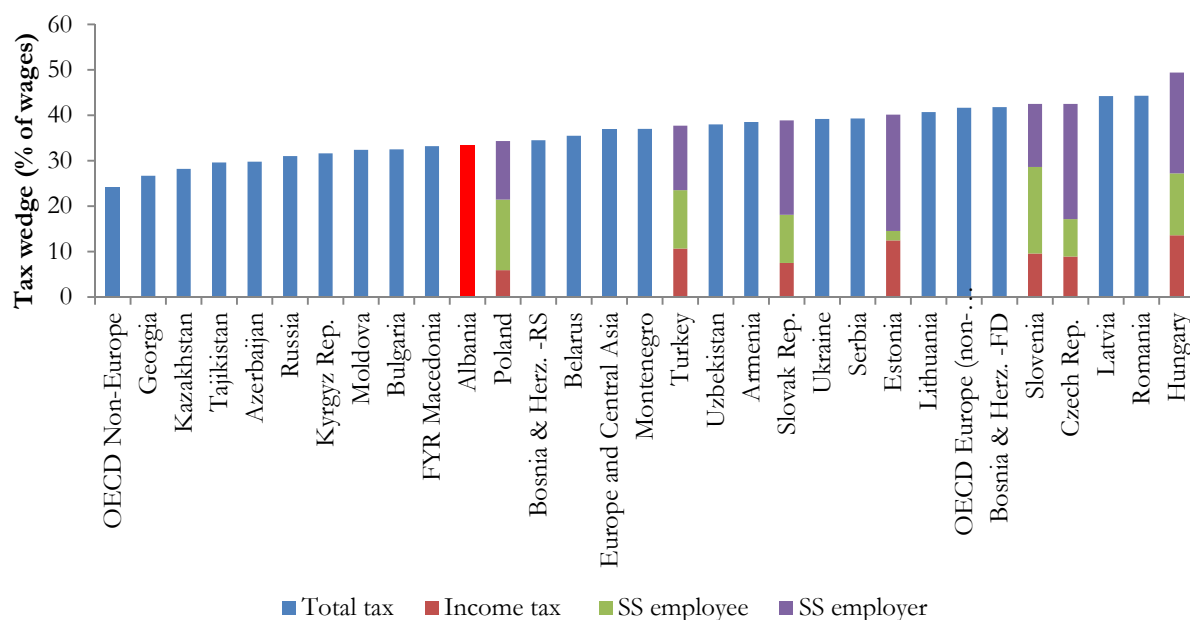
⁵² Arias et al. (2014).

⁵³ ILO (International Labour Organization). 2011. "National Labour Conference on Wage Trends and the Wage Gap in Albania." Tirana, November 17–18.

⁵⁴ Koettl, I, and M. Weber. 2012. "Does Formal Work Pay? The Role of Labor Taxation and Social Benefit Design in the New EU Member States". IZA Discussion Paper 6313.

⁵⁵ Addressed by the recently approved pension law.

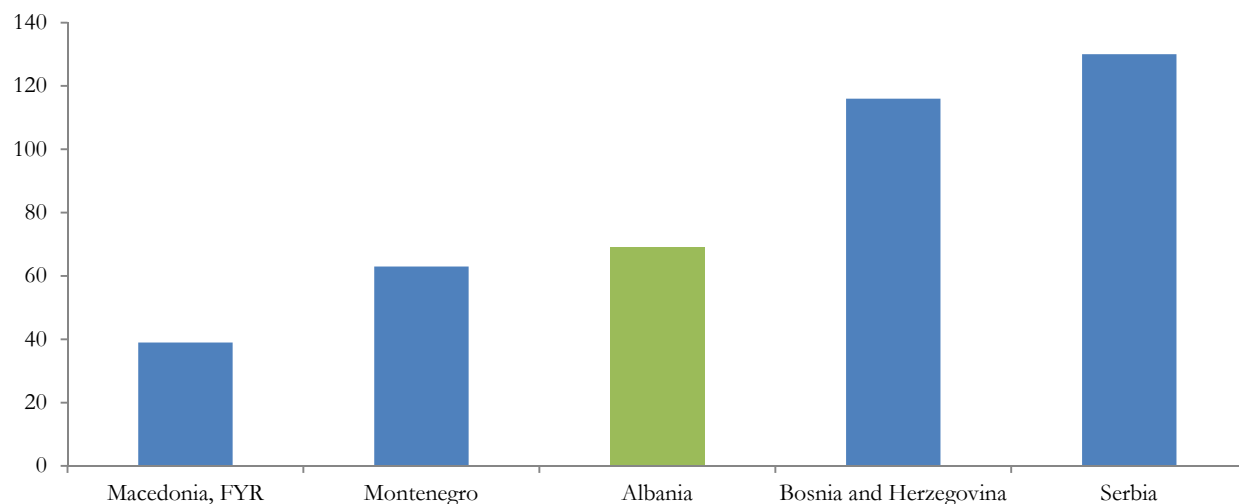
Figure 53: Labor Taxation in Albania, 2009–11, level of labor tax wedge as percent of wages



Source: Arias et al. (2014).

Note: The tax wedge is calculated for a single person, without children, at the average wage. Data for Bosnia and Herzegovina, FYR Macedonia, and Serbia are for 2009; for Bulgaria, Latvia, Lithuania and Romania, data are for 2010; for other countries, data are for 2011. SS = social security.

Figure 54: Extent to which taxation creates disincentives to work, higher ranking suggests that taxes reduce incentives to work



Source: Schwab, Klaus, ed. (2013). Insight Report: The Global Competitiveness Report 2013–2014. World Economic Forum, Geneva.

The impact of social protection on aggregate labor market outcomes is expected to be limited.

Evidence from countries in the region suggests that the design of a social protection system has the potential to discourage (formal) work. In Albania, the main social assistance program *Ndihma Ekonomike* has built-in work disincentives from exclusionary filters discouraging employment. These are currently being reformed, with ongoing pilot projects in three regions, toward a proxy means-tested targeting system. Given the low coverage and generosity of the program, it is likely to have limited impact in explaining aggregate labor market outcomes.

While the impact is arguably limited, the joint effect on formal employment of labor taxation and social protection systems should be explored. Evidence on neighboring countries in Southeast Europe suggests that combined disincentives from labor taxation and social protection systems have the potential to keep individuals out of formal employment. These disincentives arise from high implicit tax rates that capture both labor taxation and forgone social benefits in the take-up of formal employment.⁵⁶

Disincentives for formal employment in Albania, in particular, warrant special attention given the high levels of informality. Although analysis is needed to determine the root causes of informal employment and policy options, recent work by the International Labour Organization (ILO 2011) suggests a combination of factors, possibly reinforcing each other, that could raise the incentives to informality related to “complex legal and administrative regulations, high overall taxes and social security contributions, a lack of trust in the institutions and administrative procedures, a lack of access to formal property, a long-term decline in the tax-paying ethic, and a broad acceptance by the wider public of illicit work.”⁵⁷ These factors are combined with the limited capacity of institutions to tackle and investigate cases of informal employment. Box 3 captures some of the available insights on the region that are not available on Albania.

⁵⁶ Arias et al. (2014) using the OECD tax and benefit model.

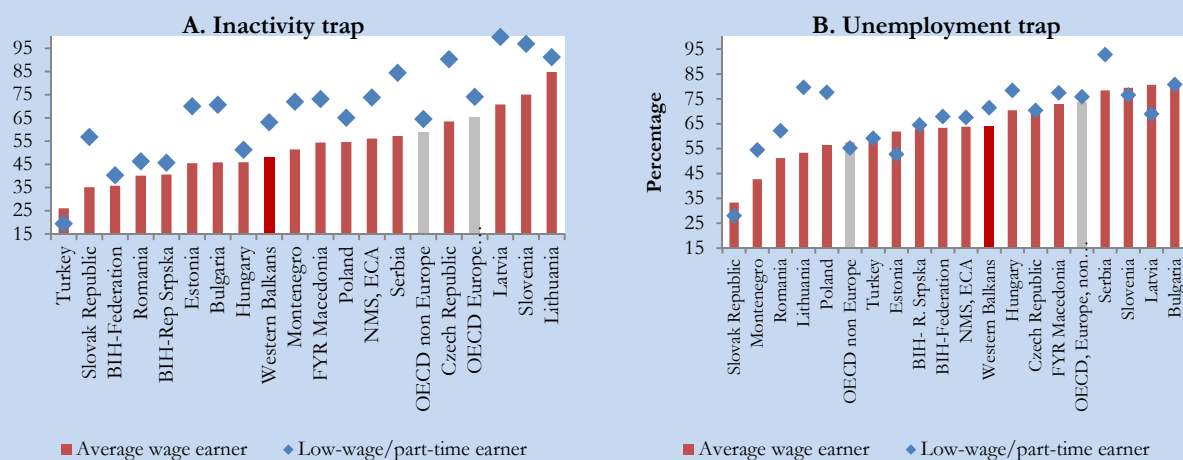
⁵⁷ Page 41, ILO (International Labour Organization). 2011. “A Comparative Overview of Informal Employment in Albania, Bosnia and Herzegovina, Moldova, and Montenegro.” Geneva.

Box 3: Disincentives to (formal) employment from labor taxation and social protection systems in the western Balkans

The World Bank report *Back to Work: Growing with Jobs in Europe and Central Asia* looks at how labor taxation and social protection systems can potentially affect incentives to work across countries in the region (Arias et al. 2014). Evidence on the western Balkans shows that labor taxation and social protection systems, particularly given their structure and design, do not always make (formal) work pay. In terms of taxation, it remains high in some countries, but it is also less progressive than in Western Europe, potentially discouraging work among low-wage earners. Levels of taxation are higher in Bosnia and Herzegovina and Serbia than in their neighbors and the regional average (figure B4.1). In FYR Macedonia and Serbia, low progressivity is driven by artificially high social contribution rates for low-wage earners given the existence of reference wages. Furthermore, social protection systems are often designed in such a way that they discourage or even prohibit work through employment-related exclusionary filters, low retirement ages, abrupt withdrawal of benefits, and other factors.

Together, labor taxation and social protection can make the cost of moving out of inactivity or unemployment high for countries in the western Balkans, particularly among low-wage earners (figure B4.1). In Serbia, around 85 percent of labor income is taxed away for a low-wage earner shifting from inactivity (receiving social assistance) to a formal job. On average in the western Balkans, the move out of unemployment can be particularly onerous, with around 64 percent of the new earnings lost between forgone unemployment benefits and labor taxes.

Figure B4.1 Average effective tax rate, 2010: Income tax, plus lost benefits from social assistance (Panel a, “inactivity trap”) or unemployment (Panel b, “unemployment trap”) as a percentage of gross labor income



Source: Arias et al. 2014.

Note: Calculations based on one-earner couples with two children. They measure the share of gross income of the accepted formal job—including in-work benefits—that is taxed away through the personal income tax, social security contributions, and lost benefits (social assistance for the inactivity trap or unemployment for the unemployment trap, plus family, and housing benefits). Children are assumed to be 4–6 years old. The data for Bosnia and Herzegovina, FYR Macedonia, and Serbia from 2009; for Montenegro from 2011.

Barriers to jobs also exist, potentially more binding among some groups, such as youth, women, and the less well off, thereby limiting the utilization of human capital in labor markets. These barriers may relate to inadequate skills (discussed above and particularly relevant for the less well off), but also to other factors such as inflexible work arrangements, access to productive inputs, limited social capital, access to childcare, and attitudes and social norms, particularly as these affect women.⁵⁸

- **Flexible work arrangements:** around 24 percent of the employed work part time, and, among these people, women are overrepresented (61 percent). Although the share of part-time workers in Albania is higher than in neighboring countries, it is not clear whether this reflects the fulfillment of worker preferences or is another manifestation of low-quality employment that is capturing the work schedules of unpaid family workers, for instance.
- **Social capital:** social capital can provide households with access to networks that could facilitate links with jobs, access to credit, and a cushion from asset depletion in the face of shocks. Albanians put a high value on having connections to facilitate access to a public or private job: around 67 percent of Albanians consider that having connections is moderately important, very important, or essential in obtaining a good public or private job.⁵⁹ This might put age categories such as youth (as new labor market entrants) and the less well off at a disadvantage because they can likely count on fewer of these networks to link them to labor markets. Among women, the poor, and the bottom 40, lower endowments in social capital may be one of the factors hindering the access to networks that could open up economic opportunities. Of individuals in the bottom 40, for example, only 8 percent say they participate in at least one association (such as trade unions, neighborhood associations, religious, cultural, or political groups), as opposed to 16 percent of individuals in the top 60.⁶⁰
- **Access to and use of productive inputs such as land and natural resources or financial services:** access to inputs represents an additional obstacle to (formal) employment (see below). For instance, Albania has one of the lowest scores in Europe and Central Asia in terms of the ease of obtaining a bank loan, and access to financing is considered one of the most problematic factors in doing business.⁶¹ The lack of access to finance limits the availability of poor and middle income households to afford formal housing and contributes to the growth of the informal housing sector. In addition, the land markets and

⁵⁸ Arias et al. (2014).

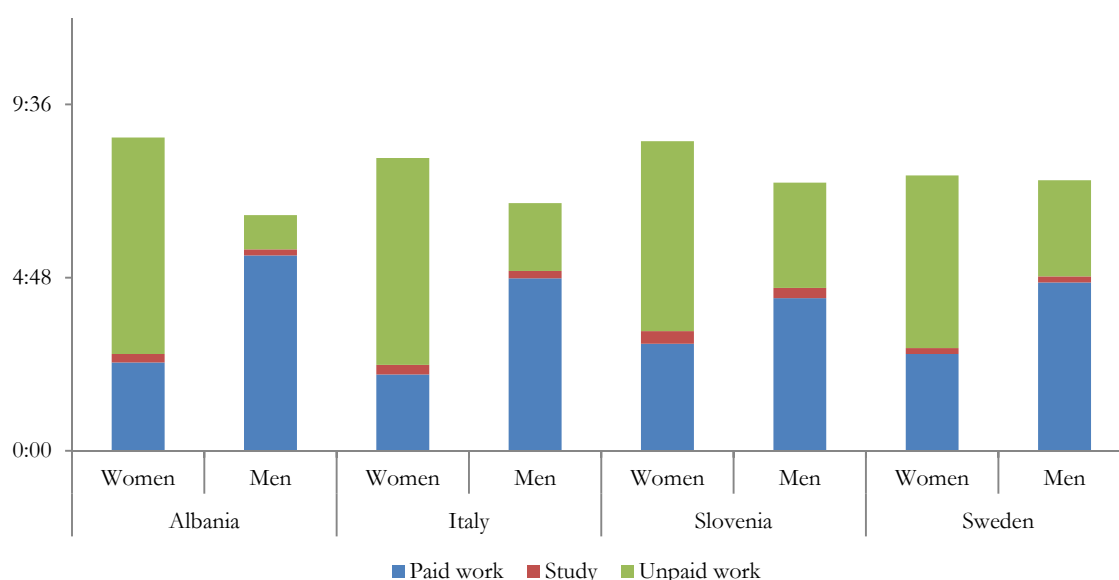
⁵⁹ World Bank calculation using LiTS 2010. The survey questions is “Some people, because of their job, position in the community or contacts, are asked by others to help influence decisions in their favour. In general, how important is it in our country to have the support of such people to influence decisions in the following situations? (a) to get a good job in the government sector; (b) to get a good job in the private sector.”

⁶⁰ 2012 LSMS.

⁶¹ The World Economic Forum gave a score of 1.86 to Albania on a scale of 1 through 7 (7 being the best score) in 2013–14, when reporting the ease “of obtaining a bank loan in your country with only a good business plan and no collateral.” See Schwab, Klaus, ed. 2013. *Insight Report: The Global Competitiveness Report 2013–2014*. Geneva: World Economic Forum.

the lack of urban planning are not conducive to the optimal use of land and space as a productive input by households and firms. Access to (and use of) to productive inputs such as land and natural resources or financial services: access to inputs represents an additional obstacle to (formal) employment (see below). For instance, Albania has one of the lowest scores in Europe and Central Asia in terms of the ease of obtaining a bank loan, and access to financing is considered one of the most problematic factors in doing business.⁶² The lack of access to finance limits the availability of poor and middle income households to afford formal housing and contributes to the growth of the informal housing sector. In addition, the land markets and the lack of urban planning are not conducive to the optimal use of land (and space) as a productive input by households and firms.

Figure 55: Average time spent on work and studies according to gender and country, population 20-74 years, hours



Source: INSTAT, Albania Time Use Survey 2010–2011.

Childcare and social norms: A relatively small share of children, particularly among the bottom quintile, are enrolled in preprimary school (see above). Because social norms across the region dictate that women are the main providers of child and elder care and household work, limited access to child care and less time available for work outside the home might represent barriers for women’s participation in productive employment. In Albania, similar to other countries in the region, women spend less time in paid work compared with unpaid work (**Figure 55**); among women with children under 6 years of age, the time spent on childcare-related activities is high, and such women perform more unpaid than paid work relative to other women. Evidence on European countries suggests that greater access to and affordability of childcare can positively impact female labor force participation.⁶² Attitudes toward women might affect even women who work by promoting gender segregation

⁶² World Bank. 2014. South East Europe: Regular Economic Report 7.

in the fields of study in education and in occupational choices. Discrimination may be partly captured in the observed adjusted wage gap, estimated at around 20 percent.

Migration and labor markets

International migration is high in Albania. From a share of 5 percent of the resident population in 1990 at the end of the communist era in Albania, the stock of emigrants rose to 40 percent, where it has remained since 2010. In 2013, almost 1.3 million Albanians were living outside the country, most of them in Greece (46 percent) and Italy (36 percent).⁶³ Compared with the global mean and regional averages, emigration rates in Albania are exceptionally high and a rather recent phenomenon (Table 2).

Table 2: Emigrants as share of source country population, and averages over country-groups, percent

Source country/region	1990	2000	2010	2013
Albania	3.64	23.80	39.95	39.66
SEE countries	13.17	22.65	24.26	25.44
Rest of Southern Europe	6.96	6.92	5.74	6.00
Rest of the World	2.66	2.60	2.99	3.03

Source: Computations based on data in Trends in International Migrant Stock (database), Population Division, Department of Economic and Social Affairs, United Nations, New York

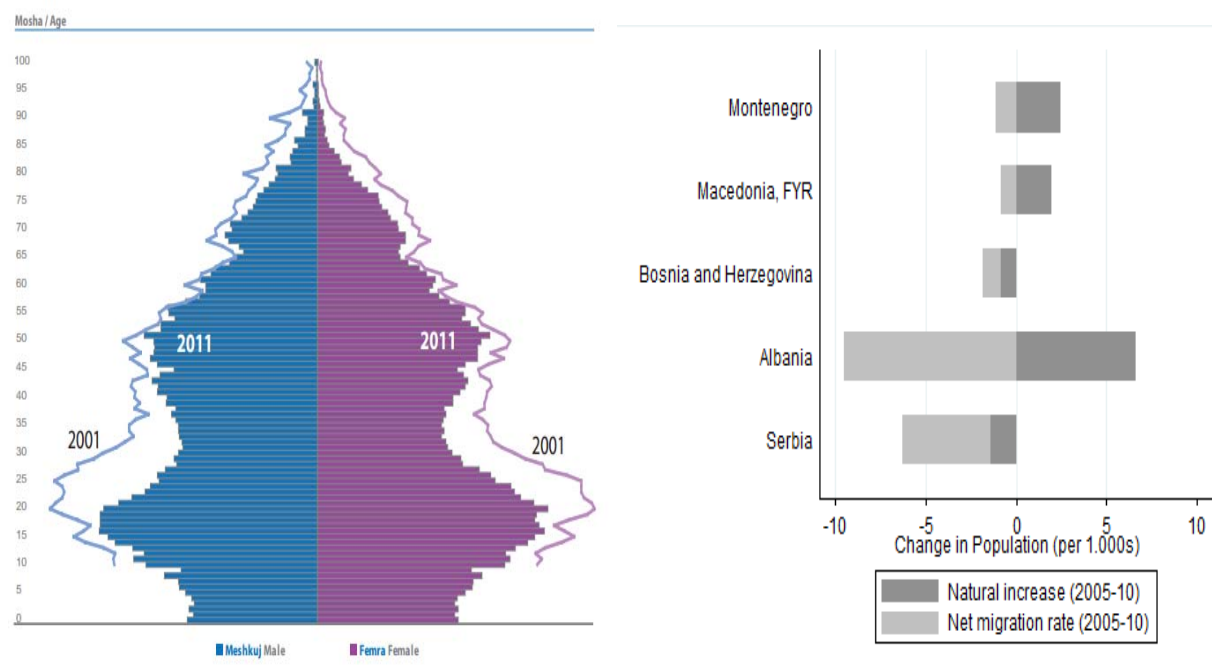
Largely because of migration, the resident population has declined, particularly among people of working age. The population pyramid in 2011 shows a decline since 2001, particularly among the 20-45 age-group (Figure 56). Although natural population increase (births relative to deaths) is comparably high in Albania, the population was around 2.8 million in 2011, compared with around 3.1 million in 2001. Decomposing the change in population into natural increase and net migration (immigration relative to emigration) shows that most of the decline in Southeast Europe in recent years can be attributed to negative net migration rates. Among other SEE countries, only in Serbia has population shrinkage more severe.

The high international migration rates in Albania, particularly among those of working-age and the more well educated, impact not only the human capital base, (and hence, the economic growth process of Albania), but also the capacity of the domestic labor market to create jobs and absorb labor. The proportion of individuals of working age is larger among emigrants than among the resident population, which results in a reduction of the labor force and higher old-age dependency ratios. Because migrants are relatively younger in the case of Albania, the resident population is older than the average emigrant, imposing additional fiscal challenges on the country. Moreover, the share of emigrants above the age of 25 who have completed secondary or tertiary education is considerably higher than the corresponding share among the

⁶³ On average, in 2000–11, around 5 percent of emigrants obtained a foreign nationality per year, which, over time, represents a considerable number of Albanians with new nationalities. See the Trends in International Migrant Stock (database), Population Division, Department of Economic and Social Affairs, United Nations, New York, <http://www.un.org/en/development/desa/population/publications/migration/migrant-stock-2013.shtml>

resident population (Figure 57), exacerbating the skills challenges of as well as affecting the labor market conditions in the country. Evidence shows that a large share of (returned) migrants went abroad to seek or take up employment opportunities: around 82 percent of male migrants (who comprise the majority of migrants) were working abroad (compared with around 40 percent of women), and 38 percent had a prearranged job. Few returned migrants left to pursue studies.⁶⁴ Given that migration is seemingly related to attractive labor market conditions abroad (especially for the better educated), part of the observed unemployment in Albania may be explained as the consequence of a high reservation price and part with the inability of the supply of skills to keep up with shifts in demand.⁶⁵ Last, but not least, the high education level of migrants also suggests that migrants are not largely comprised of the poor or the less well off.⁶⁶

Figure 56: Population pyramids from the 2001 and 2011 Censuses, and population change because of natural increase and net migration, 2005–10



Source: Data of INSTAT; World Population Prospects: The 2012 Revision (database), Population Division, Department of Economic and Social Affairs, United Nations, New York.

⁶⁴ Returned migrants are those who lived abroad more than three months at any time in their lives. Data are from the LSMS 2012 reported in a forthcoming gender note on Albania by the World Bank using LSMS data.

⁶⁵ This is to say that among those that have the opportunity to migrate, but remain in Albania, may have a high asking price before accepting a job. Further analytical work on “reservation wages” is needed to uncover some of the dynamics and links among unemployment, job creation, migration, and other factors.

⁶⁶ Similar data on other Southeast European countries show less evidence for a drain on human resources. In Bosnia and Herzegovina, FYR Macedonia, and Serbia, emigrants are characterized by similar or even lower levels of education than their resident counterparts.

Figure 57: Education of emigrants to OECD countries and of resident population by broad age-group, Albania, 2005

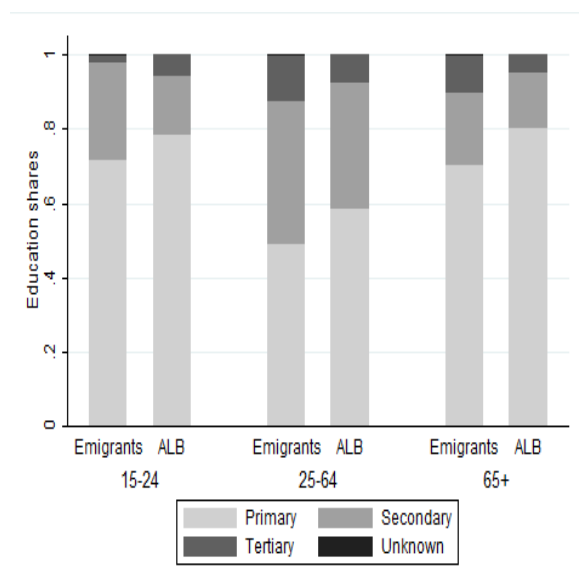


Figure 58: Men (left part) and women (right part) residents and emigrant population by education and age-group, Albania, 2005



Source: Computations based on Barro and Lee. 2013. Educational Attainment Dataset; DIOC (Database on Immigrants in OECD Countries), reference years 2005/06, Organisation for Economic Co-operation and Development, Paris.

Migration in Albania has differentiated gender and socioeconomic patterns. The migration of women and the migration of the poor and the bottom 40 are less prevalent, compared with the migration of men, the non-poor, and the more well off. Fewer women migrated for work (38.5 percent among women compared with 81.6 percent among men); they were more likely to go abroad with family to join a spouse. Nonetheless, migrant women are more likely to be from urban areas, of better socioeconomic status, and of higher educational attainment than migrant men.

These patterns affect the human capital base of the country and highlight the need to raise productivity in the economy to achieve the high income growth Albania aims for. The migration patterns also affect the economic opportunities available to individuals and households with certain characteristics. **Figure 58** approximates a hypothetical population pyramid that represents the demographic structure by gender, broad age-group, and education that could be observed if all emigrants to OECD countries returned to Albania or, alternatively, if they had never left the country. It is apparent that more men were lost to migration than women, and particularly the cohorts now between 25 and 64 years of age would be much larger. If all emigrants to OECD countries returned, the average human capital would grow, reversing the drain on human resources that Albania has experienced over the last three decades. The high out-migration puts even more emphasis on the need to shift the growth model toward raising the productivity of the economy.

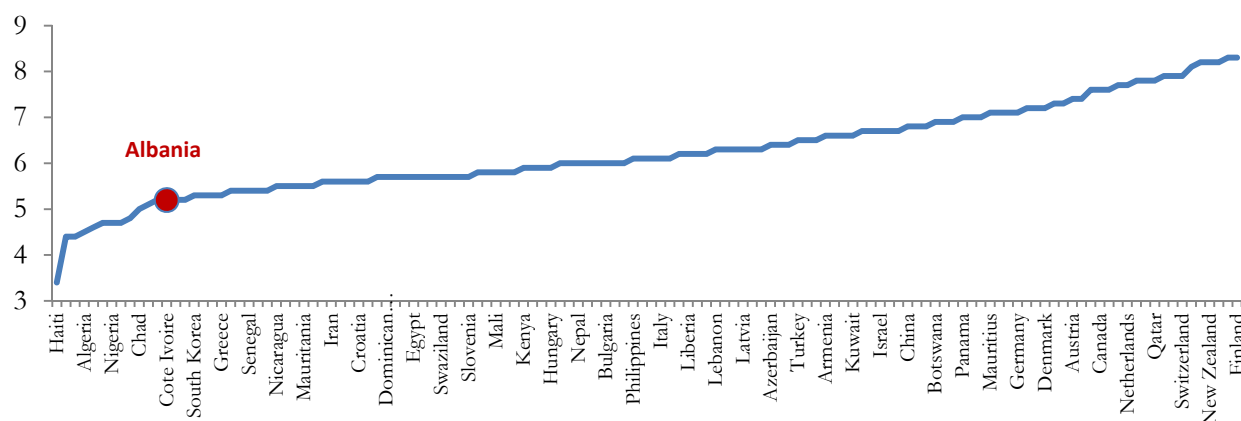
Land and Natural Resources as Productive Assets

Although Albania is endowed with rich natural diversity and abundant natural resources, their use as productive inputs by households and firms presents challenges. The beautiful coastline holds potential for tourism and economic development as one of the key drivers of growth. Yet, to realize this potential, the country needs a major upgrade in its environmental infrastructure, municipal services, improved planning, and the protection of coastal assets. Similarly, abundant hydro resources play a key role in the economy, but remain highly dependent on weather conditions, and therefore highly volatile. Albania has a high proportion of forest cover and fertile soils but most of the forest and pastureland is in poor condition. Fragile soils, combined with unsustainable forestry and agricultural practices have led to severe erosion, particularly in remote uphill areas where rural poverty is concentrated and persists. Erosion has also reduced the carrying capacity of pastures, decreased agricultural yields, and increased fertilizer costs on agricultural land, a worrisome trend given the large share of jobs that are dependent on agriculture. Upstream soil erosion and downstream sedimentation are causing problems with drainage, irrigation, power infrastructure, and flooding.

Insecure property rights issues are in the core of the inability of households and firms to use land endowments as productive assets. Albania has one of the lowest scores in the world in terms of property rights, particularly physical property rights (**Figure 59**). Similarly, it is ranked 137 in 148 countries in overall property rights, far behind neighboring countries such as FYR Macedonia (56), Montenegro (73), Bosnia and Herzegovina (105), and Serbia (130).⁶⁷ Albania is the second-worst performer in the Eastern Europe and Central Asia region with respect to registering property, ranking 118 globally. Widespread informality and the weak enforcement of property rights has limited the ability of owners to enter the formal property market, use property as collateral to obtain access to credit, or even to obtain utility services or protection from expropriation.

⁶⁷ Schwab, Klaus, ed. 2013. *Insight Report: The Global Competitiveness Report 2013–2014*. Geneva: World Economic Forum.

Figure 59: Physical Property Rights Index



Source: International Property Rights Index, <http://propertyrightsalliance.org>

Unresolved policy, legal and institutional issues are the key impediments to secure property rights.

Although Albania made rapid progress in post-1991 land reform and privatization programs, challenges remain due to unrealistic land policy, an incoherent legal framework, fragmented institutional responsibility, and a land administration system that has not been modernized. Specifically:

- Land Policy:* Albania has committed itself to an unrealistic financial obligation for restitution of property nationalized under the socialist regime. It has set the standard for compensation at full, current market value of nationalized properties. Albania is the only country in the region to set such high and unrealistic standards. In addition, the delayed implementation of legalization of land increases tenure insecurity. Overall, a comprehensive integrated land management policy and legal framework would help resolve and harmonize the remaining land reform and policy issues. It will be critical to guide urban planning and management, agriculture and rural development, forestry and tourism to improve land management and land use.
- Land Administration:* There is a large amount of unresolved property claims; almost 70 percent of all civil cases pending in Albanian courts and a large number of cases at the European Court of Human Rights involve land disputes. This is partly a reflection of the existence of manual property registration systems. Almost 80 percent of the property registration data in Albania is paper-based, outdated, and of unreliable quality. Lack of digitalization and poor quality in the underlying maps and data are among the key constraints to the operation of land markets in Albania. While the Immovable Property Registration (IPRO) performs the national land administration function, further modernization and strengthening are needed to build a professional and transparent agency. Although the IPRO has developed a modern IT system, less than 10% of the properties in the country are digitally registered.

Reliable IPRO data are also key for development of the National Spatial Data Infrastructure in compliance with the EU Directive related to spatial data.

- *Institutional Aspects:* Overall, the institution structure for administration of property rights requires consolidation and better management. There are too many institutions responsible for allocating and managing immovable property which has led to gaps and overlaps in responsibility and weak coordination. Ultimately, it would be more efficient to consolidate authority and responsibility to a single authority.

Weak enforcement of property rights has led to uncontrollable growth of informal settlements in urban areas, hampering the efficiencies in the use of land and space in cities. The process of transition to market economy in Albania was reflected in an intense and unplanned urbanization of Albanian cities (also discussed in Block 1). It is estimated that between 1992 and 1996 the informal sector provided 60 percent of the total number of houses built by the private sector.⁶⁸ This has led to inefficiencies in the allocation of land, land use and space (density) which have led to reducing the benefits of agglomeration. Lack of urban planning, reflected in the rapid informal growth of urban areas, has therefore undermined the growth potential of Albanian cities (**Figure 12**). It is estimated that only 0.6 percent of the country's territory has a development plan and only 30 of the 373 local government units count with territorial development plans.⁶⁹

Poor enforcement of property rights has also impeded the farm consolidation process in rural areas. The land privatization process has resulted in a large number of tiny and scattered farms, holding back the development of the agricultural sector. As of 2012, there were 350,916 agricultural holdings in Albania, averaging 1.02 ha.⁷⁰ Each farm unit operates on about 4.9 dispersed parcels of 0.2 ha each. Such production structures lack technical and economic efficiency. Farm fragmentation has not yet been overcome by collective action at input supply and/or marketing levels. Producer associations are very weak, and the few groups that were established were mainly donor-driven and not sustainable.⁷¹

Most farmers remain locked in low-income, subsistence structures, unable to utilize their land assets to generate economic gains. For the privately-owned land, leasing is at very low levels, estimated at 6 to 10 percent in 2013, and is mostly informal.⁷² The sales of agricultural land are even lower, with less than 2 percent of the rural households having sold their land on the formal market.⁷³ While almost all holdings report selling

⁶⁸ UNECE (2002), Albania Country Profile on the Housing Sector

⁶⁹ On the planning side, the Government has undertaken recent reforms aimed at achieving a more sustainable urban development. In 2009, it passed a law on Territorial Planning which required all local government units LGUs to have a territorial plan. A second law was passed in July, 2014 to further define the roles and responsibilities in planning of LGUs.

⁷⁰ The average farm size remained relatively stagnant over the years, fluctuating between 1 and 1.25 ha over 2000-2012. Similarly, the average size of parcels stayed virtually unchanged.

⁷¹ Kola, R., Skreli, E., Osmani, M. and A. Tanku. (2014). *Farmers' characteristics as determinants of collective action: the case of greenhouse producers in Albania*. New Medit, Vol. 13:2.

⁷² Ministry of Agriculture, Food and Consumer Protection, 2013

⁷³ USAID, Albania – [Property Rights and Resource Governance Profile](#), 2012

some of their output, primarily on the local markets, the amounts sold and the resulting incomes are marginal. The average yearly monetary gross income from sales per farm is estimated at EUR 2,221 in 2012 (Table 3), with livestock accounting for 54 percent, and field crops for 30 percent. With an average farm household of 4.5 people, this only translates into gross revenue of EUR 1.4 a day per person. Most holdings (86 percent) are engaged in mixed farming systems that combine crops and livestock. Incomes from products processed on-farm are rather negligible: they account for only 8 percent of the total gross income from sales, and are mainly generated by brandy (*raki*), cheese and wine.

Table 3: The number and distribution of farms, according to their gross annual revenues, 2012

Gross income range	Total farms (number)	Farms with sales (number)	Gross income per farm
0-10,000	16,726	5,258	1,697
10,001-100,000	77,246	77,246	57,040
100,001-400,000	168,234	168,234	228,359
>400,000	88,710	88,710	744,261

Source: INSTAT, exchange rate of 1 EUR=140 ALL for 2012

Some groups, such as women and the less well off, are at an additional disadvantage because they are excluded from landownership. There are almost twice as many men landowners than women landowners, and most women landowners have a property share of less than 25 percent.⁷⁴ Current administrative procedures of land legalization and registration exacerbate the gender inequalities in landownership.⁷⁵ Furthermore, the bottom 40 and the poor count on smaller plots relative to the rest of the population, also limiting their ability to use these endowments to produce market income. Efforts to increase formalization, some under way, could promote not only investment and growth, but also social inclusion, help streamline property tax collection by making it more equitable and transparent, and provide an important source of income to local governments that can be invested on improved services.⁷⁶

Capital Allocation, Financial Assets, and Financial Intermediation

Gross fixed capital formation was a key driver of the precrisis growth boom of Albania. Gross fixed capital formation expanded, on average, by 13.3 percent in 2000–08 and accounted for an average of 25 percent of output. In the period 2000–08, some 80 percent of total investment originated in the private sector. Private investment grew by an average of 10 percent a year, reflecting to a large extent a boom in construction. Public investment, at 17 percent of gross fixed capital formation, rose even more quickly, at a 13 percent annual

⁷⁴ This disparity translates into mortgages: two-thirds of mortgages are taken out by men, and one-third by women.

⁷⁵ The current administrative procedure of land legalization and registration that establishes an almost invariably man-head of household or family head as the sole agent and representative on land issues contributes to the systematic decline in women property owners. As these practices continue, the chances are high that property (housing and land) will be increasingly owned by men.

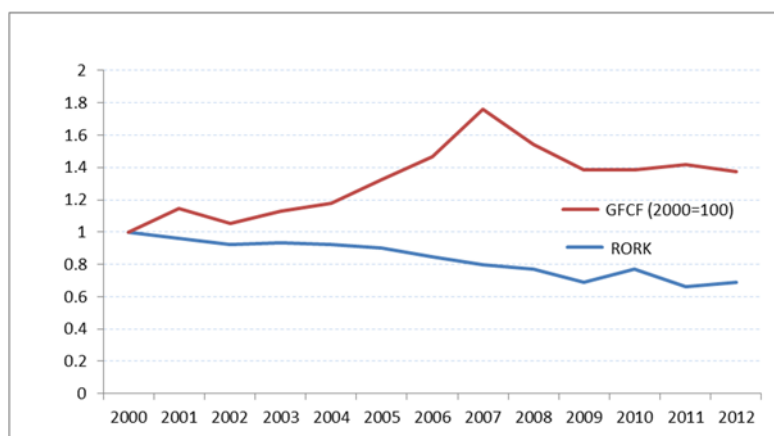
⁷⁶ The government has launched an ambitious legalization program through ALUIZNI, a government entity that is helping to bring several informally owned properties—most occupied by the poor—into the formal sector.

average. The capital spending expanded at a rate of 6.6 percent. The bulk of capital spending (about 60 percent) went to the transport sector for new road construction, not for the maintenance of existing infrastructure.

Overall, investment declined to an average of 1.2 percent a year between 2009 and 2014. Shrinking revenue and the need for substantial downward adjustment of spending meant that most of the adjustment burden after 2008 was borne by capital expenditure, one of the few discretionary items in the budget. Public investment contracted by an average of 5.8 percent per annum from 2009 to 2014. Private investment also decelerated to an annual average of 0.35 percent, due to overall slowdown of the economy and the contraction in the construction industry.

Returns on investment are low in Albania, and they have been on a steep declining path over the past decade and a half. Rates of return on capital (RORKs) have declined by over 30 percent since 2000, while investment has been steadily increasing (Figure 60). The notable boost in investment prior to 2008 coincided with the boom in the construction industry in the private sector, and in the public sector, it was the start of building of new roads. Steeply declining RORKs indicate an increasing opportunity cost of capital.

Figure 60: Gross fixed capital formation and RORKs, Albania, 2000–12, Index 2000=1000



Source: World Bank calculations, based on Penn World Tables.

While Albania enjoys high levels of capital stock per capita, inefficient use results in returns on capital investments that are significantly lower than expected given its level of income per capita. The strong rate of growth in investment led to per capita capital stock at comparatively higher levels relative to countries with similar income per capita (Figure 61). Theoretically, under the neoclassical assumptions of diminishing returns, one should observe a negative relationship between the RORK and a country's income per capita.⁷⁷ Indeed, a negative relationship between RORKs and per capita GDP holds on average for countries in Europe

⁷⁷ In essence, the RORK measures the contribution of investment to economic growth, that is, the RORK provides a basis for assessing the contribution of capital investment to the growth process. (See Solow, R. 1956. "A Contribution to the Theory of Economic Growth." *Quarterly Journal of Economics* 70 (1): 65–94.)

(Figure 62). Notable deviations from the expected average RORKs are Albania and Germany. In the case of the latter (placed above estimated RORK regression line), this indicates that fundamentals and reform policies have been associated with higher (than predicted by its income level) rate of return on capital investment. In contrast, in the case of Albania, economic and institutional fundamentals have stifled the generation of profitable activities in the country. Albania's rate of return on capital is significantly lower (over 35 percent) than the rate predicted by its income per capita levels. Emerging European economies such as the Baltic states, the Czech Republic, or Poland, have RORKs two to three times the size of Albania's, despite their significantly higher income per capita.

Figure 61: Income and Capital Stock Per Capita, 2012

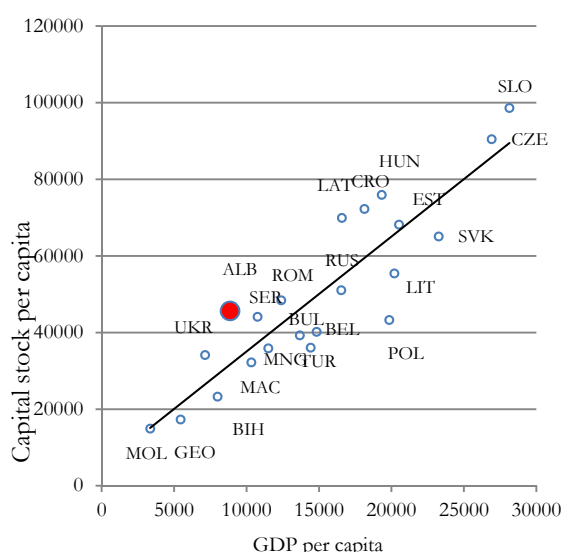
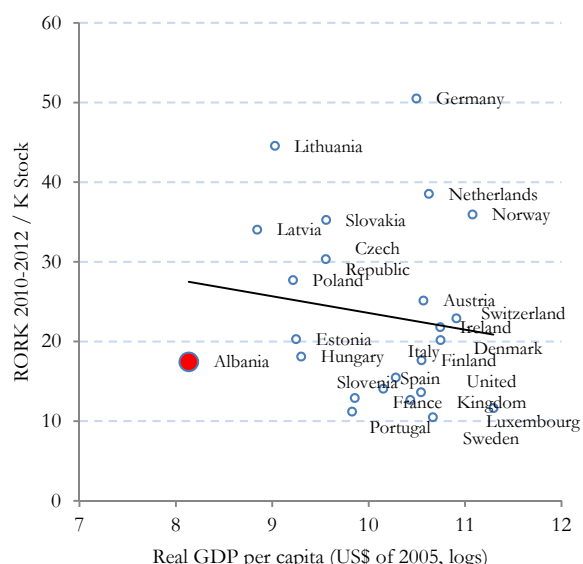


Figure 62: RORK vs per Capita GDP, 2010–12



Source: World Bank calculations, based on Penn World Tables.

Weaknesses in capital investment management partly explain the low returns on public investment.

Capital investment exhibits two key weaknesses that inhibit the efficient use of the capital factor of production:⁷⁸

- First, the **prioritization** of capital projects, particularly those funded through domestic sources, does not appear to be on robust grounds. The key weaknesses stem from the fact that the full cost of investments is not considered during the approval process. Major investment projects are discussed by the Strategic Planning Committee within the Prime Minister's Office, with input from the Ministry of Finance. However, because the preparation of multiyear plans, the screening and approval of investments, and the drafting of

⁷⁸ For a detailed discussion, see World Bank (2014) "Albania Public Finance Review."

annual budgets are not fully integrated, the management of public investment is inefficient. Despite the closer links between capital investment and integrated planning, a significant number of unplanned projects are introduced late in the budget process without a comprehensive assessment. Cost-benefit analyses, better prioritization, and monitoring and evaluation can help improve the management of capital investment.

- Second, while the focus in the past two decades has been on building new roads, spending on infrastructure **maintenance** is not sufficient. There is a considerable backlog of maintenance and other infrastructure projects (for example, hydropower and roads). A shift toward maintenance and rehabilitation is critical for preserving infrastructure and supporting growth over the medium term.

The inefficient use of capital reflects institutional weaknesses in the intermediation of financial resources. The financial sector, dominated by foreign eurozone banks, has achieved notable growth since 2000.⁷⁹ Foreign banks control over 90 percent of the market. Although the foreign banks are large for the Albanian market, they represent a negligible share in the asset structure of their parent banks. As a result, the Albanian banking sector infrastructure is exposed to policy and managerial decisions of parent banks. Capital markets are rather underdeveloped, though investment funds launched in late 2011 had grown to over \$600 million in value by the end of June 2014. There is virtually no other capital market activity. Corporate bond and equity markets, which have become a major source of investment financing in many other middle-income economies, as well as nonbank financial institutions are at a nascent stage of development. The presence of private equity and venture capital funds is minimal as evidenced by Albania's low rank (106) in the venture capital and private equity attractiveness index.⁸⁰

Despite the rapid acceleration in the intermediation of financial resources through the banking sector, sustainable access to finance is considered one of the most problematic issues among businesses in Albania. Credit to the private sector grew from less than 4.4 percent of GDP in 2000 to 40.2 percent in 2013, supporting the rapid pace of investment growth (**Figure 63**). Yet Albania fares poorly against worldwide comparators on the availability and affordability of financial services, ease of access to loans, and overall financial market development.⁸¹

⁷⁹ Austrian and Italian banks control 40 percent of the market. Greek banks hold between 15 and 20 percent. One Turkish bank holds almost 20 percent of the market, and two subsidiaries of French banks hold 14 percent. Banks in Bulgaria, Germany, Kuwait, Malaysia, and Saudi Arabia have smaller market shares.

⁸⁰ IESE Business School publication sponsored by Ernst and Young.

⁸¹ Schwab, Klaus, ed. 2013. Insight Report: The Global Competitiveness Report 2013–2014. Geneva: World Economic Forum.

Figure 63: Credit to private sector, percent of GDP

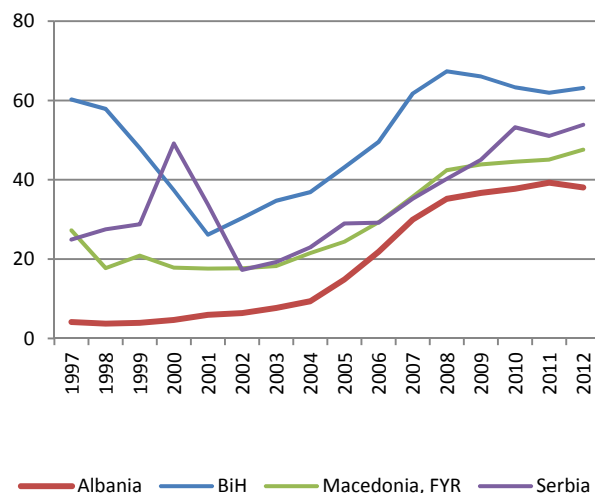
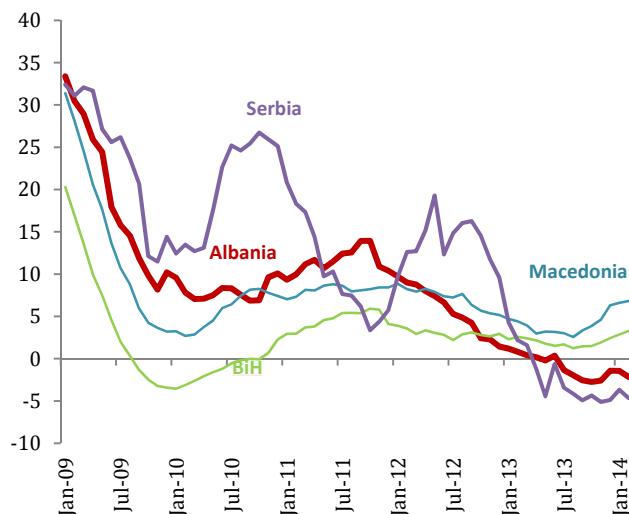


Figure 64: Private credit growth, year-on-year, percent

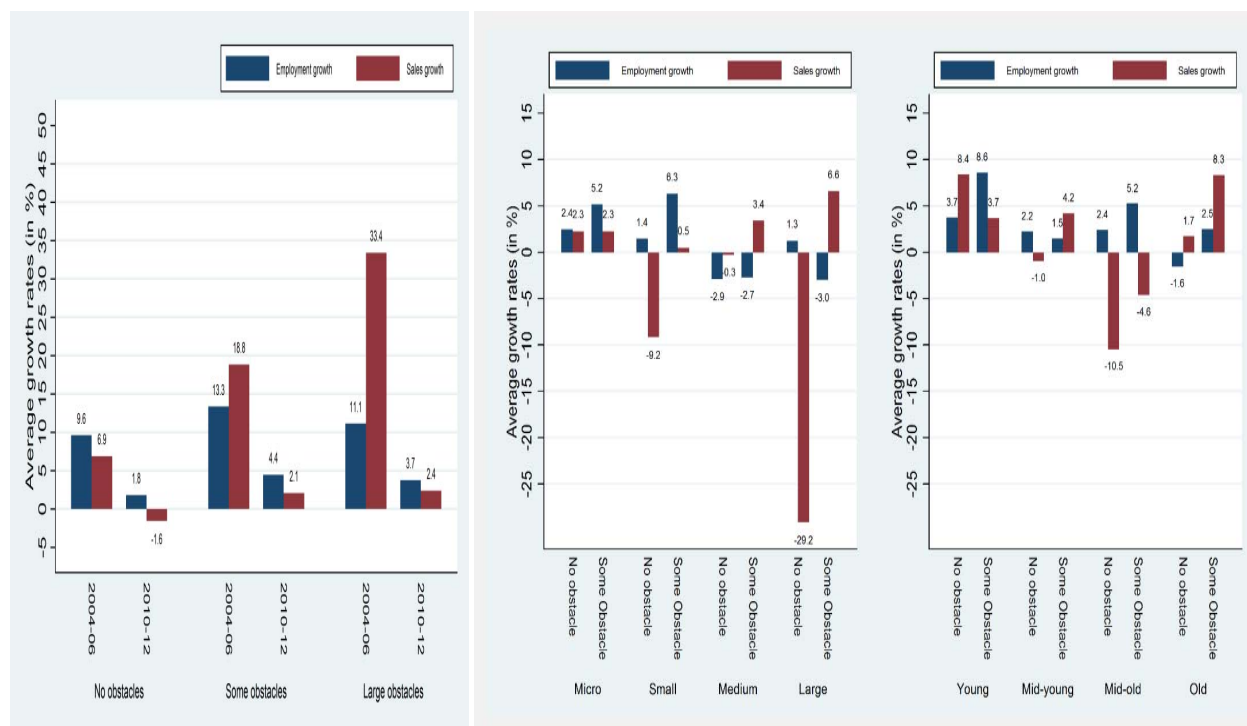


Sources: International Financial Statistics (database), International Monetary Fund, Washington, DC; WDI (World Development Indicators) (database), World Bank, Washington, DC.

Limited access to financial intermediation services negatively affects the ability of firms and households to generate and accumulate financial assets. The latest enterprise survey on Albania reveals that limited access to financial resources is considered an important business environment constraint. Compared with other countries in the Europe and Central Asia region, fewer firms in Albania have a checking or savings account or a bank loan or credit line, and a higher proportion of loans require collateral, which is often set at a higher average value.⁸² Access to finance constrains the most dynamic firms relatively more (Figure 65). Firms that considered limited access to finance as a major or a severe obstacle to doing business exhibited the largest annual average sales growth rates in 2004–06 and increases in employment and sales of more than 10 percent a year. By contrast, firms that do not consider limited access to financial resources as a barrier to doing business increased their employment by only 1.8 percent a year in 2010–12 and an annual average sales decline of 1.6 percent after the crisis. This suggests that lack of access to finance can represent a major obstacle to the operations of thriving firms. This outcome has also been observed across firms of different sizes and ages. Older firms that report they face financial constraints show better performance in sales, while microenterprises and young firms affected by financial restrictions after the recent eurozone crisis, namely, the more rigorous credit underwriting standards adopted by banks, have experienced more rapid employment growth (Figure 65).

⁸² BEEPS (Business Environment and Enterprise Performance Survey) (database), European Bank for Reconstruction and Development and World Bank, London.

Figure 65: Average employment and sales growth by perceived access to finance barriers in Albania, 2004–06 and 2010–12 (left), and firm size (center) and firm age (right) in 2010–12

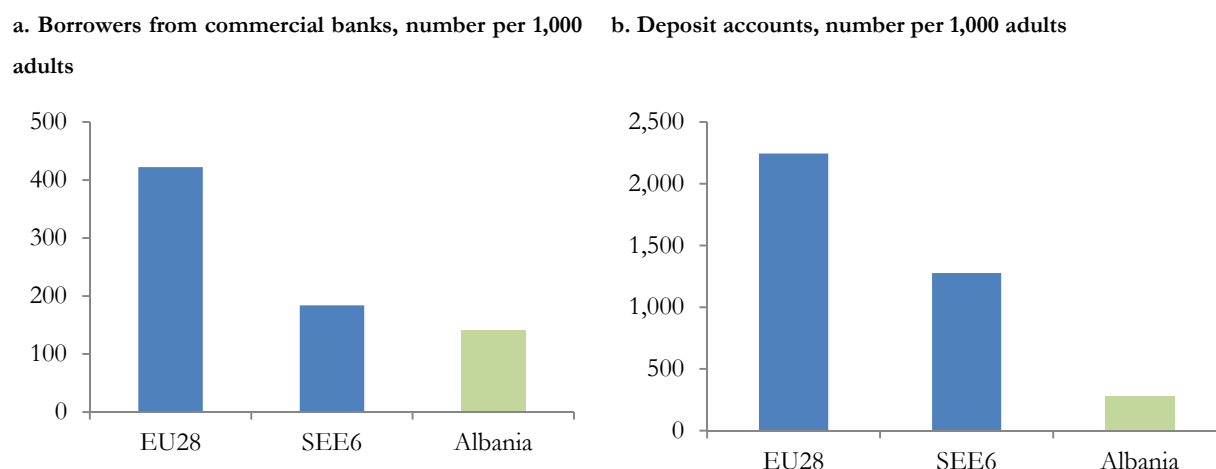


Source: Data in BEEPS (Business Environment and Enterprise Performance Survey) (database), European Bank for Reconstruction and Development and World Bank, London.

Among households, the overall access to financial services is relatively narrow. Measuring access to financial services by the penetration of bank branches throughout the country, one finds that Albania performs less well than other countries in the region. Albania had 22 branches per 100,000 adults in 2012 compared with the average of 29 in the rest of the SEE6 and 36 in the EU. Low population density makes the provision of traditional banking services outside of the capital city costly and less efficient. There were 140 borrowers from commercial banks per 1,000 adults in Albania in 2012, compared with an average of 184 in SEE6 and 442 in the EU (Figure 66a). There were also more than 280 deposit accounts per 1,000 adults, compared with 1,277 in the SEE6 and 2,245 in the EU (Figure 66b).⁸³ Nonetheless, the 126 deposit-gathering Savings and Credit Associations and 6 other non-deposit-taking microfinance entities fulfill a vital role in the provision of financial services, predominately in rural areas, because most of their branches are located outside Tirana. Moreover, 32,600 investment fund holders have been added to the financial sector since early 2012 when the first fund was registered, indicating a welcome shift in the views of (former) deposit holders.

⁸³ Country group comparators in this paragraph exclude Albania from SEE6 and Malta and Cyprus from EU, respectively.

Figure 66: Borrowers from commercial banks and deposit accounts in Albania, SEE6 and EU, 2012



Source: FAS (Financial Access Survey) (database), International Monetary Fund, Washington, DC.

Access to financial services and deposit penetration are more constrained among some population groups, including the poor, the bottom 40, and women. The stock of financial assets is lower among the less well off. Around 16 percent of people in the bottom 40 (aged 15 and over) had accumulated some savings in the previous year; among the top 60, the corresponding share was 27 percent. The share of the borrowing population that falls within the bottom 40 is one of the lowest in Europe and Central Asia.⁸⁴ The bottom 40 are half as likely to put their savings in financial institutions compared with the top 60.⁸⁵ Gender gaps also exist in access to financial services. Fewer women have accounts in formal financial institutions. Moreover, the gender gap in the access to property rights represents an obstacle for women seeking to access financial resources because relatively fewer women can supply collateral or a payment history (see above).

The significant presence of NPLs limits the efficient use of financial assets, including for entrepreneurial activities, but also diminishes the interest of banks in lending in an environment of deteriorating asset quality. The worrisome level of 24 percent of NPLs in early 2014 reflects weaknesses in the corporate sector, where the rate of corporate NPLs (especially in foreign currency) is significantly higher than the rate of household NPLs (Figure 67). Some corporate balance sheets have been strained through the long-standing accumulation of government arrears, which have impacted corporate liquidity.

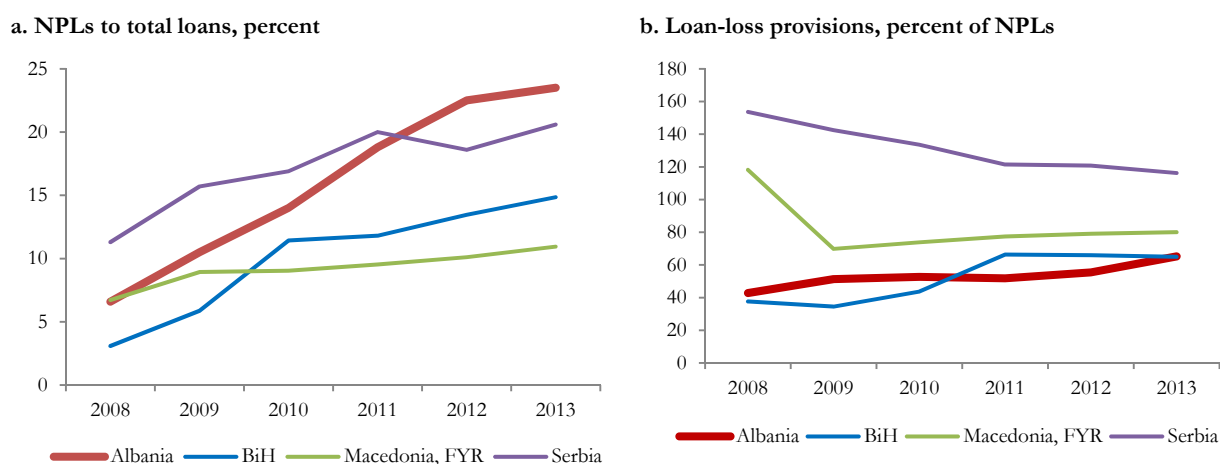
There is a need to accelerate the adoption of legal, tax, and prudential means to reduce the stock and flow of NPLs. High levels of NPLs have undermined bank earnings and capitalization and the ability and willingness of banks to extend new loans. The authorities have adopted a number of measures to strengthen

⁸⁴ Bussolo and López-Calva (2014) with data from LiTS 2010 (Life in Transition Survey), European Bank for Reconstruction and Development and World Bank, <http://www.ebrd.com/pages/research/economics/data/lits.shtml>.

⁸⁵ Global Financial Inclusion (Global Findex) Database, World Bank, Washington, DC, www.worldbank.org/globalfindex.

the NPL prudential, restructuring, and enforcement framework and resolve long-standing tax ambiguities on loan write-offs (see **Box 4**). Nonetheless, far reaching legislative, regulatory and judicial reforms are needed to improve the insolvency regime, collateral execution, and private bailiff incentive structure. The 2002 bankruptcy law (as amended in 2009), which draws most of its provisions from an old version of the German Insolvency Code, has rarely been used as a restructuring tool and is mostly employed by the tax authorities as a tax collection tool. This can be explained by the high complexity of the current provisions in the insolvency law and the absence of qualified professionals (judges, insolvency practitioners, lawyers, and so on), who can successfully apply them. Consequently, the number of restructurings is low and creditors struggle to recover their loans. Enforcement systems are also weak and the role of the judiciary is undermined by lack of experienced judges. As a result, it takes 525 days to enforce a contract and more than two years to resolve insolvency, as the Doing Business 2015 report highlights. The transparency, disclosure practices, and role of bank and firm boards of directors are weak as well.

Figure 67: Nonperforming Loans and Loan-loss provisions, four countries, 2008-13



Source: Financial Soundness Indicators (database), International Monetary Fund, Washington, DC.

Box 4: NPL Resolution

With the help of international partners, the Bank of Albania has embarked on the development of a set of measures to facilitate the reduction of NPLs.^a The aim of the measures is to create the tools and incentives necessary to facilitate the establishment of sustainable debt servicing capabilities among operationally viable borrowers through appropriate financial and corporate restructuring. The program involves (1) an NPL mapping exercise and (2) the development of individual NPL recovery plans for the largest defaulted corporate borrowers. The mapping exercise covered approximately half of the banking system's portfolio of corporate loans classified as B, C, and D. (Loans classified E were excluded because they were considered to have little or no recovery potential.) The banks classified their corporate NPLs into three categories: (1) loans that can return to sustainable debt servicing through financial or operational restructuring, (2) loans that are likely to return to nonperforming status following earlier unsuccessful restructuring, and (3) the residual portfolio of nonviable borrowers that require accelerated collection and collateral enforcement.

After the conclusion of the mapping exercise, a pilot program was instituted to help participating banks develop multicreditor recovery plans for the country's largest defaulted groups. This initiative is coordinated by the Bank of Albania, with support from the World Bank, and includes extensive training on financial and operational restructuring, as well as external feasibility assessment by restructuring specialists. More broadly, the Bank of Albania and the government have initiated a range of reforms to support the resolution of NPLs through legislative, procedural and taxation remedies.^a To date, the main achievements include the following:

1. Shortening and simplifying collateral enforcement procedures. Amendments to the Civil Procedure Code aim to shorten and simplify collateral enforcement procedures and significantly reduce the court's right to intervene in enforcement or foreclosure on real property. In addition, the Ministry of Justice and the Ministry of Finance issued a joint instruction on private bailiff fees, which provides for a clearer incentive fee structure for private bailiffs.
2. Strengthening prudential regulations. The Bank of Albania adopted prudential measures to increase the effectiveness of risk-based supervision, and the nonbank regulatory authority strengthened its independence and capacity to supervise the burgeoning investment fund sector.
3. Improving methodologies for voluntary debt restructuring and collateral appraisal. New guidelines have been published by the Bank of Albania to provide more consistent market expectations toward both debt restructuring and collateral valuation.
4. Reducing tax ambiguities with regard to the write-off of unrecoverable NPLs. Banks continue to keep on their balance sheets a significant portion of unrecoverable problem loans that have been under litigation. Parliament adopted amendments to the Tax Law that clarify the conditions under which banks can write off NPLs through litigation. The Ministry of Finance, on behalf of the Tax Authority, clarified the tax treatment of loans in protracted litigation.

a. The World Bank's Vienna Financial Sector Advisory Centre has been engaged in Albania since late 2012 under the Albania NPL Resolution Project.

b. The International Finance Corporation has been engaged for 2 years with the Ministry of Justice of Albania and the Bankruptcy Supervisory Agency through the Debt Resolution and Insolvency Program, part of the new joint World Bank/International Finance Corporation Finance and Markets Global Practice The Debt Resolution and Insolvency Program assists countries in improving their bankruptcy, insolvency, debt recovery and alternative dispute resolution (ADR) systems.

Emerging Issues

While Albania is endowed with human, natural and physical resources, which can propel the economy, their use remains inefficient. The agenda for strengthening the asset base is vast:

- On the **human capital** side, areas to promote the accumulation and better use of human capital may include a wide span of policy measures. For example: expanding the access to and quality of preprimary education; better regulation of the expansion of tertiary education to assure quality and to align the sector with population trends and country needs; lowering patient financial risks, better preventive medicine and primary care and providing equitable access and quality health care services. Strengthening the quality of human capital will increase the skilled labor in the labor force, and therefore, boost productivity through

employing a healthier and better skilled workforce. An increase in the quality of human capital can also contribute directly to the welfare of the poor (for example, by reducing the impact of catastrophic spending on poverty). However, efforts should be focused on narrowing the policy priorities to measures that directly contribute to raising the quality and equity in access to education; lowering patient financial risks, while improving the quality of health care; and improving the incentives for formal employment, including of vulnerable groups.

- With respect to **physical capital**, consistently declining rates of return on capital raise broad questions about the opportunity cost of resources. Consistently falling returns on capital discourages private investment flows, especially from abroad, puts a burden on public finances, and ultimately lowers economic growth. While broad improvements of the environment for investment helps attract more capital (see Block 3), strengthening the management of capital investment can bring large efficiency gains. Higher returns on investment could in turn contribute to the sustainable maintenance of assets. Narrow measures such as ensuring that all public projects are subject to proper assessment and prioritization as well as overcoming the considerable backlog of maintenance and rehabilitation of infrastructure will boost returns. Moreover, weaknesses in financial intermediation, including equitable access to financial markets, are some of the key areas (which if improved) could support the more efficient use of capital.
- Improving the **natural resources** base (land and space) to support a productive, competitive and inclusive growth model requires sustainable use of natural resources and stewardship of the environment. Protecting the natural endowments and effectively integrating them in the economy is a foundation for sustainable growth. Engendering environmental sustainability and avoiding irreversible degradation is beneficial for both the preservation of existing nature-based jobs and livelihoods as well as for the development of key economic sectors (energy, agriculture, tourism).

Strengthening the productivity and competitiveness of the economy is also closely intertwined with fostering improvements in the way markets operate. Well-functioning labor and land markets facilitate the efficient accumulation and use of assets through which firms and households generate economic gains.

Given the low **labor market** engagement in Albania (significant informality and a substantial proportion of unpaid family workers), particularly among youth, women, minorities, and the bottom 40, and the decline in remittances, the market income generating capacity of households must be strengthened. This will require broad-range policies of: aligning labor supply with the needs of the labor market for the creation of more (formal) jobs and as well as developing a skilled labor force needed not only for boosting firm-level productivity and attracting investment, but also to increase access to higher productivity and better paying employment opportunities for the population. Although a significant knowledge gap exists to understand the constraints to a well-functioning labor market, evidence suggests that among the key obstacles to a well-functioning labor market are the prevalent disincentive and barriers to employment among women, youth, minorities and

disadvantaged groups. Focusing the policy agenda on improving the incentives to formal employment is key to strengthening the quality of market engagement of households in Albania.

Poor enforcement of property rights presents the key obstacle for firms and households to enter the **land market** with direct consequences not only for land ownership, but also for income generation and poverty. Lack of well-functioning land markets has brought broad negative impacts both on rural development (as evidenced by high farm fragmentation) and on urban development (as evidenced by the uncontrollable growth of urban settlements). Comprehensive land policy reform is needed to increase formalization, promote inclusion, as well as to address land compensation and property valuation schemes. Focusing this agenda on improved national territorial planning to all territorial governments will help with fostering efficiency and equity in the use of land and space.

BLOCK 3: ENABLING FACTORS FOR THE ACCUMULATION AND BETTER USE OF ENDOWMENTS

A strong institutional and business environment, the efficient provision of public services, and the availability of institutions to protect the poor and vulnerable have the potential to promote the accumulation and use of Albania's assets and endowments. This section focuses on whether this is the case in Albania overall by also applying an equity lens. The main finding is that all three are ineffective in supporting the buildup and efficient use of assets by firms and households. However, all three have the potential to do so if reforms are undertaken to improve governance, strengthen institutions, promote well-functioning markets, improve the efficiency of resource allocation in the economy, improve access and equity in basic services, and ensure adequate protection for vulnerable and poor households.

Quality of Institutions

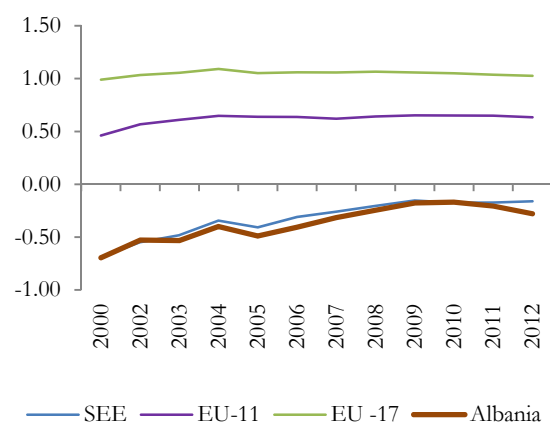
Weak governance institutions inhibit the ability of households and firms to generate economic gains in a sustainable way. Good governance and strong institutional capacity support the effective accumulation and efficient use of assets. Albania needs to strengthen institutions and overcome the significant governance gap with its neighbors and the EU. It achieved steady, positive improvement in a variety of governance indicators during the first decade of the 21st century, albeit from a low base (Figure 68). However, in 2010–12, all the world governance indicators (except political stability) revealed a reversal in the trend.⁸⁶ In 2013, the indicators stabilized or worsened. Political stability was the exception: it showed an increase, possibly attributable to the election of a new government in 2013. This deterioration in the governance climate is consistent across a broad range of governance indicators that rely on a variety of methodologies (Figure 69). The decrease was both absolute and relative because Albania fell further behind the regional averages for all the indicators except voice and accountability and regulatory quality, areas where Albania has generally seen the most improvement. At the same time, the deterioration over these years has left Albania with a significant gap relative to its neighbors and the EU in the ability to establish an effective and efficient judicial system (rule of law) and control corruption.

Weak rule of law -- because of uneven enforcement of laws and regulations and chronic tax avoidance -- represents the key governance risk today. The negative trend in governance indicators is most pronounced in areas that require an effective and efficient judicial system and the consistent application of laws and regulations. A weak and politicized judiciary raises concerns among citizens, firms and potential foreign investors about the credibility of contract enforcement. Issues of independence and depoliticization of

⁸⁶ WGI (World Governance Indicators) (database), World Bank, Washington, DC, <http://info.worldbank.org/governance/wgi/index.aspx#home>.

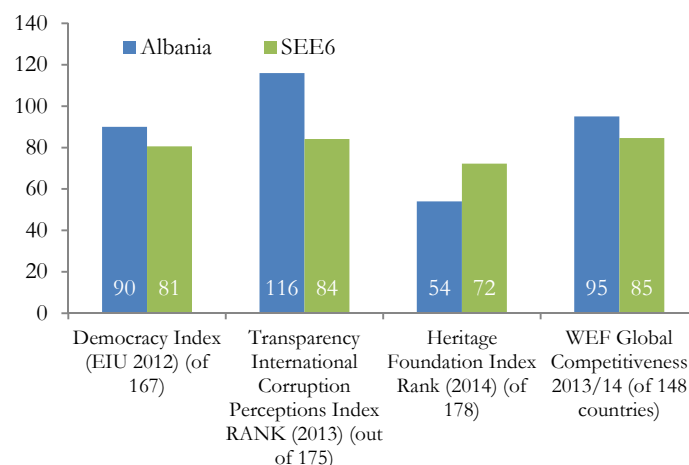
institutions, such as the High State Control, are also present.⁸⁷ The Bank of Albania alleged embezzlement of funds in September 2014 puts in question strength of internal controls in the institution.⁸⁸

Figure 68: World Governance Indicators, 2000-12



Source: WGI (World Governance Indicators) (database), World Bank, Washington, DC
 Note: The indicators range from -2.5 = worst to +2.5 = best.

Figure 69: Governance Indicators



Sources: 2014 Index of Economic Freedom (database), Heritage Foundation, Washington, DC; CPI (Corruption Perceptions Index) (database); Transparency International, London;; Democracy Index 2012 (database), Economist Intelligence Unit, London; Schwab, Klaus, ed. 2013.
 Note: Each indicator ranks those countries covered by the source (with a total number of countries indicated in brackets). A lower ranking indicates a country has better relative governance.

Albania continues to lag on several broad governance and institutional fronts, including the comprehensive implementation of newly devised strategies, the effective enforcement of new laws and regulations, and the passage of draft laws by legislators. The European Commission's June 2014 progress report noted that, over the previous eight months, Albania had drafted or adopted a number of laws (for example, a draft law on access to information and amendments to Civil Procedures and laws on asset declaration and conflict of interest) and prepared a roadmap for justice reform to address the related risks.⁸⁹ Despite this progress, interinstitutional coordination and capacity constraints, and, together, they pose a risk to the sustainability of economic growth, the equity of access, and the fair implementation of laws and regulations. The World Bank's own policy and institutional framework assessment (that is, the World Bank's Country Policy

⁸⁷ The High State Control is expected to provide independent reports to the Parliament on the quality of financial statements, and associated internal controls, provides assurance to Parliament on the reliability of the reports they receive.

⁸⁸ Following the arrest of a number of Bank of Albania staff over alleged embezzlement of funds in September 2014, the bank's governor and the inspector general were dismissed for lax oversight of internal controls.

⁸⁹ European Commission. 2014. "Report from the Commission to the Council and the European Parliament on Albania's Progress in the Fight against Corruption and Organized Crime and in the Judicial Reform." Report COM (2014) 331 final (June 4), European Commission, Brussels.

and Institutional Assessment [CPIA]) ranks Albania's low on rules-based governance and transparency, accountability, and corruption in the public sector (see annex 5).⁹⁰ To address these issues, the European Commission notes that Albania must overcome the challenges of institutional capacity, agency coordination, and consensus building in Parliament to implement and enforce newly adopted strategies, laws, and regulations.

EU candidacy status represents an opportunity for Albania to pursue a EU integration agenda, including a rise in the quality of institutions to a par with Europe. In June 2014, the EU Council formally recognized Albania as an EU candidate country. EU integration involves the upgrade of institutions to the standards set by EU member states, the *acquis communautaire*.⁹¹ The European Council Conclusions on Albania of December 2013 highlighted the key priority areas for Albania to advance along the EU integration path, which included a particular focus on administration and judiciary reform, the fight against corruption and organized crime, and the protection of fundamental rights. A constructive, sustainable political dialogue is considered essential in consolidating and maintaining the momentum of reform. The next step in the integration process is accession negotiations.⁹² Successful negotiations would mean the alignment of Albania with the *acquis communautaire*. This would require progress in modernizing the body of laws and practices to comply fully with the EU. The negotiations usually involve agreeing to undergo various transitional periods before the new member state must implement fully the laws of the EU and before they and their citizens acquire full rights under the *acquis communautaire*.

The Business Environment

Despite recent progress, entrepreneurs continue to face burdensome institutional and regulatory barriers. A look at the Global Entrepreneurship and Development Index, the latest Albania BEEPS (2013), and the Doing Business indicators offers important hints about the main issues.⁹³ According to the GEDI Index, a measure of entrepreneurial attitudes, aspirations, and activity, Albania ranks in the 70s among 120 countries.⁹⁴ Albania ranked 68th globally in the 2015 Doing Business survey, improving significantly from its 90th position in Doing Business 2014. Albania was an effective reformer in 2008–11 and introduced a number of reforms that marked improvements (albeit from a low base) in business start-up, paying taxes, obtaining

⁹⁰ The CPIA assesses the conduciveness of a country's policy and institutional framework to poverty reduction, sustainable growth, and the effective use of development assistance.

⁹¹ The *acquis communautaire* is the common foundation of rights and obligations that binds EU member states. It comprises the accumulated legislation, legal acts, and court decisions that constitute the body of EU law.

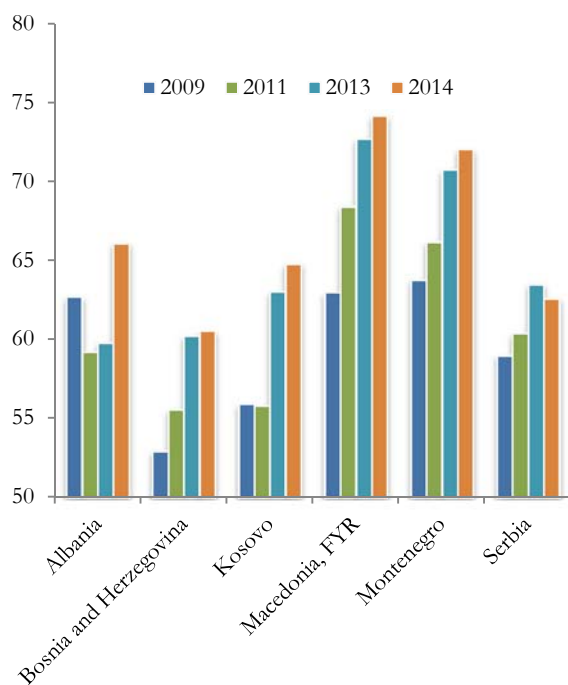
⁹² EU accession talks are expected to start after Albania demonstrates progress in reforms in public administration, the judiciary, the fight against corruption, the fight against organized crime, and the protection of human rights, particularly of the Roma community.

⁹³ See BEEPS (Business Environment and Enterprise Performance Survey) (database), European Bank for Reconstruction and Development and World Bank, London, <http://ebrd-beeps.com/data/>. The Doing Business project provides objective measures of business regulations for local firms in 189 economies. For more information, see Doing Business (database), International Finance Corporation and World Bank, Washington, DC, <http://www.doingbusiness.org/data>.

⁹⁴ See GEDI Index (Global Entrepreneurship and Development Index) (database), Global Entrepreneurship and Development Institute, Washington, DC, <http://www.thegedi.org/research/gedi-index>.

credit, protecting investors, resolving insolvency, trading across borders, and registering property. In 2013–14, Albania improved substantially, from 59.79 percentage points to 66.06 percentage points, in the distance to frontier score (Figure 70 and Figure 71).⁹⁵ This indicates that Albania has advanced toward the best practice in business regulation by 6.27 percentage points. Albania made positive improvements in three areas, reflected in Doing Business 2015, namely business start-up, construction permits, and property registration. Nevertheless, further improvements will be required particularly in registering the property, obtaining construction permits, and trade logistics where Albania is still lagging behind the rest of the region.

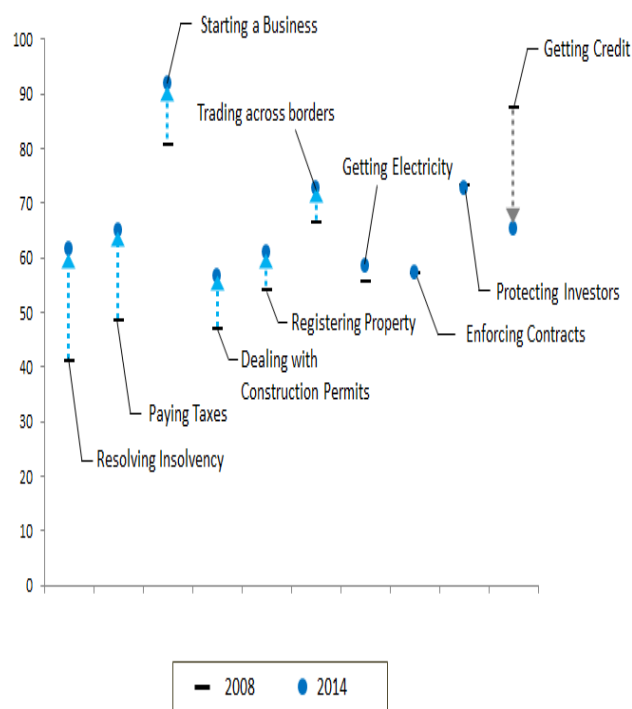
Figure 70: Distance to Frontier, 2010-2014



Source: Doing Business (database), International Finance Corporation and World Bank, Washington, DC.

Note: Distance to frontier: 100 = best practice. For details, see the text.

Figure 71: Albania Distance to Frontier Change along Doing Business Categories, 2008 and 2014



Source: Doing Business (database), International Finance Corporation and World Bank, Washington, DC.

Note: Distance to frontier: 100 = best practice. For details, see the text.

The institutional and regulatory framework, particularly its predictability and transparency, represents a critical obstacle to business development. Evidence from firm surveys, together with anecdotal evidence

⁹⁵ The Distance to Frontier indicator compares an economy's performance with the global best practice for each indicator. An economy's distance to frontier is measured on a scale from 0 to 100, where 0 represents the lowest performance, and 100 represents the frontier. For example, a score of 75 in doing business for a given year means an economy was 25 percentage points away from the best performances across all economies and across time. A higher score would indicate that the economy is narrowing the gap with global best practice. In this way, a country's progress is represented as a higher Distance to Frontier value, and is not affected by the rankings of other countries.

gathered in unstructured discussions with business leaders, suggests that laws and regulations are applied in an inconsistent, arbitrary manner. Firms complain that the lack of predictability and the uncertainty in the regulatory environment make long-term investment decisions difficult. More directly, businesses report that institutional and governance barriers negatively affect their sales and employment growth. Specifically, relative to surveyed firms reporting low institutional barriers, firms reporting high barriers tend to generate an average of 7.1 percentage points less in sales and 6.1 percentage points less in employment growth.⁹⁶

A strong and transparent investment policy framework will help spur local business development, attract foreign investors, and harness spillovers from FDI. In the absence of a strong private sector equipped with sufficient capital resources, international investment becomes even more important in the achievement of the country's goal of improving competitiveness and productivity. The shift from lower- to higher-value added jobs will depend on the ability of local companies to integrate into global production value chains. To facilitate such a shift, there is scope to strengthen the investment policy framework to maximize the benefits and spillovers from foreign investment (**Box 5**).

An institutional and regulatory environment that facilitates trade across borders and an overall reduction in the economic distance to markets is key to the global integration of Albania. The trade environment has undergone significant improvement in recent years, and the Central European Free Trade Agreement has been beneficial to regional trade. In Doing Business 2015, Albania ranked 95 among 189 countries on the ease of trading across borders. It has a middle position compared with its comparators such as Bosnia and Herzegovina (ranked 104), Croatia (86), FYR Macedonia (85), Hungary (72), and Montenegro (52). However, more effort is needed to simplify clearance procedures, including by reducing burdensome sanitary and phytosanitary inspections during cross-border trade, improving interagency information exchanges, applying World Trade Organization rules on customs valuation consistently, improving weighing procedures, synchronizing the working hours of customs and technical control agencies, simplify customs documents, and resolve issues related to the national quality infrastructure.

⁹⁶ The reported values are from bivariate regressions where the dependent variable is growth in either sales or employment and an overall institutional and governance index. The index takes a value of 1 if the firm perceives at least three of the four barriers (political instability, courts, informal competition, and corruption) to be either a major or severe obstacle. The results of the two separate bivariate regressions on sales and employment growth indicate statistically significant and negative effects for both dependent variables. For the survey, see BEEPS (Business Environment and Enterprise Performance Survey) (database), European Bank for Reconstruction and Development and World Bank, London, <http://ebrd-beeps.com/data/>.

Box 5: Channels for Improving Investment Policy in Albania

The investment policy framework comprises policies necessary to attract foreign investment of the type and volume the country needs to trigger and sustain equitable economic growth. Specific areas in which the investment policy framework might be strengthened through the following channels:

□ **Investor protection:** Weak law enforcement and justice system, uncertainty in regulations on licensing and concession agreements are a major concern of investors. Strengthening the legal framework would result in a more transparent and consistent investment climate. It is important that the legal framework for investment is characterized by

- clarity and certainty, which allows all stakeholders to understand which laws are applicable to their situation, and the specific meaning of the laws
- access to relevant legislation for all stakeholders
- predictability in the application of the law, which reduces the risks linked to changing interpretation, implementation or enforcement of the law
- stability of the legal, political and policy frameworks, which provides investors with assurances that government will not unilaterally and unfavorably change the basic conditions underlying their investment decisions
- fairness, possibility of legal options, and due process, which provides access to independent recourse and mechanisms for the settlement of disputes in connection with an investment

In addition, the establishment of an investor grievance mechanism, ensuring regulatory compliance across government agencies and promoting effective problem solving for investors, would contribute to actively preventing future investor grievances, by identifying investors' issues in a timely manner and attempting to resolve them at an early stage before escalating into open disputes. .

□ **Investment incentives:** There is a plethora of tax and financial incentives in the manufacturing and energy sectors, such as exemptions on dividends and profit-sharing payments, exemptions on public property leasing fees in manufacturing, VAT exemptions for the purchase of machinery and equipment, VAT and custom tariff exemptions, and so on. However, some of these incentive schemes are not supported by clearly defined criteria, leaving space for inconsistent and unfair application. Their cost effectiveness is also uncertain and would benefit from a cost-benefit assessment. The government should consider increasing transparency and improving governance, analyzing costs and benefits, minimizing distortions to competition, and improving administrative efficiency while contemplating on new forms of investment incentives.

□ **Investment entry barriers:** Foreign investment is open in almost all sectors in principal, with the exception of transportation and the media.^a However, there are de facto entry barriers because of the extraregulatory approvals required through the insurance and banking industries and the conditionality of work permits for foreigners, which are approved only if the number of foreign employees in a company does not exceed 10 percent of the total number of employees.^b The elimination of these and other entry barriers could help facilitate the entry of new investors.

□ **Corporate sector financial reporting:** Despite some progress, financial reporting needs to be strengthened to enable suitable differentiated financial reporting requirements for various corporate entities. In addition, strengthening the institutions responsible for various aspects of financial reporting regulation and enforcement would facilitate the access to good-quality financial information, which is crucial for the access of businesses to financing and investment.

a. Investing across Borders (database), World Bank, Washington, DC, <http://iab.worldbank.org/>.

b. United States, Department of State, 2014, "2014 Investment Climate Statement, Albania," Report (June), Bureau of Economic and Business Affairs, Department of State, Tirana, Albania, <http://www.state.gov/e/eb/rls/othr/ics/2014/228429.htm>.

The country has not fully exploited the benefits of global and regional cooperation with neighboring countries and the EU. As Albania integrates more deeply with the EU, its export performance and its attractiveness for FDI are expected to be enhanced. As a result of the Stabilization and Association Agreement with the EU in 2009, Albania now has duty-free access to the EU market for all except a few sensitive agricultural products. Although starting from a low base, Albanian exports experienced double-digit growth over 2007–13 in aggregate, and annual inflows of FDI averaged 8.4 percent of GDP. The new EU candidacy status reached in June 2014 is expected to boost trade and investment with the EU. Trade with neighboring countries has expanded, but other potential outcomes such as strategic regional coordination and cooperation (for example, in water-basin management), potential industrial clustering, and joint efforts to attract large-scale FDI have not materialized. Albania's participation in regional FDI inflows has remained low relative to neighboring countries and the upper-middle-income country group (Bulgaria, Romania, Turkey), of which Albania is a part. Trade policy, by helping to exploit the process of EU integration, as well as smaller-scale regional cooperation, can be instrumental in negotiations for additional free trade and bilateral FDI agreements.

In 2013–14, the institutional and regulatory reform has marked some progress. The government has made improving the business environment a top policy priority and has undertaken a number of initiatives that have led to improvements. It has initiated an institutional and business environment reform agenda, including the creation of working groups to identify gaps in business regulations. In 2013–14, Albania streamlined tax payments, introduced electronic payments in customs, made business start-up easier by lowering registration fees, rationalized construction permits by reducing the time, cost, and procedures for processing permit applications and by introducing new construction regulations, simplified the process of property transfers by introducing effective time limits and the digitalization of records on immovable property, and shortened the adjudication procedures involved in commercial disputes. The implementation of automated risk management has led to a sharp decline in the share of goods subject to physical inspection in customs, with corresponding savings in time and a reduction in uncertainty among traders.⁹⁷ Some of these improvements are not yet reflected in the various indexes and surveys measuring the quality of the regulatory and governance environment, likely because of a lag between the adoption and implementation of reforms and the survey reporting periods.

Corruption and Informality among Economic Agents

The prevalence of perceptions of corruption reveals weaknesses in the governance and business environment. Corruption undermines the operational efficiency of firms and raises the costs and risks associated with doing business. The presence of inefficient regulations constrains firm efficiency and presents

⁹⁷ WTO (World Trade Organization). 2010. "Trade Policy Review, Report by the Secretariat: Albania." Document WT/TPR/S/229/Rev.1 (May 5, 2010), Geneva, WTO.

opportunities for soliciting bribes. Corruption was identified as the single largest obstacle to entrepreneurship by 56 percent of the Albanian businesses surveyed in 2013.⁹⁸ Corruption among public officials, in particular, represents an administrative and financial burden on firms and poses an impediment to firm growth and development. In some public service areas, informal payments are widely prevalent. Albanian firms report an incidence of 18 percent in the payment of bribes during meetings with tax inspectors and a 34 percent incidence in meetings to secure government contracts. Almost 12 percent of the firms surveyed had experienced the same corrupt practices during the process of obtaining operating licenses (Figure 72). Similar findings were reported by respondents to the American Chamber of Commerce in Albania. The 2014 survey show that the majority of respondents think that informal economy (76 percent), government bureaucracy (76 percent), monopoly and unfair competition (62 percent) and corruption (67 percent) were at high or very high level during 2013.⁹⁹

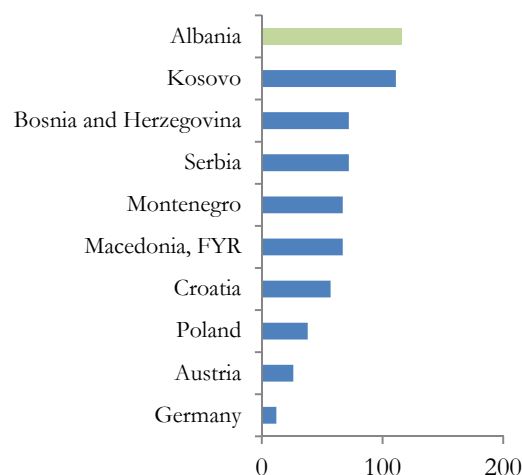
In a cross-country comparison, Albania had one of the worst rankings in the perception of corruption, as measured by Transparency International (Figure 73). Not coincidentally, Albania also ranks low in some areas of the Doing Business index, namely, the areas most often associated with corruption and the solicitation of bribes. Thus, Albania ranks 157th in dealing with construction permits, 151st in getting electricity, 131st in paying taxes, 102nd in enforcing contracts, and 118th in registering property.

Figure 72: Corruption Perception Indicators



Source: BEEPS (Business Environment and Enterprise Performance Survey) (database), European Bank for Reconstruction and Development and World Bank, London.

Figure 73: Transparency International's Corruption Perception Index



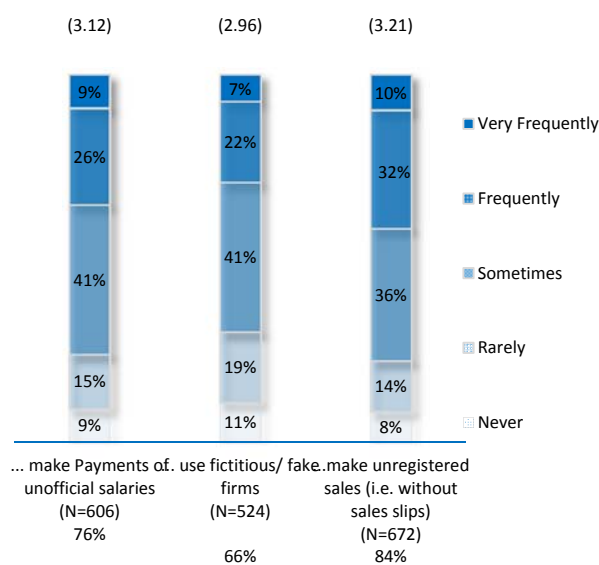
Source: CPI (Corruption Perceptions Index) (database), Transparency International, London
Note: 1 = best; 175 = worst.

⁹⁸ IFC (International Finance Corporation). 2013. "Tax Compliance Cost Survey, Albania." IDRA Research & Consulting, Tirana.

⁹⁹ American Chamber of Commerce in Albania. 2014. AmCham Business Index 2013-14, Tirana, Albania, May 2014.

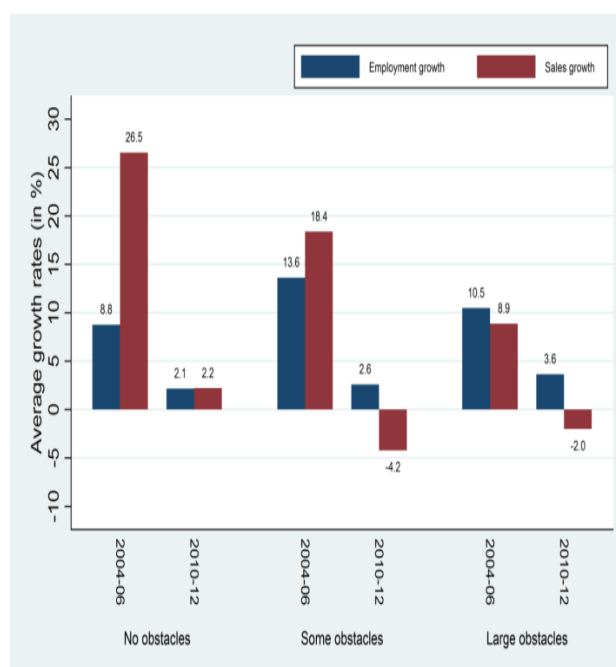
Prevalence of corruption as reported in surveys cited above encourages widespread informality, which creates unfair competition for formal sector businesses and greatly affects their growth. The practices of the informal sector are cited as the top business environment constraint by around 20 percent of the firms surveyed.¹⁰⁰ This is higher than the share in most other countries in the region (the regional average is around 14 percent), and around 40 percent of the firms in Albania are competing against unregistered or informal firms. According to the International Finance Corporation’s Tax Compliance Survey conducted in 2013, 35 percent of business respondents declare that “making payments of unofficial salaries” to reduce the tax burden occurs frequently or very frequently (**Figure 74**). About 29 percent say that “using fictitious/fake firms” also occurs frequently or very frequently. About 42 percent say that unregistered sales occur frequently or very frequently. Informal competition can negatively affect firm growth. Firms that report and experience notable informal competition have lower sales growth in general, although it seems not to deter them from hiring (**Figure 75**).¹⁰¹

Figure 74: Methods used to reduce the tax burden artificially



Source: IFC (International Finance Corporation). 2013. “Tax Compliance Cost Survey, Albania.” IDRA Research & Consulting, Tirana.
 Note: Perceptions on methods used by businesses to artificially reduce tax burden; Sample size (N = 798).

Figure 75: Informal competition among firms



Source: BEEPS (Business Environment and Enterprise Performance Survey) (database), European Bank for Reconstruction and Development and World Bank, London.

¹⁰⁰ Overall, 43 percent of Albanian firms indicated that informal sector competition was a moderate, major, or severe obstacle to business. See BEEPS (Business Environment and Enterprise Performance Survey) (database), European Bank for Reconstruction and Development and World Bank, London, <http://ebrd-beeps.com/data/>.

¹⁰¹ Based on the available surveys, there is no clear distinction between the issue of competition between registered and informal firms and the issue of registered firms evading taxes by using unregistered workers or underreporting wages, for example.

An important feature of the informal sector is the illicit activities conducted by organized crime. Cigarette smuggling and human, drug, and arms trafficking are among the prevalent illicit activities. A 2010 United States State Department report notes that Albania is a key transit country for narcotic traffickers moving Afghan heroin from Central Asia to Western Europe.¹⁰² The fight against illicit activities is hampered by corruption and weak institutions (Likmeta 2010).

Informality decreases tax revenues and thus affects the resources available for public investment and the delivery of public services. This translates into a large tax gap.¹⁰³ The tax gap is estimated at 16 to 20 percent for the VAT. Personal income tax revenues could be at least doubled through more efficient policies and more effective tax administration. Audit information suggests that the corporate income tax gap is about 38 percent. If no provision is made for nonrandom audits, the evasion potential reaches almost 66 percent.

The key interventions to combat informality and corruption would involve increasing the quality of the institutional and regulatory environment, but not the size of government. While the causes of informality are complex, cross-country empirical evidence shows clearly that the size of the shadow economy is inversely related to government effectiveness, the control of corruption, the rule of law, and regulatory quality.¹⁰⁴ Tax morale is negatively associated with the size of the informal economy.¹⁰⁵ According to the empirical literature, economic prosperity, democracy, and political stability are among the key determinants of corruption.¹⁰⁶ While greater economic prosperity is consistently associated with reductions in corruption regardless of the initial level of corruption, greater democracy is likely more effective in accomplishing this in the conditionally most corrupt nations.¹⁰⁷ However, a larger government has no clear benefit in the most corrupt countries, leading to the conclusion that increases in government size do not reduce corruption. In designing policies, the performance of the government, the integrity of government institutions, and the trust that citizens have in their government are critical in combatting corruption and informality.

Provision of Infrastructure and Public Services

Satisfaction with service delivery is low across most public services in Albania relative to the regional average (Figure 76). For example, data of the Life in Transition Survey 2010 show that, while around 61 percent

¹⁰² See Michaletos, I. (2010). *Shape of the Albanian Organized Crime*. Research Institute for European and American Studies http://rieas.gr/index.php?Itemid=42&id=332&option=com_content&task=view.

¹⁰³ A tax gap is defined as the difference between the amount of taxes the government should collect and the amount of taxes the government actually collects for a given tax regime. It points to areas of revenue where room exists to expand collection based on the existing tax regime. As part of the Albania Public Finance Review (2013), a detailed analysis of the tax gap was conducted using the top-down and bottom-up approaches on the VAT, the personal income tax, the corporate income tax, and excise taxes.

¹⁰⁴ See Koettl, Johannes, Truman Packard, and Claudio E. Montenegro. 2012. *In from the Shadow: Integrating Europe's Informal Labor*. Washington, DC: World Bank.

¹⁰⁵ For example, see Torgler, B. 2005. "Tax Morale and Direct Democracy?" *European Journal of Political Economy* 21: 525–31.

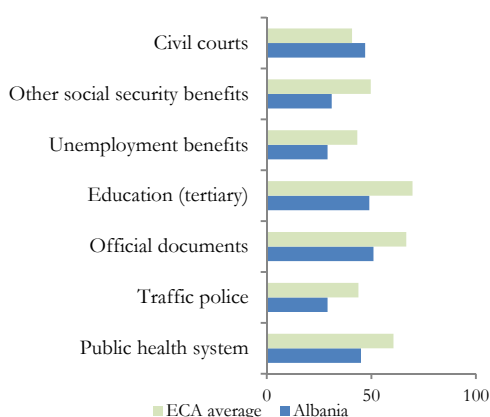
¹⁰⁶ Serra, D. 2006. "Empirical Determinants of Corruption: A Sensitivity Analysis." *Public Choice* 126: 225–56.

¹⁰⁷ Billger, S. M., and R. K. Goel. 2009. "Do Existing Corruption Levels Matter in Controlling Corruption? Cross-country Quantile Regression Estimates." *Journal of Development Economics* 90: 299–305.

of the respondents in Europe and Central Asia reported that they were satisfied with the public health care system, only 45 percent said so in Albania.¹⁰⁸ This is the lowest share in the region, along with Azerbaijan, FYR Macedonia, and Ukraine. Albania also has the lowest satisfaction with the provision of tertiary education relative to all countries in the region, at 49 percent (compared with a regional average of 70 percent); dissatisfaction in this area actually increased relative to 2006. While, on average, 84 percent of the respondents in the EU expressed satisfaction with water services, only 58 percent did so in Albania (Figure 77).¹⁰⁹

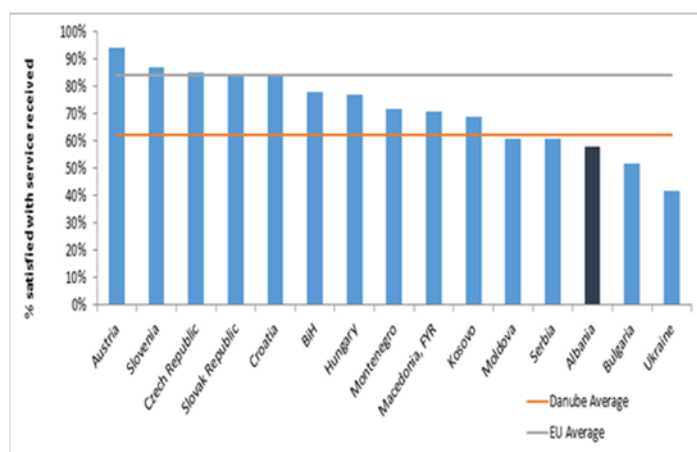
Improving the delivery of public services, particularly among the poor and the bottom 40, can promote the accumulation of assets. A more efficient and equitable delivery of health and education services would, for example, promote human capital accumulation. The provision of key services and inputs such as energy and water, can also contribute to increasing the intensity of use of assets by households and firms. There are, however, notable challenges in the provision of public services and they relate to equitable access and inefficiencies that restrict the accumulation and the intensity of use of endowments by households and firms (each discussed below).

Figure 76: Satisfaction with public service delivery, percent of respondents that are satisfied, 2010



Source: LiTS 2010 (Life in Transition Survey), European Bank for Reconstruction and Development and World Bank

Figure 77: Satisfaction with water service delivery, percent of respondents who are satisfied, 2011



Source: Gallup 2011 Survey

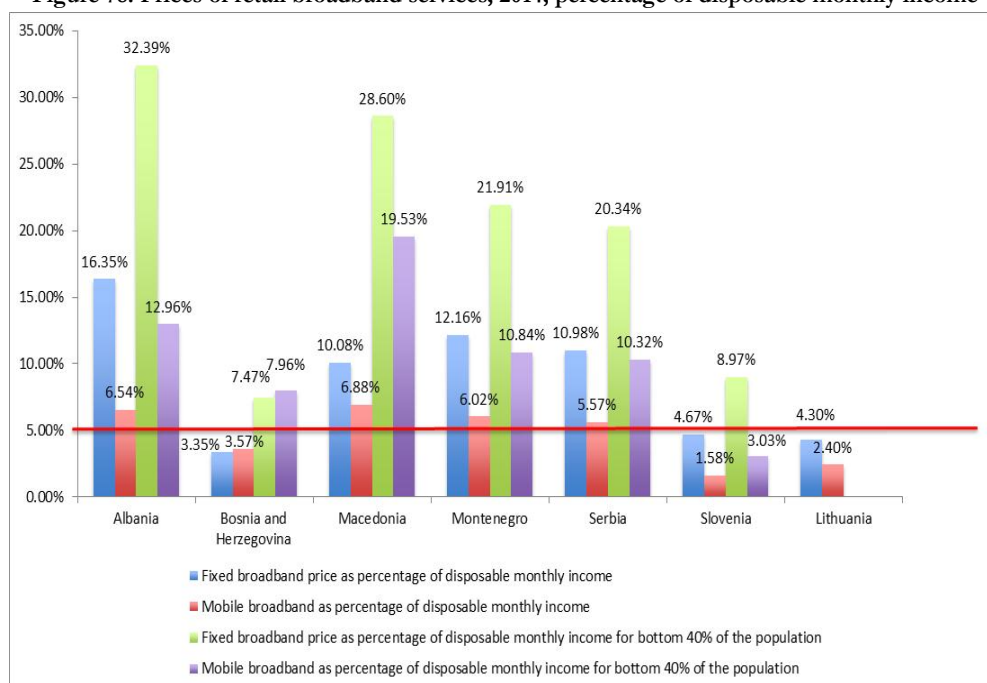
Socioeconomic and spatial inequalities exist in the provision of public services. Poorer groups in Albania have, for instance, less access to education services (see above), to affordable broadband services (Figure 78) as well as to good-quality facilities for water and sanitation (Figure 79). For example, in the case of broadband, Albania is among the most expensive country in the region and services are not affordable for a large part of

¹⁰⁸ LiTS 2010 (Life in Transition Survey), European Bank for Reconstruction and Development and World Bank, <http://www.ebrd.com/pages/research/economics/data/lits.shtml>.

¹⁰⁹ Gallup 2011 survey.

the population. In addition, significant regional disparities exist in public service delivery. For example, preprimary enrollment in urban areas is around 42 percent, compared with 23 percent in rural areas. Service delivery varies across geographical areas in the continuity, access, and quality of water provision.¹¹⁰ The share of households with access to steady water supply varies by region. It ranges from 47 percent in Durrës to 88 percent in Shkoder. Seventy-five percent of the households in Fier—the second-poorest prefecture in the country—report that the water provided there is not safe for drinking. About 50 percent of the population has access to a sewerage connection, while the rest use on-site sanitation facilities. Similarly, there is a large gap between rural and urban areas related to connectivity. While Albania performs reasonably well in terms of the mobile broadband penetration (third highest in the region); the household penetration of the fixed broadband market is the lowest in SEE6: 25 percent comparing with the second lowest fixed broadband households penetration in the region of 46 percent in Serbia. The footprint of the fixed telephony network is limited, covering only 34 percent of households, and hardly reaching the rural areas (where some 46 percent of the population resides).

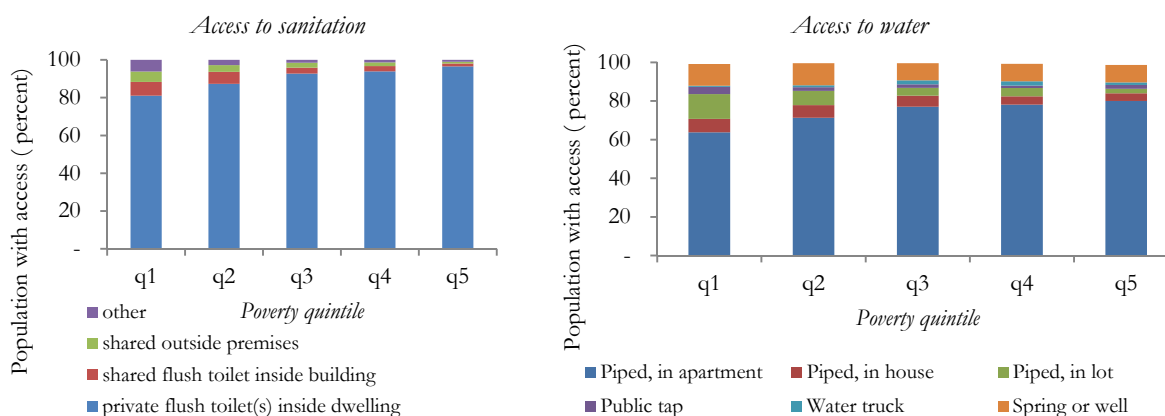
Figure 78: Prices of retail broadband services, 2014, percentage of disposable monthly income



Source: World Bank calculations

¹¹⁰ Maps by prefecture are available using the 2012 LSMS that show geographical differences in water supply, access to water, and access to safe drinking water.

Figure 79: Access to sanitation and water services by socioeconomic group and type of service, percent



Source: World Bank calculations based on 2012 LSMS.

The inefficient provision of public services is widespread in Albania. For example, in 2012, over 50 percent of the electricity generated or imported was lost during transmission and distribution. For every 3 percent of reduction in electricity losses, the contingent liabilities of the sector decline by 1 percent of GDP. A distribution loss reduction plan encompassing gains from better network management, the regular metering of all customers (including large-tariff customers), customer outreach, and collection efforts can cut energy losses by 6 percent of GDP and halve the contingent liabilities by 2 percent of GDP relative to the status quo. Similarly, in the water supply sector, only 46 percent of water connections are metered, compared with nearly 97 percent in the top 10 percent of the best performing utilities in SEE (2012). Only about 45 percent of the water produced is billed to end consumers, against a benchmark of 75 percent for the same top 10 percent in the SEE and above 90 percent in Western Europe. This has led to large losses in the sector, and cost recovery rates of around 50 percent, which is almost three times lower than in the top performing countries (**Figure 80** and **Figure 81**). The delivery of public environmental services is also characterized by large inefficiencies. Of an estimated 360,000 hectares that have been equipped for irrigation in the country, only 80,000 hectares were irrigated (2009), and many canals and pumping stations are no longer operational.

There are common reasons behind the inefficiency in the delivery of public services across sections.

- (i) **The prevalent perception of corruption and politicization intensified the inefficient provision of public services, affecting quality and hampering access, especially among lower-income groups.** Citizen trust in the state has been historically low, and hence facilitation payments (bribes) to seek services common. Two examples illustrate this point. For example, health care delivery in Albania is characterized by the poor quality of care, inadequate primary care and preventive services, the excessive use of tertiary hospital care, and persistent unofficial payments or bribes. The public health sector is perceived by Albanians to be the most corrupt in

terms of informal payments. Forty percent of the population report that they make informal payments (down from 50 percent in 2006). From 10 to 20 percent of the population reports corruption by the police and the courts, in the education system, and in the distribution of social benefits.¹¹¹ A recent United Nations Office on Drugs and Crime study of corruption in Albania finds that 71 percent of payers of bribes pay bribes to doctors, and almost half (47 percent) pay bribes to nurses; the third-highest group (14 percent) pays bribes to the police, indicating that corruption is significantly more prevalent in the health sector than in other public services.¹¹² Because of a lack of confidence in primary and secondary hospital care, patients tend to bypass these and go directly to the tertiary hospital, or visit primary care facilities mostly to obtain referrals for higher levels of care. The quality of care is an important source of concern: a recent study found that doctors only properly diagnosed and treated common conditions half the time. Hospital autonomy remains limited, and accountability mechanisms are weak. Politicization in the management of public services also negatively affects service delivery (**Box 6**).

- (ii) **The existing institutional arrangements and governance issues in key public service sectors affect service provision.** Highly fragmented, overlapping, or nontransparent institutional arrangements and delivery systems often cannot benefit from economies of scale and efficiency in operations. Low population density and extreme fragmentation in administrative responsibility seem to be the key obstacles to cost-effective local service delivery and have created deep inequalities between municipalities and communes (see above).¹¹³ For example, the management of public utilities involves several ministries and agencies with overlapping or unclear jurisdiction. This makes it difficult to manage resources and ensure that urban and rural households enjoy equal access to public utilities. The administrative reform currently underway is expected to improve efficiency in the system by reducing fragmentation of local governments.¹¹⁴ However, it will also require strengthening the capacity of the newly formed local governments which will cover larger population and territory than at present.
- (iii) **Many utility companies operate significantly below their own regulator's good performance benchmarks, which are typically unambitious.** For example in the water and wastewater sector, nonrevenue water is estimated at around 67 percent of all water (regulatory benchmark: 30 percent). Only 55 percent of all connections are metered (regulatory benchmark: 85 percent). Utilities have on average of 9.3 staff per 1,000 connections (regulatory benchmark: 4).

¹¹¹ LiTS 2010 (Life in Transition Survey), European Bank for Reconstruction and Development and World Bank, <http://www.ebrd.com/pages/research/economics/data/lits.shtml>.

¹¹² UNODC (United Nations Office on Drugs and Crime). 2011. *Corruption in Albania: Bribery as Experienced by the Population*. Vienna.

¹¹³ Municipalities and communes constitute the first level of local government. These have full powers in administrative, regulatory, service, and investment functions, including a wide range of local public services, such as communal services, economic development, and social and cultural services.

¹¹⁴ See the 2009 and 2014 laws on Territorial Planning

The existence of best-in-class performers such as the utilities of Korça and Pogradec, both of which achieve 98 percent of the overall regulatory benchmarks, show that efficient utilities can exist. On the other side of the spectrum, the Durres utility reaches only 55 percent of the regulator's benchmarks, but a recent business plan shows that the utility could improve from covering only 52 percent of the costs of operations through tariff collections to covering 148 percent in only five years through a combination of efficiency measures and tariff adjustments, thus creating room for a self-financed service expansion and improvement plan.

Box 6: The Politics of Power: The Energy Sector in Albania

Albania's energy sector is based on a single buyer structure, whereby a legal monopoly manages the wholesale purchase and supply of electricity. This arrangement is common in small and medium systems in a phase of transition and growth, but presents particular political and economic challenges.

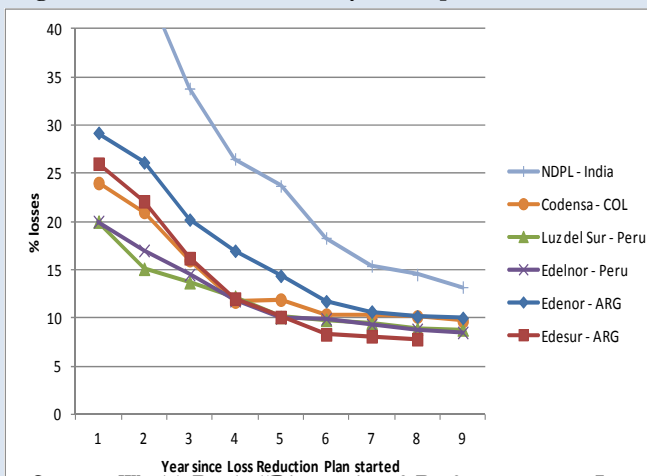
In the past, the sector has been besieged by significant losses in the distribution sector, leading to annual power imports of €120 million to €160 million to cover these losses, thus making the distribution entity the worst performing company in the SEE6 countries. The new Government has launched a reform effort aimed at improving the efficiency of the distribution sector by improving collection and reducing losses, and continuing the process of market liberalization as per EU guidelines.

Moving forward in this reform process will need to take account of the political economy underpinning most of the key problems. For example, the regulatory commission, which is independent in financial matters and in decision making, consists of managers appointed by Parliamentary majorities, which may mean that they are dependent on the political patronage of governing parties. In other countries facing similar problems, qualified technocrats, at line Ministries, counterweight these potential conflicts of interest. In Albania there is a need to strengthen the experience of staff at both the Ministry of Energy and energy to monitor and manage the sector. Moreover, civil society has not been able to play a major role, apart from pointing in frustration at the government's lack of transparency.

These institutional shortcomings have led in the past in significant losses and leakage from the distribution system. The biggest cause is theft, which suggests that metering, billing, and enforcement are weak.

Reversing this trend in a way similar to what other countries have experienced (Figure B7.1) will require strong political will to ensure that the sector is managed properly and at arms-length of political influence.

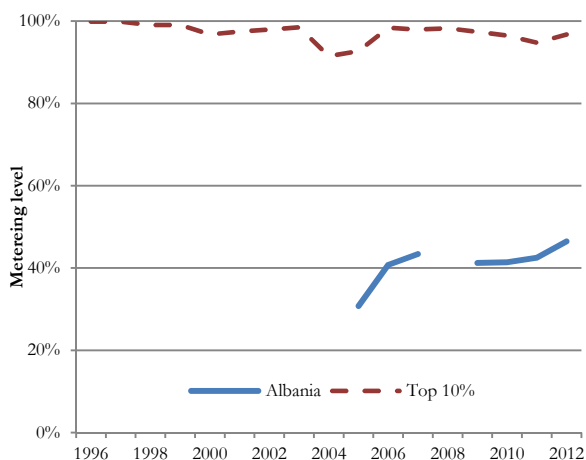
Figure B7.1. Cross Country Comparative Loss^a



Source: World Bank "Diagnosis of Performance on Loss Reduction and Collection Improvement."

Note: NDL: North Delhi Power & Light; Edelnor: Empresa de Distribucion Electrica de Lia; Edenor: Empresa Distribuidora y Comercializadora Norte; Edesur: Empresa Distribuidora y Comercializadora Sur Codensa: Empresa Electrica de Bogota.

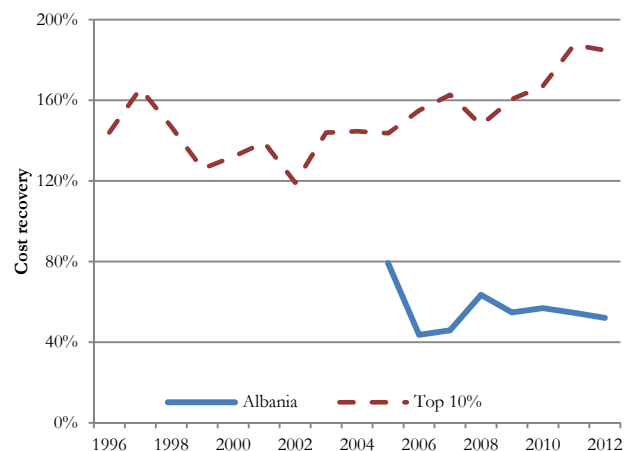
Figure 80: Water Metering Level in Albania and Top 10 Performers, percent



Source: World Bank calculations based on IB-Net/DANUBIS data.

Note: Top 10 performers include the top 10 percent of participating utilities in Southeastern Europe.

Figure 81: Water Cost Recovery in Albania and Top 10 Performers, percent

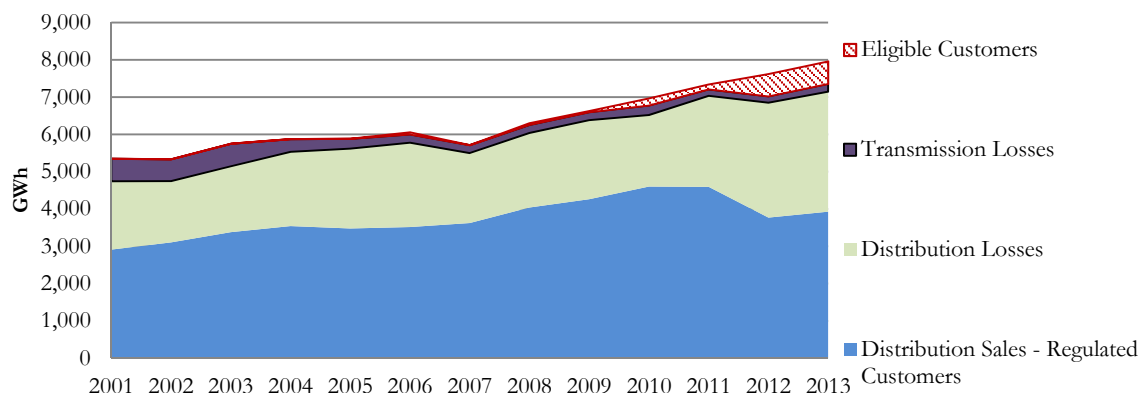


Source: World Bank calculations based on IB-Net/DANUBIS data.

Note: Top 10 performers include the top 10 percent of participating utilities in Southeastern Europe.

Inefficient provision of public services has led to rampant losses. High distribution losses and low collection rates have been at the core of the energy sector's poor performance. Close to one half of the energy supplied is lost in Albania. Distribution losses rose to 45 percent of supplied energy in 2013 (from 30.5 percent in 2010). Following the poor performance of CEZ Sh leading to its distribution license being revoked, nontechnical losses (theft) are estimated to account for about 37 percent of total energy supplied in 2013. Transmission losses, albeit reduced, accounted to 2.3 percent of total energy supplied in 2013. Collection rates stood between 75 percent and 84 percent from 2010-2013, further exacerbating the financial distresses of the energy sector.

Figure 82: Distribution of Electricity



Source: World Bank staff calculations.

The poor quality of infrastructure and public services often means significant coping costs for the population, which are often more onerous for the less well off. In the case of water supply, for example, household costs include the need to purchase water from other sources or resorting to in-home pumping, treatment, and storage of water or on-site sanitation solutions. Such costs must be added to the \$30 million spent annually in subsidies to the utility companies. In the case of health care, out-of-pocket health expenditures represent 9 percent of the household incomes of the poor and the bottom 40 (see block 2).

In a fiscally constrained environment, the delivery of public services can be improved primarily through efficiency gains. Over the medium to long term, as fiscal space opens, additional budgetary allocation may be warranted. Currently, Albania's investment in the social sectors such as in health care and education is below the regional average. The costs in wastewater and solid waste management will also rise because of the requirement to satisfy the EU *acquis communautaire*. The Albania Public Finance Review (2013) analyzed spending in the country and spelled out detailed recommendations on how to achieve greater efficiency. Some specific examples relate to transport, the health care sector, and education (also see annex table A4.2).

- (i) **Room remains to improve the efficiency of spending on the road network.** The bulk of capital spending in the transport sector (more than 90 percent) goes to roads. The country's ranking in the quality of road infrastructure has improved based on the roads newly constructed over the last decade, which accounted for an annual average expenditure of over 3 percent of GDP in 2008–12. Average expenditure on maintenance of the national road network in 2008–12 was about €12 million per annum. It is estimated that Albania would need €40 million to €45 million per annum to maintain the country's primary and secondary roads. In addition, the country is faced with a large stock of unfinished road construction and rehabilitation. While the additional maintenance expenditures could be funded within current allocations, a shift away from investment in new roads toward maintenance and rehabilitation is critical for preserving the road network and ultimately saving public resources. Inadequate maintenance exacerbates the rate of deterioration, hastening the failure of the roadway and creating a need for reconstruction that could have been avoided. Reconstructing a paved road is estimated to be three to five times more expensive than maintaining it.¹¹⁵ Failure to maintain a paved road has also been estimated to increase user costs by a factor of three in terms of additional time, fuel, and vehicular wear and tear, which have a direct impact on the price of goods and the prices consumers pay for goods and services.
- (ii) **Significant scope exists for efficiency gains in the health sector.** Public spending on health care was 2.6 percent of GDP in 2013, the lowest level among countries in the region, equivalent only to Romania. The low budget expenditure on health reflects in part the country's low level of public

¹¹⁵ See Heggie, I. G., and P. Vickers. 1998. *Commercial Management and Financing of Roads*. Washington, DC: World Bank.

spending generally. The scarce funds are not used efficiently. Inefficiencies stem from the areas of expenditure, financing that is delinked from outputs or performance, excessive spending on pharmaceuticals and medical supplies, poor systems management, and other issues.¹¹⁶ In addition, the government faces challenges in enhancing revenue mobilization, pooling of health care resources, expanding insurance coverage, and reducing the reliance on payroll taxes in a difficult fiscal environment.¹¹⁷

- (iii) **Similarly, public spending on education is inefficiently allocated.** Albania spends much less on education than its neighbors. General government spending on education, at 3 percent of GDP in 2013 (10.2 percent of all public spending) is below virtually every other country in SEE6 (for example, Kosovo at 4.2 percent and Serbia at 4.7 percent). The institutional framework for preuniversity education and the resource allocation formula are complex, and financing is not clearly linked to needs or performance. Inequities in the distribution of resources remain, although the government revised several norms in 2010—the minimum class size, the criteria for creating multigrade classes, and the hours of instruction required of full-time-equivalent teaching positions—to improve the regional distribution of resources. The complex institutional arrangements and the lack of clear criteria in financing—especially in preuniversity education—have to be tackled to drive up efficiency and equity in education. The partial decentralization of management and the financing of preuniversity education have led to less clarity in local investment and maintenance spending. Education financing needs to become more transparent and accountable, and investments need to be targeted to areas that will most effectively improve learning outcomes. Specifically, the government needs a transparent per capita financing formula that will account for and provide better funding to schools that disproportionately serve disadvantaged households.

Some of the inefficiencies in public spending stem from underdeveloped institutions for reinforcing financial discipline and strengthening fiscal policy. Public financial management has improved, especially following the recent efforts to clear arrears and strengthen the commitment control system.¹¹⁸ More action is

¹¹⁶ More than 50 percent of the health care budget goes to hospital-based services, mostly to the University Hospital Center Mother Theresa Tirana, the country's only university hospital. Primary care accounts for about 30.0 percent, and public health services for about 8.5 percent. District hospitals receive too much of the budget given their low bed occupancy rates. About 90 percent of the budget is for recurrent spending, including growing transfers to the Health Insurance Institute. Capital spending accounts for about 10 percent of the budget.

¹¹⁷ The Health Insurance Institute initially financed primary care and certain pharmaceutical expenditures, but took on the responsibility for hospital financing in 2010. A payroll tax of 3.4 percent, divided equally between employer and employee contributions, generates 21 percent of the institute's revenue; the rest is financed by a budget transfer from the Ministry of Health. Because of the negative impact of payroll taxes on labor and capital formation, the new government has proposed an increase in the share of general revenues, with a longer-term goal to shift toward general revenue financing. Reductions in payroll taxes would need to be sequenced with efforts to expand insurance coverage for the poor and for the informal sector.

¹¹⁸ Gustafsson, Allan, Andy Macdonald, and Antonin Braho. 2012. "Albania: Public Economic Financial Accountability Assessment (PEFA) 2011." Public Expenditure and Financial Accountability Program, World Bank, Washington, DC. <http://www.pefa.org/en/assessment/al-jan12-pfmp-public-en>.

required to improve discipline in budget planning, preparation, capital investment management, cash management, and expenditure commitment. Another challenge relates to the implementation of effective commitment control to prevent the accumulation of payment arrears. The recent initiative to register all contracts with the Treasury is a major step forward, but more needs to be done to manage future obligations and establish financial accountability and good financial management.

Related, overcoming institutional weaknesses with regard to preaccession EU fund management could unlock investment resources for the Albanian economy. For example, the available EU preaccession funds in the agriculture sector (such as IPARD) could provide much needed financing for the modernization of agriculture and rural areas, thus promoting a shift to higher productivity and commercial production. The start of the IPARD program (totaling EUR 92 million over 2014-20) is on hold, because of lacking organizational framework (to include office space and equipment), difficulty to retain qualified staff, and inability to meet the EU's fiduciary and managerial requirements.

Strengthening the capacity of the government workers responsible for the management of public services can contribute to improvements in the services. The CPIA ranks quality of public administration among the top relative policy weaknesses in Albania (see Annex 5). The civil service suffers from several weaknesses, especially with respect to merit-based recruitment, the allocation of temporary contracts, and rules on promotion, worker mobility, and dismissal. Salaries have sometimes been increased to enhance equity rather than performance. This has led to compression in the pay system, which has created disincentives for attracting high-quality staff. Politicization has also interfered with the functioning of the civil service, particularly with regard to appointments. The EU *acquis communautaire* requires a professional, impartial, and reliable public administration system, operating according to the rule of law.

Efforts to digitalize processes have been launched, but they have not yet led to greater efficiency or greater satisfaction with public services. According to the United Nations e-government development index 2014 rating, Albania ranks well. The ranking partly reflect the progress made in the digitalization of public services, including the e-Albania portal, which offers 10 level-4 e-services and provides information on many others; online procurement; the digitalization of 20 percent of property records; several one-stop shops for municipal services; modernized business registration and licensing services; legal reforms, including digital signatures; and the digitalization of passports and national identification numbers. Despite these efforts, citizen satisfaction with public services remains low.

Major reform efforts have yet to focus on citizens, as opposed to businesses. The impact of municipal one-stop shops is limited. Property records, a major source of citizen frustration and anger, are only partially digitalized. Rising citizen expectations also partly explain the level of dissatisfaction with petty corruption. A whole generation of Albanians who have come off age in the postcommunist era, has been regularly exposed

to high standards of service in Europe and in the modernizing private sector in Albania. Further sensitized by an assertive print and electronic media, this cohort, unlike their parents, also demands much more from the state and the democratic process.

Aware of the poor record in public service provision, the government has embarked on an ambitious reform program. Elected on an anticorruption platform, the government seeks rapidly to improve a wide range of services through enhanced interfaces at citizen service centers in Tirana that provides information and access to 250-plus services offered by the government.¹¹⁹ The government is also undertaking regulatory reform and business process reengineering and eventual digitalization.¹²⁰ In the energy sector, the government's Power Sector Recovery Plan aims to address the key problems in the sector.¹²¹ While the goals are laudable and the political will palpable, important considerations relate to the sequencing of the reform process and the access to the citizen service center outside Tirana, perhaps through regional offices.

Albania can selectively capitalize on fiscally sound public-private partnerships (PPP) to improve service delivery. The country has the potential for PPP projects in energy, renewable energy, waste management, health care, and education. However, the current experience with private sector involvement has been mixed, including well-documented failures such as the private sector involvement in the electricity distribution sector. PPPs can help relax Albania's fiscal constraints, while also bringing in market expertise and technology in finding solutions in service delivery. International best practice reveals that the ingredients for the success of PPPs include the long-term, sustainable design of projects (based on a realistic evaluation of public and private capacities), an embedded and clear long-term sectorial strategy (including the role of the private sector), a robust governance framework, and the commitment of the public sector to fulfill its contractual obligations. Proper selection, design, and implementation are key to ensuring that PPPs deliver the expected results, do not present a fiscal burden, and contribute to improved public service delivery, while making the sector more efficient by lowering costs or improving services.

Institutions to Protect the Poor and Vulnerable

Social safety nets can ensure an adequate minimum living standard for the more vulnerable and promote and protect the accumulation of assets. The existing social safety nets are ill targeted and provide

¹¹⁹ By end-2014, the Government plans to pilot programs in four urban areas with citizen service malls. They will cover 24 public services in four priority areas.

¹²⁰ The specific objectives of the reform include reducing the scope for corruption, implementing modern service delivery, adopting citizen-focused ethics in the provision of public services, and reducing the time and cost of service delivery for both citizens and the government. The rationale behind creating the one-stop shop is the separation of the front office from the back office for public service provision, which should reduce the opportunities for corruption among service providers. It will also allow the government to focus on customer service at the front office. The government also intends to establish mechanisms for citizen feedback about the quality and timeliness of service delivery. The efforts in business process simplification and digitalization are being planned in parallel.

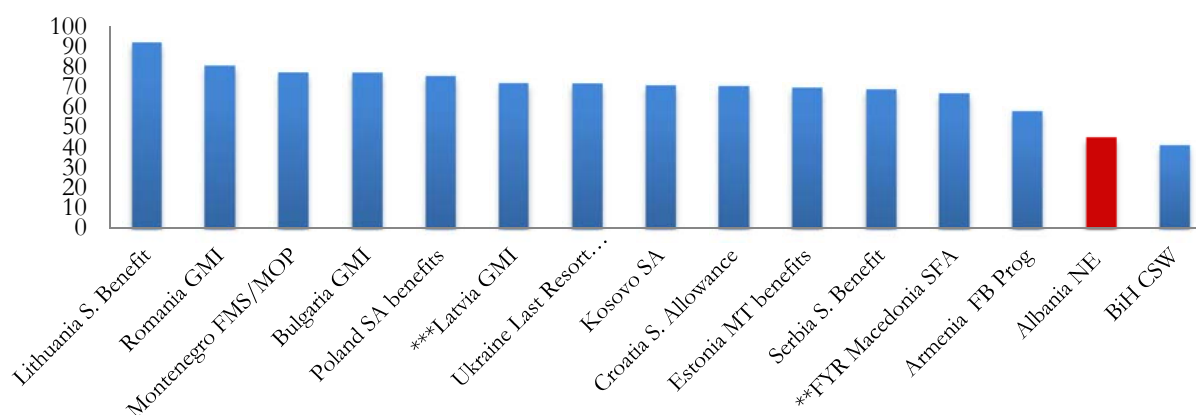
¹²¹ The Power Sector Recovery plan is centered around four main pillars: a) enhancing security of supply through diversification of generation sources and strengthening regional integration; b) improving system efficiency in the distribution sector by reducing losses and improving cash collection; c) supporting improvements of the electricity market and d) introducing priority power reforms in the power sector to create a competitive market that will attract private investment while reducing fiscal risks for the government.

inadequate coverage. The social safety net program consists principally of two cash benefit schemes: the Solidarity Albania Program and disability assistance. The former is the main poverty-targeted benefit. Disability assistance is a categorical benefit provided irrespective of the economic status or degree of disability. The central government finances both, but local governments carry them out based on centrally designed eligibility criteria. Currently, local councils make the final decisions.

Overall spending on social assistance is comparable in Albania with other countries in the region, at about 1.7 percent of GDP, but the system exhibits several weaknesses that limit its ability to reduce vulnerability. The Solidarity Albania Program suffers from poor targeting and coverage and low benefit levels, while the quality of spending on the more generous disability assistance program could be improved. Specifically:

- **The relative balance of social assistance spending has shifted significantly in favor of disability benefits**, crowding out the poverty-targeted assistance of the Solidarity Albania Program. Disability assistance grew from 0.4 percent of GDP in 2000 to 1.1 percent in 2013, while Solidarity Albania Program spending declined from 0.8 percent of GDP to 0.38 percent. Solidarity Albania Program targeting accuracy is among the lowest in Eastern Europe (**Figure 83**). About 66 percent of the total benefits are captured by the bottom 40; 46 percent by the poorest quintile. The wealthiest quintile receives 8 percent. In 2008–12, the targeting accuracy of the Solidarity Albania Program deteriorated, and the share of total benefits captured by poorer households declined from 56 percent to 46 percent. Ongoing reforms are already aimed at improving targeting through a scoring formula (a proxy means test) that is being piloted in three areas of the country and covering 50 percent of the population.

Figure 83: Last Resort Social Assistance in Eastern Europe: Total Benefits Received by the Poorest Quintile, percent



Source: Europe and Central Asia Social Protection expenditure and evaluation Database, World Bank

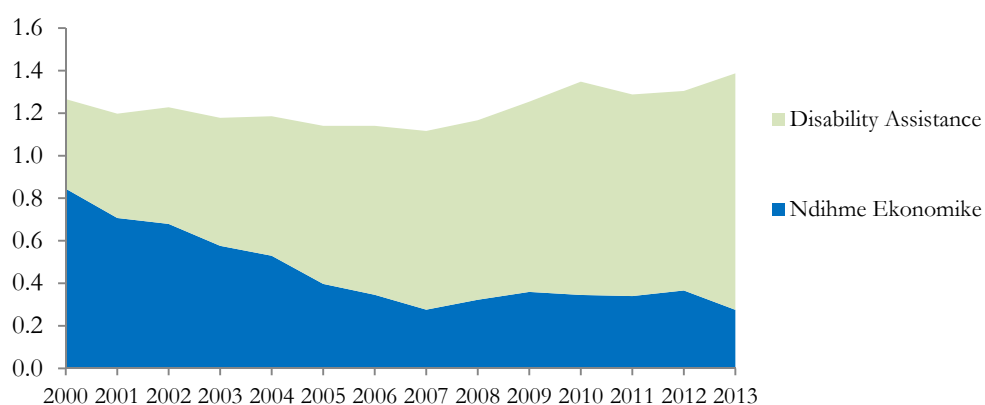
* Indicates that the standardized methodology was not applied.

** Performance indicators were generated as part of analytical work supporting the FYR Macedonia Development Policy Loan Program.

*** Performance indicators were generated as part of analytical work supporting Latvia Reimbursable Advisory Services on long-term unemployment.

- **Solidarity Albania Program coverage is low** because of definitions and eligibility criteria that cause serious errors of exclusion. As of 2012, the share of the poor the program covered was 24 percent, but its coverage of the nonpoor rose from 5.2 percent in 2008 to 7.4 percent in 2012. Meanwhile, the spending on disability assistance has increased because of a larger number of beneficiaries and the overly generous indexation and ad hoc increases in benefits. In 2007–13, the number of beneficiaries rose by 50 percent, from 108,000 to 165,000 (Figure 84).
- **Solidarity Albania Program benefits are low** and account for only 16 percent of the total posttransfer consumption of the poorest beneficiaries. This is in part because the benefits are not indexed to inflation, which has led to an erosion in real benefits. The disability assistance benefit, on the other hand, is almost triple the Solidarity Albania Program transfers and accounts for 46 percent of the total posttransfer consumption of the poorest beneficiaries. Benefit indexation has outpaced inflation by 100 percent because it is indexed to minimum wages, plus ad hoc adjustments. To contain the rise in disability spending and reverse the shift of resources away from the Solidarity Albania Program, the government is now indexing disability assistance to inflation.
- **Disability benefits do not necessarily favor the poor or the most severely disabled.** Only 3.8 percent of the poorest quintile receive disability assistance benefits. Survey data indicate that 11 percent of all disability benefits go to beneficiaries who report no functional disability at all, and another 18 percent go to those with only mild disabilities. Clearly, there is room to improve the quality of spending. An initial diagnostic shows that disability legislation is scattered; medical eligibility criteria are outdated; and the system for assessing disability cases is open to conflicts of interests (often, the doctors assessing disability cases are also on the reviewing commission).

Figure 84: Composition of social assistance transfers in Albania, 2000–13, percent of GDP



Source: World Bank staff calculations

Note: Ndhime Ekonomike is the main poverty-focused program

The pension system currently provides pension benefits to most of the elderly, but, until recently, the benefit was not guaranteed for the full pool of future retirees. Most elderly today meet the eligibility requirements for the contributory pensions given their pretransition work histories; however, many of the future elderly will not have accrued sufficient pension benefits to be eligible for a contributory pension (estimated at around 20,000 people in 2030, compared with fewer than 5,000 today). It is likely that the poor and less well off are overrepresented among this group, given their higher rates of unemployment and inactivity today. The government recently approved a law to introduce a social pension as a minimum benefit (at a level similar to the poverty line), providing a way of addressing this issue and tackling old-age poverty in the future. The law also dictates rules for pension indexation, ensuring that the real value of pensions is not eroded and preventing fiscally unsustainable ad hoc pension increases.

These weaknesses suggest that the current social safety net system does not provide adequate coverage to the vulnerable and to excluded groups and poses social risks. The government can mitigate these risks and has an active reform agenda seeking to improve the targeting of the extreme poor and the truly disabled by refining eligibility criteria and expanding coverage; rebalancing social assistance spending in favor of the Solidarity Albania Program by curbing spending on disability benefits; revising disability benefit eligibility to move away from a purely medical approach to a more comprehensive functional abilities approach; and using management information systems to modernize the administration of benefits and the mechanisms to reduce error and prevent fraud. All these are critical steps needed to reduce the social risks. Over the medium to long term, the government should also consolidate social assistance by channeling various subsidies (for example, energy subsidies to protect the poor from tariff increases) through the Solidarity Albania Program; link social assistance to human capital and activation mechanisms to ensure the inclusion of marginalized groups in the growth process; and adopt a holistic view of social protection, particularly in the introduction of the social pension.

Emerging issues

Weaknesses in governance and perception of corruption have long-dominated Albania's public image. Inefficient judicial system and inconsistent application of the rule of law coupled with prevalent perceptions of corruption have led to mistrust in the overall governance system by economic agents and citizens and to high informality. Enhanced independence, accountability and professionalism of the judiciary will ensure that the implementation of laws and regulations is done in a nondiscretionary manner. Expanding consensus building in Parliament in the adoption of reform strategies, laws and regulations can also help address issues related to the inconsistent application of regulation by courts and executive agencies. Tackling these high-level governance issues will contribute to restoring the confidence in the legal and institutional environment that it can protect and enforce property, contract, and overall rights of economic agents. Focusing the policy agenda on improved transparency and predictability of economic management, in turn, will decrease the implicit "tax"

which poor institutions and regulation put on economic activity, increase investment in the formal economy, firm growth and job creation.

Despite improvements, the regulatory burden for business development in Albania remains large. This is reflected in the mediocre investment environment with direct effect on firm (and farm) productivity and overall competitiveness of the economy. It is still more burdensome in Albania to deal with construction permits, trade logistics, inspections, and property and land registration than in neighboring countries and others around the world. The immediate policy agenda can tackle these specific regulatory issues. Moreover, businesses and entrepreneurs voice strong concerns about discriminatory implementation of regulation and high level of complexity in rules, procedures and reporting guidelines. These obstacles to business development present broad challenges for promoting entrepreneurship, investment and trade domestically and across borders. Increasing the quality of the business environment in Albania will help reduce corruption and widespread informality. In turn, it is expected to positively affect incomes across the distribution and economic sectors through increased employment and entrepreneurial opportunities from a regulatory environment where firms can grow and thrive.

The provision of public services and infrastructure in Albania is ineffective to support a growing economy. Across the board and large inefficiencies in delivery and public spending are reflected in the poor quality, weak institutional capacity, limited accountability to service users, territorial fragmentation, and socioeconomic and spatial inequalities in access. Moreover, the current systems for performance management, monitoring, and accountability for service delivery to citizens remain weak in Albania. In a fiscally constrained environment, efficiency gains are the primary road to improvement in the delivery of equitable public services. With respect to public spending, emerging priority areas would include: improving public investment management to ensure that scaling up public investment supports macro-fiscal stability and growth (for example, a shift from investment in new roads toward maintenance and rehabilitation); strengthening the link between outputs/performance and spending (for example, in preuniversity education, pharmaceuticals and medical supplies, among other); enhancing revenue mobilization (for example, pooling of health care resources, expanding health insurance coverage, reducing the reliance on payroll taxes). Moreover, fostering the development of institutions and practices for reinforcing financial discipline (such as strengthening the commitment control system at the central government level) and compliance with regulatory benchmarks (for example, in the water and wastewater sectors), improving the public-citizen interface for delivery of public services to improve responsiveness and to reduce the high rate of informal payments (for example, in health), capitalizing on fiscally sound PPPs, overcoming institutional weaknesses related to absorption of preaccession EU funds (for example, in agriculture) can help to better use public funds in delivering services. Inefficient public service provision has meant significant coping costs for both households and businesses, and has ultimately hurt their income. Overcoming socioeconomic and spatial inequalities in the provision of public

services (for example, in education, water, sanitation, connectivity) promotes both the equitable accumulation and use of assets by households as inputs into the growth process and their own incomes.

Energy supply is not reliable in Albania and poses large burden on economic growth. High economic dependence on hydro resources for energy provision makes energy supply vulnerable to weather patterns and in dry years heavily dependent on energy imports. Moreover, high distribution losses, low collection rates, and technical inefficiencies have made the energy sector an unreliable and financially-unsound supplier of energy in Albania. Securing Albania's energy supply is an immediate need and can be achieved through: diversification of generation sources and strengthening regional integration; efficiency gains in the distribution sector by reducing losses and raising cash collection; the development of a competitive energy market that will attract private investment, while reducing fiscal risks for the government. Addressing these issues will not only boost the efficiency and quality of energy supply – a critical input to the growth process of the economy, but also bring energy reliability in the day-to-day operation of businesses and households.

Institutions to protect the poor and vulnerable are ineffective in Albania. The main poverty-focused program is poorly targeted and characterized by low coverage and low benefit level; ongoing reforms to improve targeting of the program are expected to result in progress toward poverty reduction. In addition, the disability assistance program does not effectively target and support the truly disabled. As a result, the current social safety nets do not effectively address the needs of the poor, and are ineffective in protecting the vulnerable and the disadvantaged from household-level or systemic shocks. Effectively reforming the social protection system by, for example, rebalancing spending between social programs and creating links to human capital accumulation and activation mechanisms will contribute directly to the welfare of the poor in the short and long-runs.

BLOCK 4: MITIGATING RISKS TO PROMOTE SUSTAINABILITY

Unmanaged risks—whether economic, environmental, or social—can jeopardize the sustainability of economic growth and the progress toward the twin goals of reduced poverty and shared prosperity. The main finding of this section is that Albania needs to combat a multiplicity of risks to ensure sustainable growth and lasting welfare gains among the people. The risks identified include external and domestic economic pressures, natural hazards and climate change, and potential social pressures because of the exclusion of marginalized groups.

Macroeconomic Risks

The key macroeconomic risks relate to both external and internal factors that could jeopardize the sustainability of economic growth and the achievement of the twin goals. External risks pertain to lower-than-expected growth and possible delays in Europe's overall economic recovery. These delays would have an effect on Albania's economic outlook through their adverse impact on exports, remittances, and capital flows because the EU countries, particularly Greece and Italy, are Albania's largest trading partners and source of financial flows. External economic development and the pace of the economic recovery in key export markets such as Greece and Italy are uncertain and beyond the control of the authorities. A slower than projected pace of recovery in the Eurozone could lead to lower than expected export-led growth, revenue collection, and fiscal consolidation. Insufficient fiscal consolidation could undermine already fragile investor confidence and adversely affect the rollover of public debt and holdings of government paper. Similarly, deterioration in the financial health of foreign parent banks, most of which are in the Eurozone, could jeopardize credit recovery and undermine credit, growth, and inclusion.

The domestic risks are related to the implementation of the fiscal and structural reforms currently under way to reduce public debt and ensure inclusive and sustainable growth over the medium term.

First, the public and publically guaranteed debt has surged since the 2008 crisis, from about 55 percent of GDP in 2008 to over 70 percent of GDP in 2014. Loose fiscal policy, currency depreciation, and recognition of new stock of payment arrears have contributed to the increase. The high and growing debt poses interest rate and rollover risks. Spending on interest, at about 3.2 percent of GDP, is already much higher in Albania than in the other SEE countries, crowding out more productive spending and representing a major source of vulnerability. Over 55 percent of domestic debt (almost 30 percent of GDP) should be rolled over within a year, exposing the government to changes in market conditions. In a baseline scenario of no policy reforms, Albania's public debt-to-GDP ratio is projected to remain on a raising and unsustainable trajectory in the medium term.¹²² This scenario excludes the contingent liabilities in the energy sector (see below), which

¹²² Public debt is estimated to reach 73.5 percent in 2015 and stay above 72 percent over the medium term. By 2018, the central government debt-to-GDP ratio is projected to reach 76.2 percent if the primary deficit holds constant at 2.4 percent throughout the

would put the debt dynamics on a rapidly accelerating unsustainable path, ultimately increasing the probability of default. To successfully manage this risk the medium-term fiscal policy has to be recalibrated to accommodate a gradual recovery in real sector growth and steadily reduce public sector debt. Decisive fiscal consolidation has now become imperative to reduce the risk of macroeconomic crisis, reduce interest payments, and free up resources for productive investments in education, health, and infrastructure.

Second, the financial sector is exposed to a number of potential vulnerabilities, which, if realized, could negatively affect economic growth. Key potential vulnerabilities to financial stability include (a) low and declining commercial bank profitability, (b) the large stock of NPLs, (c) substantial levels of euro-based lending (giving rise to indirect foreign exchange credit risks), (d) the continued deleveraging of foreign bank subsidiaries (leading to shrinking subsidiary balance sheets), (e) the consolidation of the savings and credit association sector ahead of the introduction of the sector's deposit insurance scheme, (f) the expansion of government debt issuances without an active secondary market, and (g) the presence of contingent liabilities. Financial sector risks are amplified by the fact that commercial banks are the main holders of Albania's domestic debt, with Raiffeissen Bank and the Bank of Albania holding nearly half of it. With some European banks recently taking steps to reduce their exposure outside the Eurozone and the weak European growth outlook, concerns about the rollover of public debt risk have risen. In addition, there is a need to improve financial infrastructure, including the payment system, credit information bureaus, and collateral registries. Overall, strengthening the independence and capacities of financial regulators is a prerequisite for the development of intermediation and the maintenance of financial stability.

Third, the energy sector poses significant fiscal, growth, and inclusion risks. Recurrent energy shortages because of fluctuations in rainfall, persistently high distribution losses (about 43 percent in 2013), and regulated tariffs below recovery costs, have resulted in sustained fiscal support from the government through guarantees for power imports. In the distribution sector, low collection rates among households, businesses, and public institutions (78 percent in 2013) have contributed to the financial woes. Serious reforms are needed in the energy sector to reduce the risks to the budget (especially in the form of contingent liabilities) and to the country's energy security and future growth (see **Box 7**). These include diversifying the sources of energy generation, reducing distribution losses, increasing collection rates, improving the energy market model, and implementing appropriate tariff levels closer to cost recovery.¹²³ While the implementation of these reforms has already begun, a large medium-term agenda remains unfinished, including additional investments in the grid to reduce losses, changes in the market model (for example, the liberalization of the power market in accordance with Energy Community Treaty obligations), and adjustments in energy tariffs closer to cost recovery.

period; 81.5 percent if real GDP growth is 1 percentage point lower than projected throughout; and 84.5 percent if there is a one-time 30 percent real depreciation. See World Bank. 2014. *Albania Public Finance Review*. Vol 1.

¹²³ Alternative sustainable and clean energy sources are available and include solar, wind, and geothermal. These sources generate a tiny fraction of the total energy supply needed in Albania.

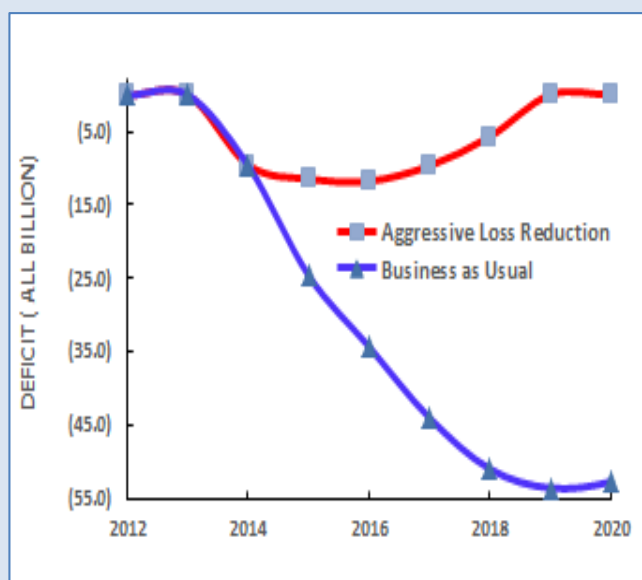
Improving the performance in energy efficiency would help manage demand by limiting the need for expensive imports of electricity.

Box 7: Financial Impact of Alternative Structural Reform in the Energy Sector

In a **business-as-usual scenario**—which assumes growth in electricity demand by 1.5-1.8 percent a year, normal hydrological conditions, no new generation added to the system and distribution losses gradually reduced to the level of 20 percent by 2020—the energy sector becomes financially unsustainable. The expected annual financial gap of the sector in this scenario would be about lek 25 billion (US\$ 230 million) in 2015 up to lek 55 billion (US\$ 510 million) in 2020 (around 4 percent of GDP).

An **aggressive loss reduction scenario** assumes the distribution operator reduces losses by 6 percent annually through 2017—through better metering of large customers, clamping down on the illicit use of electricity, and higher collections of 1 percent annually until the collection rate reaches 95 percent (year 2020), a rate common in the region. The expected annual financial gap of the sector in this scenario would be about lek 10 billion (US\$ 90 million) in 2015-2017, assuming tariff increase by 20 percent (from 9.8 lek/kWh to 11.5 lek/kWh). This would also require investment to improve the metering and other infrastructure (US\$ 160 million), included in the assumptions.

Figure B7.1: Energy Sector Unfunded Deficits, lek



Source: World Bank staff calculations

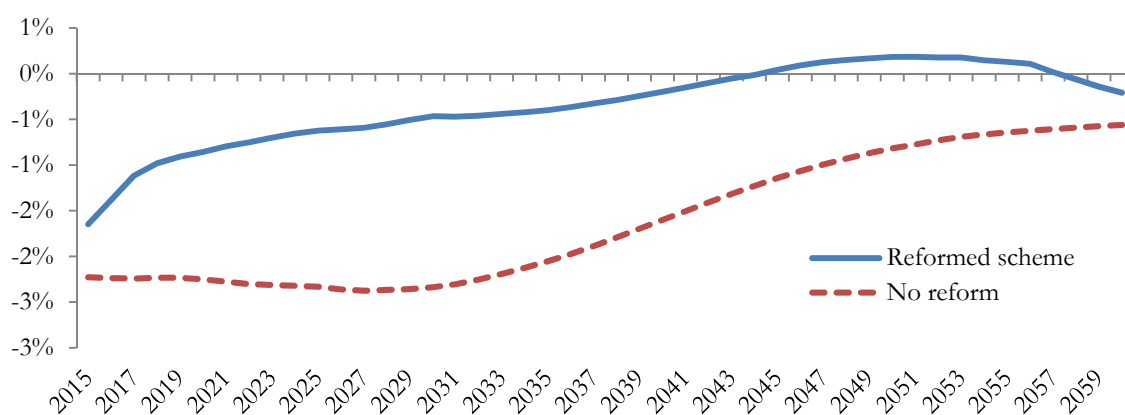
Fourth, property restitution and compensation for formerly expropriated land constitute another major source of fiscal and growth risk. The recent rulings of the European Court of Human Rights in favor of previous property owners who must receive compensation for expropriated land have heightened the potential fiscal risks from property compensation.¹²⁴ The government will need to undertake a comprehensive review of the claims that have been filed, complete the ongoing cadaster work to assess the claims fairly, and amend existing legislation on property to offer a fair judicial procedure for compensation and for appeal mechanisms. The government has established a working group and initiated a process to look into these issues. The problem requires a clear mechanism that provides a fair settlement to those owed compensation, while ensuring that the settlements are within Albania's fiscal capacity to meet these obligations.

Fifth, comprehensive pension reform has been initiated, but managing the risks related to the fiscal sustainability of the system hinges on the successful implementation of the new policy measures

¹²⁴ Albanian law currently stipulates that former landowners are compensated at 100 percent of the value of for their land, which is unprecedented in Europe.

(Figure 85). A pension law was passed by Parliament on July 31, 2014, with the aim to ensure the pension system's fairness, incentives, and fiscal sustainability. The legislation responds to four key problems in the current pensions system: low future benefits if the system were implemented as legislated; a loose link between contributions and benefits; low participation rates among the working-age population today; and unpredictability among workers and retirees and in fiscal policy because of discretionary increases and subsidies. The new legislation tackles each of these issues, tightening the links between contributions and benefits, providing a social pension at the poverty level for the future elderly who will not be eligible for a pension because of a lack of contribution history, protecting pensioners from cost-of-living increases, and promoting the fiscal sustainability of the system. The expected gains of the pension reform will depend on how well the law is implemented.

Figure 85: Pension system projected fiscal balances before/after reform, percent of GDP



Source: World Bank staff calculations

The government has initiated reforms and has already made significant progress in a number of these areas, but sustained implementation over the medium term will be key to ensuring macroeconomic stability, reducing fiscal risks, and restoring robust, sustainable, and inclusive growth. While the government has moved energetically to tackle the fiscal and structural reform agenda (fiscal consolidation, public financial management, eliminating payment arrears, and addressing structural challenges in energy, pensions, the financial sector, and land registration), sustained efforts are required to tackle these deep structural challenges fully over the medium term. Without such efforts to ensure macroeconomic stability, growth (if any) will not be robust, sustainable, or inclusive.

In addition to decisive reforms pursued internally, there are benefits to joining efforts with neighboring countries and EU countries to manage some of these risks. For example, in the power sector, Albania can benefit from integration with the European electric energy grid. In gas, the building of the Trans-Atlantic Pipeline and the Ionian-Adriatic Branch would open new possibilities for power production and

industrial development.¹²⁵ Generally improving interconnections—such as trade and links with external markets, transport routes, and connectivity—among countries of the region and with the EU enhance the capacity of firms and individuals to use their assets.

Environmental Risks

Albania is one of the top countries in the world with high economic risks because of multiple hazards.

In Albania, 88.5 percent of GDP and 86.0 percent of the total territory is exposed to risk from two or more natural disasters.¹²⁶ The entire country is prone to hydrometeorological hazards (floods, drought, heavy snowfalls, and extreme temperatures) and geological hazards (earthquakes and landslides). According to EM-DAT, in 1974–2013, more than 60 percent of disasters had a hydrometeorological origin.¹²⁷ The risk is compounded by Albania's complex topography because more than 70 percent of the territory is mountainous. In the last five years, the main disasters that have hit Albania were the devastating floods in Shkodra (2010) and forest fires (2012) in several areas of the country.

Moreover, Albania is the Europe's most vulnerable country to climate change as it suffers both from substantial exposure to climate extremes and significant sensitivity to climate change. The just released World Bank's Turn Down the Heat 3 report projects a “new climate normal” for Western Balkans. Temperature increases of up to 1.7°C to 2.3°C are expected by mid-century, along with a significant decline in precipitation. Considering that over 95 percent of Albania's electricity is derived from hydroelectric power, this will pose additional challenges to power infrastructure.¹²⁸ Albania is expected to suffer from more frequent and severe extreme weather events (floods, heat waves), droughts, and greater risk of fire in forests and pasture areas. Sea level rise is likely to result in a loss of wetlands and coastal forest. Increases in the variability of precipitation, steep topography, heavily populated low-lying coastal zones, and reliance on water for energy and agriculture mean that Albania is extremely vulnerable to climate change.

While information on the risk of natural hazards remains patchy, available data show that the risk level is comparatively higher in Albania than in neighboring countries and that it affects the poor disproportionately.¹²⁹ Albania ranks 41st in the world in terms of vulnerability to landslides, 43rd in terms of earthquakes, and 58th in terms of drought risks.¹³⁰ Considering that buildings in Albania are not built to acceptable construction standards, the impacts of natural disasters on the built environment is of major concern.

¹²⁵ This project would fit well within the commitments of the Energy Community Treaty.

¹²⁶ World Bank. 2005. “Natural Disasters Hotspot: A Global Risk Analysis.”

¹²⁷ EM-DAT (OFDA/CRED International Disaster Database), Centre for Research on the Epidemiology of Disasters, Université Catholique de Louvain, Brussels (data version: v11.08), <http://www.emdat.be/database>.

¹²⁸ World Bank. 2014. “The New Climate Normal.”

¹²⁹ Two reports outline the level of risk to natural hazards and capacities in disaster risk management in Albania: UNDP. 2003. *Disaster Risk Assessment in Albania*; and UNDP. 2011. *Disaster Risk Reduction Capacity Assessment Report for Albania*.

¹³⁰ UNISDR (United Nations International Strategy for Disaster Reduction). 2013. *Global Assessment Report*.

The organizational and technical capacities to respond effectively to emergencies are limited. The poor and the less well off are more vulnerable to shocks than the rest of the population because they can rely on fewer mechanisms to cope and must often resort to asset depletion. Natural disasters may also have large macroeconomic impacts, and strengthening the resistance of assets to disasters is important, especially in highly vulnerable countries such as Albania.¹³¹

The Albanian agriculture sector in particular is facing increased vulnerability in the face of climate change. Data analysis suggests that Albania should expect an overall warming trend over the next 50 years of some 1.5°C in a medium impact scenario. This contrasts to a 0.5°C warming over the previous 50 years. Precipitation changes are much more uncertain than temperature changes, but a decline in 50 mm yearly can be expected under the medium impact scenario, although with significant regional variations. The most fertile lowlands could be most affected. Climate change could also increase the frequency and magnitude of flooding, which already poses serious challenges to the country.

The risks of climate-related disasters for the agricultural sector and human settlements are immediate. Recent flooding events in Albania have underscored these risks. Although no single weather event of this type can be directly tied to climate change, an increase in extreme temperature and rainfall events such as these are consistent with the best known science on the impacts of climate change. The majority of the rural population, including a large share of the poor and the bottom 40, depends directly or indirectly on agriculture for their livelihoods. The rural poor will be disproportionately affected because of their greater dependence on agriculture, their relatively more limited ability to adapt, and the high share of income they spend on food. Climate impacts could therefore undermine the progress that has been made in poverty reduction and adversely impact food security and economic growth in vulnerable rural areas. There is a clear need for developing operational adaptation strategies and plans, integrating regional knowledge and approaches, and upgrading an institutional framework and development planning to deal with these new challenges. In addition, unplanned growth of human settlements in hazard prone areas is increasing exposure. Managing the impact of climate change on human settlements is therefore closely linked to land use administration and planning.

The internal electricity generation capacity is almost entirely dependent on hydropower and thus sensitive to hydrological variability, which will further increase with climatic changes. Dependence on hydrology poses a major risk to the country's electricity supply and causes enormous variation from year to year in the costs of meeting electricity demand. In 2010, Albania reached a record breaking generation output of 7,702 GWh, but in 2011 it dropped down to 4,159 GWh, which is about half compared to the previous year. The costs of covering growing electricity demand are particularly high in poor hydrological years because

¹³¹ A recent study found that the risk of a catastrophic earthquake is around 18 percent of GDP and, in the case of a major flood, 10 percent of GDP. (Air for Europe Re. 2014. *Country Risk Profile for Albania*.)

additional imports are needed to offset reductions in domestic hydropower production (**Figure 86**). The cost of this hydrological volatility has been quite substantial in the last decade totaling about €782 million in the 2007-2008 and 2011-2012 drought periods.¹³² If there are not enough imports secured to cover the demand, the system has to resort to load-shedding, which peaked to 900 GWh in 2007. It is thus important to diversify energy resources on a regional basis and expand and improve intra- and interregional transmission networks. Gas is a critical element of this longer-term vision. With respect to hydropower, investing in hydro storage and the better integration of hydro development with integrated river basin management that takes account of climate risks would have notable sectorial, environmental and social benefits.

The depletion of natural wealth threatens sustainability and growth potential. Albania's level of natural capital depletion increased sharply in 2008–12. Natural capital depletion represented 2.2 percent of gross national income in 2008 and 3.9 percent in 2012 (**Figure 87**).¹³³ This is of special concern given the role of natural resources (coastal tourism, agriculture, hydropower and mining) in Albania's exports and overall economy (**Box 1**). While policy to mitigate these risks are obvious (such as strengthening environmental management in the mining sector, protecting ecologically critical coastal assets, and encouraging sustainable land management practices), it would be important to better understand how effective the country has been in converting national wealth into other forms of wealth; and whether this conversion is sustainable from the growth and competitiveness viewpoint.

Albania needs to grow in an environmentally sustainable manner to maximize its growth potential and become compliant with EU environmental standards. The EU accession process opens new economic opportunities; therefore, actions along this path, of which the environmental acquis are an integrate part, are important for sustaining and accelerating growth. Further, the immediate impacts of a degraded environment on health are being increasingly recognized, and the reduction of these impacts is a major announced goal of the government's environmental protection policy, programs, and regulations. However, limited institutional capacity and insufficient public finance, human resources, and environmental management practices are a challenge to national, regional, and local administrations in aligning economic policies and sustainable development goals.^{134, 135} For example, a significant ramp-up in the quality and coverage of water services and

¹³² During the droughts of 2011 and 2012, Albania had to cover about 40 percent of its electricity demand through imports. In 2011, 3,181 GWh were imported to meet the annual demand of 7,340, while in 2012, demand grew to 7,621 GWh requiring 2,895 GWh of imports. Cost of imports mounted to €197 million euro in 2011 and €161 million in 2012. This unforeseen cost of additional imports was not factored in the electricity tariff creating significant deficits for CEZ Sh. In 2011 and 2012, the cost of CEZ Sh.'s imports not covered by tariff was €45.7 million and €95 million, respectively.

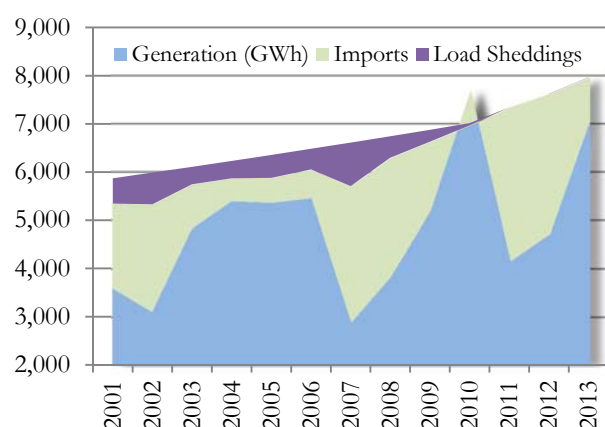
¹³³ Natural capital depletion is the sum of changes in national wealth derived from energy, minerals, and forests. Depletion is calculated as the ratio of stocks to reserves in the case of energy and minerals or the ratio of roundwood harvest to natural growth in the case of forest.

¹³⁴ The CPIA ranks the policies for environmental sustainability among the top relative policy weaknesses in Albania (see table A4.3).

¹³⁵ In 2011, public expenditure on environmental protection was lek 457 million, which was less than 1 percent of total government budget expenditure. In 2012, an increase of 7.8 percent relative to 2011 was observed primarily in investments in the rehabilitation of hotspots, solid waste facilities (landfills), the rehabilitation of wastewater collection, and the construction of new wastewater treatment facilities.

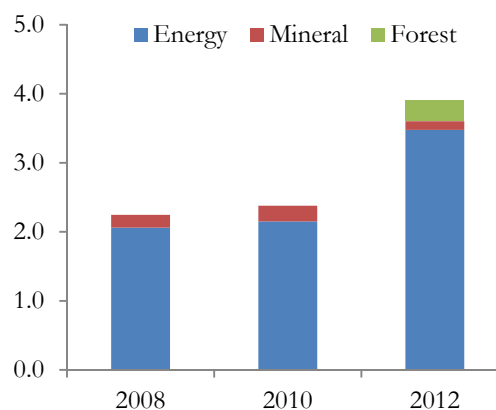
wastewater management services is needed to meet EU standards. In most cities where sewerage service is available, coverage is still limited, and effluent is discharged untreated into the sea and water streams, which poses public health concerns and reduces tourism potential. Currently, Albania has few conventional wastewater treatment plants which, cover less than 10 percent of the population. Further, utilities are unable to operate a number of recently built wastewater treatment plants due to lack of sewerage connections and cost-recovery of treatment.

Figure 86: Electricity Demand, 2001-13



Source: World Bank staff calculations

Figure 87: Natural Capital Depletion, percent of GNI



Source: World Bank

Waste management is a growing problem across the country. In larger cities, dump sites and landfills do not properly prevent uncontrolled toxic fires or leachate pollution, both of which are harmful to human health. In smaller towns, in the countryside and along the beaches, the lack of proper water collection and disposal adversely affects local economic development and does particular harm to the tourism potential of Albania's natural beauty and cultural heritage. Further, water streams clogged with waste compromise performance of the irrigation systems; increase the impact of flooding, and, more recently, started affecting performance of hydropower generation, elevating the waste situation to the level of a national emergency. Industrial waste amounts to 170,000 tons a year, of which 3–5 percent is hazardous. Collaboration with the United Nations Development Programme identified 35 priority hotspots of industrial pollution; remediation plans exist for only nine of these sites. Clean-up of these sites will not only take away a major health hazard for nearby communities but also facilitate foreign investment by addressing past environmental liability issues.

Social Risks and Exclusion

Even during the high growth period, around one Albanian in five considered the economic situation to be worse than in the past.¹³⁶ Perceptions of economic well-being are not always aligned with the reality of the improvements in living standards observed in the country, presenting social risks and potentially affecting the process of development. In 2006, a year of substantial economic growth, 19 percent of the population reported that their economic situation had deteriorated relative to 1989, and 51 percent that it had remained the same.

Evidence in the region suggests that the negative perceptions may be linked to perceptions of rising inequality and increased uncertainty and vulnerability.¹³⁷ Inequality measures, including the Gini coefficient and percentile consumption ratios, do not show a systematic increase in social risks in the past decade. However, the discussion on governance may indicate one source of discontent among the population. Around 33 percent of Albanians reported in 2010 that political connections or breaking the law, as opposed to individual effort or skills, are the principal means of achieving success in life. This contrasts with 15 percent of the people in 25 countries in Europe and Central Asia.¹³⁸ These negative perceptions can have an impact on the progress toward the twin goals because they potentially affect people's behaviors and attitudes, such as efforts to acquire skills, search for jobs, and support of reform processes.¹³⁹

Equity concerns exist because some groups among the population have less access to economic opportunities, thus excluding them from contributing to and benefitting from economic growth. The poor and less well off, women, youth and sexual minorities are among those who are excluded from economic opportunities or access to essential services (see Block 2). Youth, in particular, both men and women, are relatively more disengaged from labor market participation and express less optimism about the future of younger generations relative to those in other age-groups.¹⁴⁰ Young women in particular have significantly lower labor force participation, despite having higher enrollment rates in upper secondary and tertiary education and scoring higher than boys on Programme for International Student Assessment (OECD) tests (see Block 2). Roma and Egyptians primarily work in the informal market, where they are mainly involved in the collection of scrap metals, trade in second-hand clothes, casual jobs, construction and begging.¹⁴¹ Lesbian, Gay, Bisexual

¹³⁶ LiTS 2010 (Life in Transition Survey), European Bank for Reconstruction and Development and World Bank, <http://www.ebrd.com/pages/research/economics/data/lits.shtml>.

¹³⁷ World Bank (2014) "Economic Mobility in Europe and Central Asia: Exploring Patterns and Uncovering Puzzles."

¹³⁸ Bussolo and López-Calva (2014), using data in LiTS 2010 (Life in Transition Survey), European Bank for Reconstruction and Development and World Bank, <http://www.ebrd.com/pages/research/economics/data/lits.shtml>.

¹³⁹ World Bank (2014) "Economic Mobility in Europe and Central Asia: Exploring Patterns and Uncovering Puzzles."

¹⁴⁰ For the 18–39 age-group, LiTS 2010 (Life in Transition Survey), European Bank for Reconstruction and Development and World Bank, <http://www.ebrd.com/pages/research/economics/data/lits.shtml>.

¹⁴¹ UNDP. 2012. *A Needs Assessment Study on Roma and Egyptian Communities in Albania*.

and Transgender (LGBT) individuals face discrimination based on sexual orientation in accessing health services, employment, education, and housing, and are sometimes subject to bullying or violence. Albania's Ombudsman has recommended revising education curriculum and providing anti-discrimination training to teachers, and to modify the Labor Code to incorporate discrimination on grounds of sexual orientation and gender identity.¹⁴²

Ethnic minorities face obstacles in taking full advantage of economic opportunities. The Roma and Egyptians, for instance, have a lower stock and utilization of assets than the non-Roma.¹⁴³ According to official census, the group of Roma and Egyptians represent 0.42 percent of the population, but this may reflect underreporting due to fears of discrimination.¹⁴⁴ Others estimate the size of the Roma population in Albania to be as high as 150,000 (3.2 percent of the Albanian population) in 2010.¹⁴⁵ Across indicators, Roma have poorer outcomes: while literacy rates are around 95 percent among non-Roma neighbors, they reach only 65 percent among the Roma. Malnutrition among Roma children is as high 65 percent compared to 24 percent for non-Roma neighbors, with lifelong implications for health and cognitive development. Both the stock (educational attainment) and accumulation (enrollment) of education is sharply lower among the Roma. Low preschool enrollment of Roma and other factors contribute to early drop out from school: the latest Regional Roma Survey (2011) reports young Roma adults (aged 16-24) had completed only 3.9 years of schooling on average, compared to 10 years average of their non-Roma neighbors. Smaller differences are found in employment and unemployment rates, although a gap exists, but differences become larger in terms of the quality of employment. For instance, the Roma are more likely than the non-Roma to be in informal work (90 percent versus 71 percent, respectively). Overall, poverty rates are higher among the Roma than among the non-Roma: controlling for other factors, Roma ethnicity was associated with a 170 percent increased likelihood of being poor.^{146, 147} High rates of poverty and low rates of education perpetuate the cycle of poverty and increase the risks of exclusion.

Emerging Issues

Albania is exposed to multiple risks, which if not managed well, will threaten the income growth and inclusion prospects of the population. These risks are cross-cutting in nature and affect the pattern and distribution of economic growth (as per the discussion in Block 1), the ability of economic agents to build and use assets and endowments (as per the discussion in Block 2) as well as the institutional environment that

¹⁴² The Ombudsman, Republic of Albania, *Special Report of the activity of the Ombudsman on the rights of LGBT persons in 2012*, 23 August 2012.

¹⁴³ Egyptians are an Albanian-speaking ethnic minority mainly in Kosovo and FYR Macedonia.

¹⁴⁴ A recent UNICEF survey of all Roma settlements in Albania (about 100 locations) estimated that approximately 15,000 Roma live in these settlements, one-third of them children. See <http://www.sidalbania.org/romacom.html>.

¹⁴⁵ European Commission. 2011. Annex of the 2011 EU Roma Framework. Brussels.

¹⁴⁶ EU Agency for Fundamental Rights, United Nations Development Programme, and World Bank. 2011. "Regional Roma Survey." www.eurasia.undp.org.

¹⁴⁷ World Bank analysis using LSMS data from 2005, 2008, and 2012.

enables households' and firms' income generating capacity (as per the discussion in Block 3). Managing well these risks is necessary to ensure that the gains achieved in shifting the growth model are sustainable instead of short-lived and sporadic.

With respect to macroeconomic risks, the key challenges relate to the restoration of macro-fiscal imbalances, critical for boosting the competitiveness of the Albanian economy. Fiscal consolidation is an important step toward improving macro-fiscal stability. It would need to be supported by structural reforms related to the reduction in explicit and implicit contingent liabilities (such as in the energy sector or the pension system) in order to ensure that the consolidation process is not undermined through inefficient ad hoc expenditures and in line with the medium-term fiscal framework. Additional (albeit broader) macroeconomic risks stem from the continued weak European recovery and the internal risk of insufficient political will to sustain the commitment to medium-term macroeconomic stabilization and fiscal consolidation.

The unsustainable use of natural resources comprises risks associated with inadequate stewardship of valuable natural resources. Managing well these risks underpins Albania's competitiveness and growth potential in areas such as water, land, and coastal assets. Ensuring that the economy can count on natural resources is key for securing the income sources of households and firms in sectors relying on natural endowments (agriculture, energy, water, tourism, extractive industry). Moreover, the exposure of the country to natural disasters is large and exacerbated by on-going climate change. This in turn, increases the vulnerability of households and the overall economy to climate shocks, which if materialized, can reverse progress toward the goals. Therefore, natural resources (many of which cannot be restored or at least easily restored once depleted) need to be used in a sustainable manner.

Last, but not least, there are social risks from the exclusion of some groups from economic opportunities which threaten the sustainability of the growth process. Exclusion can jeopardize progress toward boosting shared prosperity in particular, but also prevents maximizing the gains from the growth process given that some groups will not contribute to their maximum potential. Promoting inclusion across socio-economic groups (including ethnic minority, gender, gender-identity, age, and economic status) will directly guard against the erosion of living standards and incomes of marginalized groups and ensure that all groups are part of the new growth path of the economy. Addressing challenges along the three blocks discussed in this report, reforms need to ensure equity and inclusion across the board.

ACHIEVING THE TWIN GOALS IN ALBANIA: SETTING PRIORITIES

*The SCD shows that achieving lasting poverty reduction and shared prosperity in Albania will require a new economic strategy. Equitable, export-driven growth is likely to generate long-term economic and employment gains, but will require sustained macroeconomic stability and comprehensive structural and institutional reforms. The evidence presented in this SCD, combined with informed judgment and extensive stakeholder consultations, allowed the SCD team to identify twelve key constraints to accelerating growth for reducing poverty and promoting shared prosperity. Further prioritization was carried out among these twelve priorities based on their direct impact on achieving the twin goals. Five top priorities are seen as **fundamental** to reaching the twin goals through their impact on both growth and inclusion: i) restoring fiscal sustainability and maintaining financial stability; ii) establishing a high-quality business environment; iii) providing clean, efficient, equitable, and financially sustainable sources of energy; iv) formalizing and enhancing the inclusiveness of land and property markets; and, v) enhancing governance, transparency, and the accountability of the government toward citizens. Addressing the constraints in these five areas is a necessary and immediate prerequisite to unlock constraints in multiple areas that hamper achievement of the twin goals. Another four areas were seen as **supporting** priorities which amplify the impact of the top five (fundamental) priorities over the longer run. These four policies would seek to: i) boost the quality of the labor market engagement of the bottom 40, youth, women, and minorities; ii) improve the quality and relevance of the education system and skills training programs; iii) improve the efficiency and equity of public resource management; and iv) ensure more inclusive access to financial markets. The final three policy priorities are seen as **sustaining**, that is, contributing to the financial, social and environmental sustainability of the other priorities and of the overall reform agenda. These three additional policies would be aimed at: i) enhancing the effectiveness and efficiency of social protection systems with respect to vulnerable groups; ii) ensuring the sustainable use of natural resources and the stewardship of the environment; and, iii) improving the quality and equity of health services and reducing health-related financial risks. Notable complementarities exist among priorities that have significant impact on economic growth (such as macroeconomic stability and energy security) and those that have more direct impact on equity (such as the quality of labor market engagement and the protection of vulnerable groups). Capturing synergies, developing proper sequencing and building institutional capacity to develop and implement reforms will be critical to maximize equitable growth in a sustainable manner.*

The four-block diagnostic presented in this SCD identifies an array of constraints to effectively reducing poverty and increasing shared prosperity in Albania. In particular, the SCD concludes that:

1. The earlier domestic demand-fueled growth model is no longer sustainable and has contributed to severe macroeconomic imbalances—characterized by high public debt, structural fiscal deficits, public sector arrears and large non-performing loans—which must now be addressed in order to reignite growth and reverse the recent increase in poverty.
2. Households and firms face constraints to efficient and intensive use of their assets and endowments. This limits their capacity to benefit from, and contribute to, economic growth. This includes inequities in access to education, health care, land, finance and labor markets, along with general shortcomings such as the

poor quality of the education system, widespread informality in land and labor markets, lack of urban planning, limited access to finance, and poor use of environmental resources.

3. The enabling environment for households and firms to accumulate and efficiently use assets needs considerable strengthening. This includes the regulatory environment for doing business, the delivery of public services and the provision of a well-targeted social safety net. Institutional weaknesses affect overall governance, create regulatory barriers that limit enterprise development, undermine the quality and equity of public service provision and perpetuate inadequate targeting, coverage, and benefit levels of social safety nets.
4. Albania faces a multiplicity of risks to the sustainability of growth and welfare gains for citizens. These risks may directly undermine growth or indirectly affect the accumulation and use of assets by economic agents or weaken the enabling environment. These include macroeconomic risks, natural resource risks and social risks related to exclusion of certain groups from economic opportunities.

To unlock these constraints, restore economic growth and return Albania to a path of poverty reduction and shared prosperity, a new economic model is warranted based on increased domestic productivity and orientation toward regional and global markets. This SCD argues that a shift toward a new growth model is necessary because the earlier domestic consumption-based model has been largely exhausted since the 2008 global crisis. Boosting productivity and competitiveness of the economy and expanding inclusiveness are needed to generate long-term economic and employment gains.

In this SCD, a two-stage approach was adopted to identify priorities for overcoming the constraints to advancing the twin goals in Albania (see Annex 1 for details). In the first stage, the SCD identified twelve major constraints which are undermining the achievement of substantial progress toward the twin goals, and then defined a policy priority for addressing each of these twelve constraints. In the second stage, the Albania SCD Team drew on the findings of the diagnostic and of stakeholder consultations (see Annex 3) in order to cluster the twelve priorities based on their direct impact on achieving the twin goals. Priorities were scored based on their direct impact on growth, poverty reduction and shared prosperity. Three mutually-reinforcing categories of priorities were identified. The section below summarizes the results of the priority-setting exercise and discusses complementarities among different categories of priorities.

Results of the Priority-setting Exercise

Twelve broad policy priorities have been selectively identified for Albania to make progress toward the twin goals. Table 4 summarizes the key constraints that results from the top-down and bottom-up analysis of a spectrum of issues in this SCD, including assessment of the enabling environment and the cross-cutting risks to sustainability that links the macro framework to the micro situation at household and firm level.

Table 4: Key Constraints and Policy Priorities in Advancing toward the Twin Goals




KEY CONSTRAINTS	POLICY PRIORITIES
BLOCK 1: TOP-DOWN	
Macroeconomic imbalances related to high public debt, structural-fiscal deficits, public sector arrears, potential external imbalances, and large NPLs in the financial sector	→ RESTORING FISCAL SUSTAINABILITY AND MAINTAINING FINANCIAL STABILITY
BLOCK 2: BOTTOM-UP	
Inequitable access to quality preprimary and higher education ; the poor quality of the education system, leading to poor overall learning outcomes; the weak links of education and training systems with labor demand	→ IMPROVING QUALITY, ACCESS AND RELEVANCE OF EDUCATION AND TRAINING SYSTEMS
Inequitable access to quality health services; inequities in health outcomes among the poor, the bottom 40, and ethnic minorities; the increasing burden of noncommunicable diseases; high out-of-pocket expenditures; and high informal payments, particularly among the poor and the bottom 40	→ IMPROVING QUALITY, EFFICIENCY AND EQUITY OF HEALTH SERVICES
Widespread informality and the weak enforcement of property rights in land markets in rural and urban areas; the lack of urban planning and enforcement leading to the inefficient allocation of land, land use, and space (density)	→ FORMALIZING AND ENHANCING INCLUSIVENESS OF LAND AND PROPERTY MARKETS
The unsustainable use of natural resources , on which livelihoods and key economic sectors (energy, agriculture, tourism) depend; the growing pressure on environmental assets and the climate risks in water resources	→ ENSURING SUSTAINABLE USE OF NATURAL RESOURCES AND STEWARDSHIP OF THE ENVIRONMENT
High overall informal employment and significant joblessness (from economic inactivity and unemployment) among the bottom 40, women, youth, and minorities undermine the quality of the labor market engagement of economic agents	→ INCREASING THE QUALITY AND INCLUSIVENESS OF LABOR MARKET ENGAGEMENT
Limited access to finance and savings because of the low penetration of financial services and the low level of financial inclusion, especially among certain groups and in rural areas	→ IMPROVING INCLUSIVENESS OF ACCESS TO FINANCIAL MARKETS
BLOCK 3: THE ENABLING ENVIRONMENT	
Institutional weaknesses, the inefficient judicial system, the discretionary application of the rule of law , and corruption	→ ENHANCING GOVERNANCE, TRANSPARENCY AND ACCOUNTABILITY OF GOVERNMENT
The large regulatory barriers to doing business harm firm growth and job creation	→ ESTABLISHING A HIGH QUALITY BUSINESS ENVIRONMENT
Socioeconomic and spatial inequalities in public service provision; significant inefficiencies in public spending; the low quality in the provision of public services	→ IMPROVING EFFICIENCY, ACCESS AND QUALITY OF PUBLIC SERVICE DELIVERY
High economic dependence on hydro resources for energy provision, resulting in vulnerability to weather phenomena; the pervasive waste of energy resources; and the substantial reliance on imports	→ PROVIDING CLEAN, EFFICIENT, EQUITABLE, AND FINANCIALLY SUSTAINABLE ENERGY
The poor targeting, coverage, and benefit levels of the main poverty-focused social protection programs; the poor targeting of the truly disabled and the inefficient spending of the disability assistance program	→ INCREASING THE QUALITY AND INCLUSIVENESS OF LABOR MARKET ENGAGEMENT

This SCD goes further in its prioritization to identify five top priorities to accelerate growth and achieve the twin goals. The priorities have been clustered into the following three groups based on their contribution to the twin goals through their direct impact on growth, poverty reduction and shared prosperity:

4. **Fundamental Priorities:** This group comprises the highest-ranking policy priorities, considered fundamental for reaching the twin goals in Albania. Unlocking these five constraints is the *necessary and immediate prerequisite* for the success of all policy priorities in advancing the twin goals. This group exerts direct impact both on the productivity and competitiveness of the economy and on greater inclusion. It includes: (1) restoring fiscal sustainability and financial stability; (2) establishing a high-quality business environment that promotes firm growth and job creation; (3) providing clean energy efficiently, equitably, and in a sustainable manner; (4) formalizing and enhancing the inclusiveness and sustainability of the land market; and (5) enhancing governance, transparency, and the accountability of government toward citizens.
5. **Supporting Priorities:** A further four are viewed as supporting priorities that *amplify the impact of the top five priorities* over the longer run. The group includes (1) increasing the quality of labor market engagement among the bottom 40, youth, women, and minorities; (2) improving the quality and relevance of the education system and skills training programs; (3) improving the efficiency and equity of public resource management; and (4) ensuring more inclusive access to financial markets.
6. **Sustaining Priorities:** This group—although not seen as having the strongest direct and immediate impact on growth and inclusion—is considered critical to *enhancing the economic, social, and environmental sustainability* of the top five priorities and the overall reform agenda. The group includes: (1) enhancing the effectiveness and efficiency of social protection systems for the benefit of vulnerable groups, (2) ensuring the sustainable use of natural resources and the stewardship of the environment, (3) improving the quality and equity of health services and reducing health-related financial risks.

Table 5: Scoring of Priorities based on Direct Impact on Achieving the Twin Goals

<u>Priority Policies</u>	<u>Overall Impact</u>
Restoring fiscal sustainability and maintaining financial stability	<i>Fundamental</i>
Establishing a high quality business environment	<i>Fundamental</i>
Providing clean, efficient, equitable and financially sustainable energy	<i>Fundamental</i>
Formalizing and enhancing inclusiveness and sustainability of the land market	<i>Fundamental</i>
Enhancing governance, transparency and accountability of government	<i>Fundamental</i>
Increasing the quality and inclusiveness of labor market engagement	<i>Supporting</i>
Improving quality, access and relevance of education and training systems	<i>Supporting</i>
Improving efficiency, access and quality of public services delivery	<i>Supporting</i>
Improving inclusiveness of access to financial markets	<i>Supporting</i>
Enhancing effectiveness and efficiency of social protection systems	<i>Sustaining</i>
Ensuring sustainable use of natural resources and stewardship of the environment	<i>Sustaining</i>
Improving quality, efficiency and equity of health services	<i>Sustaining</i>

Note: The impact scores are derived from the qualitative assessment of SCD experts and range between 1 (minimum) and 5 (maximum) for each policy priority as well as for the short and the medium to long term. They are consolidated in an Overall Impact Index per policy priority. Sustaining impact refers to  (yellow) cells with a medium-low impact score between 1.67 and lower than 2.5]. Supporting impact refers to  (orange) cells with a medium-high impact score (2.1 and lower than 3.3. Fundamental impact  (red) indicates high impact and comprises scores higher than 3.3. See Annex 1 for details.

Complementarities and Capacity to Implement Priorities

There are notable complementarities among priorities which must be taken into account when defining and sequencing the reform agenda in Albania. Complementarities are evident within each of the three categories: reform of land markets, for example, will have an important positive effect on the business environment, showing complementarity among fundamental priorities. Complementarities are important across categories as well: reform of health insurance, pension and social protection schemes is essential to restore fiscal sustainability in the medium-term. Selective reform may be necessary within an area deemed to have a lesser direct impact on achievement of the twin goals due to its indirect effect on one of the fundamental priorities. Some priorities would have higher impact on short-term growth (e.g. business environment) or longer-term growth (e.g. education system), while others would have higher immediate impact on the income of the bottom 40 (e.g. social protection), which may have an important social solidarity and sustainability dimension. In a fiscally-constrained environment, improving delivery of public services in the near term, for instance, can only be achieved through efficiency gains rather than increased spending. These complementarities and tradeoffs must be considered by Government and society in determining the timing and sequencing of priority reforms.

Capacity to implement reforms varies across the priority areas, and will need to be reinforced in order to maximize progress toward the twin goals. The question of implementation capacity is not necessarily at the center of the diagnostic or prioritization exercise, but is also an essential question in defining and sequencing

Albania's reform agenda (and the World Bank Group's support for that agenda). Annex 2 presents a cluster analysis that assesses implementation capacity for each of the twelve priority areas. The analysis suggests limitations in the current institutional environment for implementing reforms across the policy priorities. Capacity is relatively higher in the areas of macroeconomic stability, improving the business environment, reforming the land market, improving public resource management and expanding the labor market engagement of vulnerable population groups. Reforms in these areas, which have a large impact on both economic growth and income among the bottom 40, should be pursued vigorously to exploit available capacity. The capacity to carry out policy reforms is found to be relatively low for establishing rule of law and for ensuring energy security (Figure A2.2). Given the large impact of these two priorities on the twin goals, capacity-building efforts will need to be strengthened in these areas.¹⁴⁸

The Policy Agenda in Priority Areas

This section discusses in more detail the findings for each category of priorities, including top policy actions to alleviate constraints in each of the twelve priority areas. This includes the expected impact of specific policy actions in overcoming the relevant constraints to advancing the twin goals.

FUNDAMENTAL PRIORITIES

RESTORING FISCAL SUSTAINABILITY AND MAINTAINING FINANCIAL STABILITY

The diagnostic reveals that Albania faces key economic vulnerabilities that could directly jeopardize the effort to realize a new growth model. Specifically, macroeconomic imbalances related to high public debt, high structural-fiscal deficits, public sector arrears, large potential external imbalances, and the volume of NPLs in the financial sector are noteworthy. In the short term and beyond, these vulnerabilities can affect the generation and distribution of the gains among households and firms, the capacity of households and firms to accumulate assets, and the returns households and firms receive. Addressing these imbalances would thus create large benefits to the economy through positive direct and indirect effects in reducing poverty and increasing shared prosperity. For instance, clearing the large public sector arrears is likely to boost growth not only by fostering fiscal stability, but also by repaying suppliers and reducing the unpaid obligations of these suppliers to subcontractors. These financial flows to the private sector are likely to raise domestic demand and contribute

¹⁴⁸ This finding is supported by the positive association between mean growth and growth distribution (the bottom 40) in the subset of macroeconomic and financial stability, improving the business environment, reforming the land market, making the management of public resources more efficient and equitable, and expanding the engagement of vulnerable population groups in the labor market. See Figure A2.3.

directly to growth. Direct impacts on the incomes of vulnerable and poor households may also take place by clearing disability insurance arrears.¹⁴⁹

Restoring fiscal sustainability, maintaining financial sector stability and improving macroeconomic balances represent a first order priority and a prerequisite for eliminating many other constraints.

Lasting macro, fiscal, and financial stability is a necessary condition for the realization of a sustainable growth model—one that is not achieved at the cost of the prosperity of future generations (for example, because it is financed by an unsustainable accumulation of public debt)—and for poverty reduction and shared prosperity. Improving the predictability of fiscal policy by limiting ad hoc fiscal adjustments can open up the fiscal space for productive spending and for strengthening social programs among the poor. These benefits would arise in addition to the economy-wide benefits of macroeconomic stability in providing a foundation for well-functioning markets and the household-level benefits derived from protecting incomes from macroeconomic volatility (for example, excessive taxation). The implementation of sound fiscal policies aimed at fiscal consolidation can be achieved by improving the efficiency and quality of public spending, carrying out revenue enhancing measures, tackling outstanding public arrears, addressing pension sustainability, and eliminating quasi-fiscal deficits. Also, the improved planning and prioritization of public investment (for example, by rebalancing new investment in roads by favoring road maintenance) can directly support the efficiency, quality, and equitable management of public resources. Moreover, a strengthened public financial management system would enhance the predictability and transparency of the government management of public resources.

Macroeconomic stability is essential for boosting the competitiveness of the Albanian economy and protecting the incomes of the population. Large inflows of foreign resources (mainly remittances) and a tendency of the exchange rate to appreciate have pushed unit labor costs above the levels supported by the human capital that remains in the country. Restoring fiscal balance will counteract these trends, thereby directly boosting the competitiveness of the economy. In addition, maintaining financial sector stability, implementing complementary policies to improve the allocation of financial resources (by reducing NPLs and reviving credit growth), and supporting the credibility of monetary policy are essential not only to spur economic growth, but also to protect the incomes of economic agents (households, firms, farms).

¹⁴⁹ A part of the public arrears relate to disability insurance; of individuals receiving the urban disability benefit, 11 percent are poor, and 32 percent are in the bottom 40, while, among individuals receiving the rural disability benefit, 24 percent are poor, and 56 percent are in the bottom 40.

POLICY PRIORITY: RESTORING FISCAL SUSTAINABILITY AND MAINTAINING FINANCIAL STABILITY	
Fundamental	<p>SPECIFIC POLICY ACTIONS</p> <ul style="list-style-type: none"> • Implement sound fiscal policies by improving the efficiency of public spending, enhancing revenue measures, tackling the outstanding public arrears, addressing pension sustainability, eliminating quasi-fiscal deficits (especially in energy through a time-bound recovery plan), strengthening the management of public debt, and strengthening public financial management • Strengthen public investment decision making, reflecting improved planning and the prioritization of capital spending (for example, by rebalancing new investment in roads toward maintenance, developing financing mechanisms for infrastructure, and addressing environmental externalities such as wastewater treatment and waste management) • Maintain financial sector stability by reducing NPLs, reviving sustainable credit growth, increasing the reserves of the deposit insurance fund, safeguarding the credibility of monetary policy, and strengthening the autonomy of the financial regulatory authorities

ESTABLISHING A HIGH-QUALITY BUSINESS ENVIRONMENT

The creation and growth of firms are currently limited by large regulatory barriers that prevent firms from successfully competing in domestic and international markets. This regulatory burden affects firm productivity and the overall competitiveness of the economy. It is reflected in poor integration with the EU and the world so that total exports account for a mere 30 percent of GDP. As demonstrated empirically in the SCD, the shortcomings of the business climate represent an obstacle to business development by lowering firm-level growth and job creation. The key challenge resides in establishing and implementing transparent business practices that encourage entrepreneurship and investment and that facilitate trade domestically and internationally.

Increasing the quality of the business environment will help reduce the prevalence of widespread informality. In turn, it is expected to affect incomes positively across the distribution and the sectors of the economy.

The impact of improving the quality of the business climate on equitable economic growth can be extensive in the short term and beyond. Specifically, improvement can help promote private sector investment and new firm and farm creation and growth, including by reducing export costs and attracting FDI. It can also foster formal job creation, as new firms emerge or grow in a business environment that incentivizes the formalization of businesses and jobs. A policy agenda for improving the business environment should focus on (1) cutting the regulatory burden across the board (for example, reducing regulations on construction permits, trade logistics, inspections, and so on); (2) strengthening the government's capacity to coordinate and monitor business environment reform; (3) strengthening the policy, legal, and institutional framework for private investment (including FDI) to boost the incomes of economic agents (both farm and nonfarm); (4) minimizing informality through streamlined and simplified rules, procedures, and reporting guidelines; and (5) improving trade logistics and facilitation, as well as deepening international and regional integration.

POLICY PRIORITY: ESTABLISHING A HIGH-QUALITY BUSINESS ENVIRONMENT	
Fundamental	<p>SPECIFIC POLICY ACTIONS</p> <ul style="list-style-type: none"> • Cut the regulatory burden across the board (for example, construction permits, trade logistics, inspections, property and land registration, and so on) and ensure the nondiscriminatory implementation of regulations among all economic agents • Strengthen the policy, legal, and institutional framework to attract FDI and the entry and protection of FDI to maximize the benefits and spillovers of FDI among local economic agents (firms, farms, entrepreneurs) • Improve trade logistics and facilitation and deepen international and regional integration • Improve corporate governance and the financial reporting practices of banks and firms through streamlined rules, procedures, disclosure practices, the role of boards of directors, and financial reporting and auditing standards

PROVIDING CLEAN, EFFICIENT, EQUITABLE, AND FINANCIALLY SUSTAINABLE ENERGY

The efficient, secure provision of clean energy in a fiscally sustainable manner exerts a large impact on economic growth and sustainability. The Albanian energy sector poses significant economic risks stemming from recurrent energy shortages (because of fluctuations in rainfall), persistently high distribution losses, regulated tariffs that are below recovery costs, and low collection rates. It has required sustained large fiscal support through import guarantees and injections of liquidity into energy generation and distribution companies.

The energy sector reforms are expected to contribute to poverty reduction and shared prosperity in the long term by helping sustain growth, reduce fiscal risks, and ensure reliable energy supply. Reforms in the energy sector could help reduce the contingent liabilities (of about 2 percent of GDP) to the government budget and promote economic growth through reliable energy supply. For example, a distribution loss reduction plan that reduces energy losses by 6 percent through better network management, the metering of large tariff customers, customer outreach, and better collection could halve the contingent liabilities compared with the no reform scenario. However, some of the reforms—for example, greater energy tariff collection and a reduction in power grid losses—could have potentially negative short-term effects on poor households. This entails a need for complementary measures that ensure energy affordability among the bottom 40 in the face of sector reforms (including tariff reform). Thus, providing well-targeted public assistance to mitigate tariff increases can be an effective tool.

Restoring the financial viability of the energy sector for reliable energy supply calls for immediate high-priority reforms to break away from the unsustainable practices in the sector. Specific policy actions include improving the management of hydro resources through integrated water basin approaches, investing in new generation and diversifying the generation mix, decreasing distribution system losses to reduce waste and increase energy efficiency, adjusting tariffs to reflect true energy costs, and opening up the electricity market to regional competition. The market should move toward compliance with EU directives: large

consumers could start buying electricity on the market, and the distribution sector operator could become responsible for a consistent supply of energy to tariffed customers. These measures are needed not only to restore the financial viability of the sector and reduce the fiscal risks on the budget, but also to support growth through a reliable supply of power. In addition, boosting energy efficiency would help manage demand by limiting the need for expensive imports of electricity.

POLICY PRIORITY: PROVIDING CLEAN, EFFICIENT, EQUITABLE, AND FINANCIALLY SUSTAINABLE ENERGY	
Fundamental	SPECIFIC POLICY ACTIONS
	<ul style="list-style-type: none"> • Reduce waste and increase energy efficiency through reduction in distribution losses and improved collection from consumers • Reduce weather vulnerability through preparation and implementation of Risk Management Strategy, including among others, diversification of generation sources, regional integration and insurance instruments. • Improve the management of hydro resources through integrated water basin approaches

FORMALIZING AND ENHANCING THE INCLUSIVENESS AND SUSTAINABILITY OF THE LAND MARKET

Formalizing and making the land market more inclusive and sustainable in Albania is expected to have a positive impact on poverty reduction and the welfare of the bottom 40. The land market currently suffers from widespread informality and the weak enforcement of property rights in both rural and urban areas. This has limited the productive use of land assets, particularly among population groups such as the bottom 40 and women. Addressing the issue of land formalization through a realistic, fiscally affordable scheme and within a reasonable time frame is key to eliminating this constraint.

Land policy reform is expected to have a strong impact on the twin goals. This impact can materialize over the short to medium term if the access to land assets for productive use is expanded and secured in an equitable manner, thus promoting economic growth and stimulating business development and job creation. The land policy agenda includes an integrated land management reform with a focus on (1) increasing formalization, including current administrative procedures for land titling and digital registration; (2) addressing exclusionary practices in property registration that particularly affect the bottom 40 and women; (3) addressing the current land compensation scheme in a fiscally sound and fair manner in line with international practice; and (4) addressing land and property tax practices and valuation. Overcoming the constraints to well-functioning land markets can also promote fiscal sustainability by raising the revenue of local governments from property taxes and reforming the land compensation scheme.

Improving territorial planning and improving the technical and financial capacity of local governments to implement plans will have a positive impact on economic growth and contribute to the preservation of the country's environmental and cultural assets. This impact can materialize in the short to medium term through the implementation of recent planning reforms and by increasing the technical and financial capacity of newly formed local governments to implement their plans. Strategic planning will allow

the identification of priority investments that should yield higher rates of return to capital and produce true economic benefits for local populations. In addition, protecting cultural and environmental assets in parallel with bringing services up to EU standards will allow the country to exploit its potential in tourism, generate jobs, and contribute to shared prosperity. Finally, compared with the unplanned growth business-as-usual scenario, planned development can contribute to the mitigation of the risks linked to natural hazards that disproportionately affect the poor.

POLICY PRIORITY: FORMALIZING AND ENHANCING INCLUSIVENESS AND SUSTAINABILITY OF THE LAND MARKET	
Fundamental	SPECIFIC POLICY ACTIONS
	<ul style="list-style-type: none"> • Increase land formalization and promote inclusionary practices through streamlined and transparent administrative procedures of land legalization (including for b40 and women), land and property valuation following international standards, digital land cadaster registration lined to a fiscal cadaster • Address land restitution/compensation scheme in fiscally sound and fair manner in line with best international practices; • Develop a land and farm consolidation program to help increase farm productivity and improve land management • Improve land planning and management to protect endowment and foster agglomeration economies

ENHANCING GOVERNANCE, TRANSPARENCY, AND ACCOUNTABILITY OF GOVERNMENT

A rule of law that is transparent, predictable, and respected will have an overall positive impact on economic growth and job creation in the medium to long term. Strengthening the operations of public institutions facilitates the accumulation and use of assets by economic agents. Weak rule of law and the poor, inconsistent, and uneven enforcement of laws and regulations are among the leading challenges in this area.

Large benefits to equitable growth arise from more transparency in the application of laws and procedures and greater accountability in decision making. The first legislative steps have been taken to fight corruption and organized crime. However, Albania still needs to enhance the independence, accountability, and professionalism of the judiciary.¹⁵⁰ This is especially important as the country pursues its ambition to accede to the EU. In addition, expanding consensus building in Parliament in the adoption of reform strategies, laws, and regulations and addressing the inconsistent application of laws and regulations by the courts and by executive agencies will directly improve the efficiency of lawmaking and depoliticize the process. Furthermore, improved corporate governance and financial reporting practices among banks and firms (transparency, disclosure practices, the role of boards of directors, and financial reporting and auditing

¹⁵⁰ For example, the new Civil Service Law that went into effect in February 2014 is designed to improve professionalism and reduce politicization and corruption in public administration.

standards) can help reduce the implicit tax on economic activity generated by poor governance among institutions, thereby boosting trust and investment in the formal economy.

POLICY PRIORITY: ENHANCING GOVERNANCE, TRANSPARENCY, AND ACCOUNTABILITY OF GOVERNMENT	
Fundamental	SPECIFIC POLICY ACTIONS
	<ul style="list-style-type: none"> • Increase transparency and accountability of decision-making, including through an integrated e-Government system, strengthened the independence and depoliticization of public institutions • Enhance the independence, accountability, professionalism of the judiciary/courts and executive agencies to ensure non-discretionary and consistent implementation of laws and regulations • Expand consensus building in Parliament in the adoption of reform strategies, laws and regulations

SUPPORTING PRIORITIES

INCREASING THE QUALITY AND INCLUSIVENESS OF LABOR MARKET ENGAGEMENT

The SCD clearly identifies the low quality of labor market engagement, especially among the bottom 40, youth, and women, as a key constraint to achieving the twin goals. Key labor market outcomes such as high unemployment rates, low employment rates, low labor force participation, and the high rate of young NEETs reflect poor labor market engagement. Among vulnerable groups such as youth and women, labor market attachment has been deteriorating since 2008. Labor demand is being affected by mediocre growth performance, but overcoming the constraints to building up and using human capital, including among the less well off, will help foster significant, high-quality labor market engagement.

Formal job creation is a major pathway for combatting poverty and boosting shared prosperity. Promoting flexible labor regulations and removing disincentives and barriers to formal work can help boost the reliance of households on labor income. Activation measures benefiting particularly the less well off and improving access to formal employment are two of the areas that can deliver a substantial impact on the achievement of the twin goals.

POLICY PRIORITY: INCREASING THE QUALITY AND INCLUSIVENESS OF LABOR MARKET ENGAGEMENT	
Supporting	SPECIFIC POLICY ACTIONS
	<ul style="list-style-type: none"> • Improve policy incentives and remove barriers for formal employment, particularly for the b40, youth and women, including by strengthening the evidence base • Strengthen active labor market programs to promote activation of particular groups (e.g. youth, women, minorities) • Enhance labor market information systems to improve education, training, and job matching, including through enhanced coordination between government and private sector, strengthened linkages with active labor market measures, and regular collection and use of labor market information • Promote formal sector firm registration by reducing barriers to registration and reducing personal income tax disincentives to formal sector employment

The diagnostic is candid in highlighting the knowledge gap in a potential policy agenda for labor markets given the scarcity of evidence on existing disincentives and barriers to employment, particularly across some population groups (Box 8). This is an area of critical importance, but for which the policy agenda remains partially undefined given the limited analytical base.

Box 8. Labor Markets in Albania: A Key Knowledge Gap

Improving the quality of labor market engagement, especially among the bottom 40, youth, and women, is a priority in the effort to achieve the twin goals in Albania. Yet, the SCD notes a knowledge gap in a potential policy agenda on labor markets given the scarcity of evidence on existing disincentives and barriers to employment, particularly across some population groups. There is thus a pressing need to gather knowledge in this direction.

Priority areas in advancing the evidence-based policy agenda in this area include (a) conducting in-depth labor market analysis to identify and propose policies to address the disincentives and barriers to formal work (labor regulations, labor taxation, social protection, additional barriers), especially those affecting specific population groups disproportionately, and (b) collecting timely, accurate data on labor market supply and demand that can also feed into education and training system policies and reforms and active labor market policies. On the supply side, Albania could participate in the Organisation for Economic Co-operation and Development's Program for the International Assessment of Adult Competencies, which measures skill levels among adults. It could also participate in the Skills toward Employment and Productivity skill measurement survey, which covers supply-side (including cognitive and noncognitive skills) and demand-side information. To understand the weaknesses of the education system, Albania might capture early grade learning outcomes among younger students. Taking part in international assessments, including the Trends in International Mathematics and Science Study (mathematics and science, grades 4 and 8) or the Progress in International Reading Literacy Study (reading comprehension, grade 4), and facilitating classroom-based assessments such as early grade reading or mathematics assessments could be a suitable way to measure early grade outcomes.

*IMPROVING QUALITY, ACCESS AND RELEVANCE OF EDUCATION AND
TRAINING SYSTEMS*

Achieving high quality, relevance, and equity in access in education and training systems is a key ingredient in increasing the quality of the growth process by shifting to a model centered on productivity, competitiveness, and inclusion. However, Albania's education and training systems suffer from serious deficiencies in meeting this challenge. There include inequalities in access to quality preprimary and higher education that affect the less well-off disproportionately. Severe issues of quality and relevance of education and training systems exist across the board.

Addressing the constraints in education and training is expected to have a significant impact on the achievement of the twin goals. Raising the human capital of the population in a relevant manner (particularly by starting early on among those groups currently at a disadvantage) and aligning education and training systems with labor markets can boost economic growth by increasing the supply of skilled labor, enhancing productivity, and opening up employment opportunities. This impact is anticipated to materialize primarily over the long term as the new generation and future workforce begin to benefit from the overhauled systems. Nonetheless, even in the short to medium term, gains are available from targeted interventions in education and training by,

for example, tightening the links with active labor market policies and improving the links with firms. A policy agenda aimed at strengthening the human capital base by raising the quality, relevance, and equity of education and training systems should focus on (1) improving access and expanding the equity in the access to preprimary and higher education by targeting children and youth among the bottom 40; (2) improving the quality of the education system in an equitable manner from preprimary to higher education by ensuring that graduates at each level acquire requisite cognitive, noncognitive, and technical skills; (3) improving the relevance of education and training systems through enhanced coordination between the government and the private sector, strengthened links with active labor market measures, and the regular collection and use of labor market information; and (4) improving the efficiency of public spending through enhanced school-level accountability and management, including in financial decisions, and the adoption of a per capita financing model.

POLICY PRIORITY: IMPROVING QUALITY, ACCESS AND RELEVANCE OF EDUCATION AND TRAINING SYSTEMS	
Supporting	SPECIFIC POLICY ACTIONS
	<ul style="list-style-type: none"> • Improve access and equity in access to pre-primary and higher education, by targeting b40 children and youth • Improve quality of formal education system in an equitable manner from preprimary to higher education, by ensuring that graduates at each level acquire requisite cognitive, non-cognitive, and technical skills • Enhanced management, efficiency, and quality of higher education system through targeted scholarships and institutional performance based/competitive grants • Strengthened management and governance of education system, including resource allocation and decentralized autonomy and accountability

IMPROVING EFFICIENCY, ACCESS, AND QUALITY OF PUBLIC SERVICE DELIVERY

The provision of public services in Albania is characterized by significant inefficiencies in delivery and public spending, poor quality, weak institutional capacity, limited accountability in providing services to users, territorial fragmentation, and socioeconomic and spatial inequalities in access. Informal payments (in health care) and perceptions of corruption are prevalent.

The short- and medium-term impact on reducing poverty and increasing shared prosperity could be notable through improved efficiency in public resource allocation and utilization. An additional step toward achieving the twin goals in the medium to long term would be to enhance the supporting role of public services in building the capacity of the bottom 40 to acquire and use assets (for example, through the equitable provision of quality education and health care), thus improving overall welfare as well as promoting the ability of the bottom 40 to contribute to and benefit from economic growth, thereby positively affecting long-term social sustainability. More efficient spending and the crowding in of private investment further promote macro-fiscal stability.

Given the tight fiscal space, specific policy actions on the agenda to improve public service delivery may include (1) strengthening institutions and building the human capacity to reinforce financial discipline; (2) improving governance, management, and accountability in service delivery; (3) strengthening efficiency and equity in the management of public resources (for example, in health care, education, water, transport, and sanitation) to expand access and quality; and (4) improving the legal and regulatory framework and the human capacity in public service delivery, including through enhanced levels of accountability and management and fiscally sound PPPs (for example, in ports, waste management, roads, and the social sectors).

POLICY PRIORITY: IMPROVING EFFICIENCY, ACCESS, AND QUALITY OF PUBLIC SERVICE DELIVERY	
Supporting	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Strengthen institutions and build human capacity for reinforcing financial discipline, improving governance/management/accountability in service delivery • Strengthen the efficiency and equity in managing public resources (e.g. in health, education, water, transport, sanitation, etc) to improve access to, quality of and equity in public services • Improve the legal and regulatory framework for public services delivery, including through enhanced level of accountability and management as well as fiscally-sound PPPs

IMPROVING INCLUSIVENESS OF ACCESS TO FINANCIAL MARKETS

Expanding financial markets and making them more inclusive represent a potential area of sizable impact on the achievement of the twin goals both in the short and medium term. Households and firms in Albania currently have limited access to finance because of the low penetration of financial services and the low financial inclusion. Especially women, rural populations, and the less well off are overrepresented in the unbanked population. Building equitable opportunities to acquire greater financial assets among households and firms is crucial to overcoming this challenge.

Addressing this constraint is expected to promote equitable growth and job creation by opening up more opportunities for access to savings and borrowing using viable financial instruments, particularly among excluded groups. A policy agenda to help expand financial markets and make them more inclusive would include (1) improving efficient asset allocation and the availability of financing for long-term debt or equity (for example, the development of government debt markets and other domestic capital market activities); (2) encouraging the development of nonbank financial institutions (insurance companies, leasing, investment funds, asset management companies, and so on); (3) strengthening financial infrastructure (deposit insurance, payment systems, collateral registries, and so on); and (4) improving financial inclusion, particularly among the bottom 40, rural populations, and women, by providing new savings, lending, and payment opportunities to the unbanked population through banks and nonbank financial sector channels, such as savings and credit associations, microfinance institutions, Albania Post, and mobile money providers.

POLICY PRIORITY: IMPROVING INCLUSIVENESS OF ACCESS TO FINANCIAL MARKETS	
Supporting	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Encourage development of non-bank financial institutions (SCAs, insurance, leasing, investment funds and asset management companies, etc.) • Strengthen financial infrastructure (deposit insurance, payment system, collateral registries, the insolvency regime, etc.) as well as the availability of long-term debt and equity financing (e.g. domestic capital market activities) • Improve financial inclusion, particularly for b40 and women, by providing new saving, lending and money payment opportunities to the unbanked population through both banks and non-bank financial sector channels (e.g. through SCAs, MFIs, Albanian Post, mobile money providers, etc.)

SUSTAINING PRIORITIES

ENHANCING EFFECTIVENESS AND EFFICIENCY OF SOCIAL PROTECTION SYSTEMS

The effective and efficient provision of protection to vulnerable groups, including the poor, the disabled, and the elderly will be key in advancing the achievement of the twin goals. Existing social safety nets are not well targeted (although reforms are currently under way), do not provide adequate coverage among the most vulnerable, and do not provide adequate protection against household shocks or cyclical economic downturns. The qualitative assessment reveals the high impact of the effective and efficient provision of protection to vulnerable groups, including the poor, the disabled, and the elderly, specifically through the distributional effects.

The policy agenda in this area would include the continuation of ongoing efforts to improve poverty targeting in the Solidarity Albania Program and the targeting of the disability program on the disabled, rebalance spending across programs, modernize the administration of benefits, and enhance the link to active labor market programs. A medium-term vision would include consolidation of social assistance by channeling various benefits through the Solidarity Albania Program as well as linking social assistance to human capital and economic activation measures and improving the institutional capacity to implement economic activation measures so as to promote the inclusion of marginalized groups within the growth process. More effective protection against income shocks to vulnerable families will likely boost the incomes of these families immediately. Moreover, by allowing households to protect themselves against and cope with income shocks, strengthened social safety nets are likely to enhance the impact of policies in support of asset accumulation and use. Therefore, a holistic view of social protection is warranted, particularly through the introduction of social pensions. The recent positive reforms of pensions need to continue, and there should be a focus on the implementation of the recently passed legislation.

POLICY PRIORITY: ENHANCING EFFECTIVENESS AND EFFICIENCY OF SOCIAL PROTECTION SYSTEMS	
Sustaining Impact	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Continue the reform agenda to improve the poverty targeting of Solidarity Albania Program and the targeting of the disability program on the disabled, rebalance spending between programs, and modernize the administration of benefits, while consolidating social assistance by channeling various benefits through the Solidarity Albania Program • Continue the agenda to reform the pension system and focus on the implementation of the recent pension law • Link social assistance to human capital and economic activation measures and improve the institutional capacity to implement economic activation measures so as to promote the inclusion of marginalized groups within the growth process

ENSURING SUSTAINABLE USE OF NATURAL RESOURCES AND STEWARDSHIP OF THE ENVIRONMENT

Natural resources are at the heart of Albania's comparative advantage, competitiveness, and growth, and they have a direct impact on the well-being of the poor. Much of Albania's growth and export potential has been linked to nature-based sectors such as coastal tourism, agriculture, hydropower, and mining. This high dependence on natural resources and highly volatile water resources creates extreme vulnerabilities. Albania's economy is the most vulnerable in Europe to climate change and one of the most vulnerable in the world to natural disasters. Its substantial exposure and sensitivity to the quality of natural assets, disaster risks, and climate change directly affect sectors such as agriculture, energy, and tourism, but also the livelihoods of large parts of the population, especially the less well off. Furthermore, Albania must align its environmental policies, institutions, and outcomes with EU directives to maintain its path to EU accession, which is a complex and expensive process.

A range of policy actions is required to allow the country to take advantage of its natural wealth to accelerate and sustain inclusive growth and address growing environmental and climate risks. These policy actions include support for and the enhancement of existing nature-based endowments, jobs, and livelihoods in the poorest uphill areas with the most heavily degraded lands; measures to prevent the irreversible degradation of coastal assets; improvements in waste collection, which is impacting the economic performance of several major sectors (for example, agriculture, tourism); and cleaning up hazardous hot spots. In addition, improving the capacities and the governance framework for managing natural and the environmental risks that deplete valuable natural assets and expose people to harmful pollution and waste, protecting critical ecological resources, and improving the management of hydro resources through integrated river basin approaches, including through regional cooperation, will strengthen the ability of Albania to manage environmental risks. While the impact of some policy actions on the twin goals will occur mostly in the medium to long term, these actions remain critical for ensuring the environmental sustainability of Albania's development.

POLICY PRIORITY: ENSURING SUSTAINABLE USE OF NATURAL RESOURCES AND STEWARDSHIP OF THE ENVIRONMENT	
Sustaining Impact	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Improve capacities and the governance framework for managing natural, environment and climate risks, and protecting valuable ecological resources and natural assets • Increase the value of ecosystem services from land and forest management, focusing on upland rural areas • Improve management of hydro resources through integrated water basin approaches, including regional cooperation • Shift to a more sustainable production trajectory by focusing on climate smart farm practices, and improvements in the irrigation infrastructure

IMPROVING QUALITY, EFFICIENCY, AND EQUITY OF HEALTH SERVICES

Inequitable access to quality health services, inequities in health and nutrition outcomes, the increasing burden of noncommunicable diseases, and high out-of-pocket expenditures for services erode the quality of human capital. While Albania has made strides in improving health outcomes in recent years, challenges remain. Life expectancy is relatively high compared with rates in neighboring countries, and significant disparities persist in health and nutrition outcomes between rich and poor, among minorities, and across geographical regions. The quality of health service provision is weak overall, but health service quality and access are significantly worse among lower-income groups. Despite some improvements, the public health system is the sector most associated with informal payments. Overall, out-of-pocket spending for health is high, but much higher among the poor than among the wealthy, contributing to increased poverty and reduced access to health care. The distributional impact of addressing these constraints is therefore high.

The policy priorities in this area include steps to build up the quality of human capital by improving efficiency, quality, and equity in health service provision and reducing poverty by decreasing the size of out-of-pocket catastrophic spending, including through informal payments. Strengthening preventive medicine and primary care to ensure equitable access and quality services for all is expected to improve the quality of human capital (healthy workers), which, in turn, will entail medium- to long-term positive dividends in growth through increased productivity. In addition, reforms in hospital services to improve the quality of care and efficiency would free up the public resources for productive expenditures.

Several reforms will be key to reducing vulnerabilities to income shocks among the poor and the less well off. These include strengthened pharmaceutical policies to reduce costs and out-of-pocket spending; the expanded coverage of health insurance, particularly among the bottom 40, and expanding coverage to the poor and in the informal sector, while ensuring the sustainability of public health insurance benefits and enhancing accountability to reduce informal payments.

POLICY PRIORITY: IMPROVING QUALITY, EFFICIENCY, AND EQUITY OF HEALTH SERVICES	
Sustaining Impact	SPECIFIC POLICY ACTIONS
	<ul style="list-style-type: none"> • Strengthen preventive medicine and primary care to provide equitable access and quality services, particularly for poor and b40, including through provider training, payment reforms, and upgraded equipment and infrastructure • Reform hospital services and enhance critical support services to improve quality of care and efficiency, including through rationalization of the hospital network, payment reforms, increased autonomy and accountability, improved monitoring of quality and efficiency, and selective upgrades in infrastructure and equipment, as well as improved health management information systems, laboratories, emergency services. • Strengthen pharmaceutical policies and accountability mechanisms to reduce costs, informal payments, and out-of-pocket spending • Increase coverage of health insurance, particularly for the b40, while ensuring sustainability of the public health insurance benefits package

* * *

The sections above set out a policy agenda in each of the twelve broad priority areas for eliminating constraints to growth and accelerating progress in reducing poverty and increasing shared prosperity in Albania. This broad agenda is useful for Government and its stakeholders to define and sequence reforms over the medium term. Overall, this SCD shows that the rapid economic growth until 2008 was the key driver of poverty reduction and shared prosperity, but that the domestic demand-driven and foreign-financed growth model of those years is no longer sufficient to propel the country toward EU living standards. A change in course is needed to raise the productivity and competitiveness of the economy, create more and better employment opportunities, include the poor and the less well off in the growth process, and guard against risks to the sustainability and equity of growth.

This SCD goes further in its prioritization to identify five top priorities to accelerate growth and achieve the twin goals: (1) restoring fiscal sustainability and financial stability; (2) establishing a high-quality business environment that promotes firm growth and job creation; (3) providing clean energy efficiently, equitably, and in a sustainable manner; (4) formalizing and enhancing the inclusiveness and sustainability of the land market; and (5) enhancing governance, transparency, and the accountability of government toward citizens. The World Bank Group's strategy to support Albania will be built around these five top priorities, with additional selectivity within these priority areas based on political feasibility, institutional capacity, the World Bank Group's comparative advantage *vis a vis* other partners and our history of engagement in Albania.

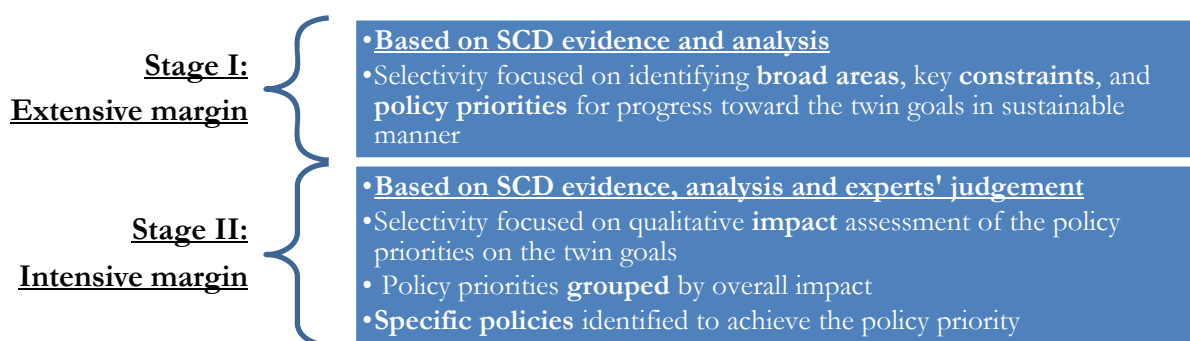
Government is already pursuing reforms in each of these five priority areas as part of its broader set of development priorities. With support from the World Bank Group and other partners, Government has already made notable progress in addressing fiscal deficits and public sector arrears, including through bold reforms to improve the fiscal sustainability and targeting of pension and social protection systems. Several notable reforms in the business environment have been implemented, which began improving Albania's global

ranking on the Doing Business Index. Government also has moved aggressively to resolve a failed privatization and tackle weak governance and rampant losses in the energy sector. The administration is beginning to address illegal land settlements and restitution issues, and have made a commitment to enhancing trust in Government through transparency and accountability. To this end, Government has embarked on a citizen centric service delivery model, with introduction of citizen feedback mechanisms and progressive reengineering of public service delivery. Government's strong commitment to these top SCD priorities puts the World Bank Group in a position to define a robust and ramped-up program of support through the upcoming Country Partnership Framework.

ANNEX 1: Prioritization Approach

This Annex details the approach taken in conducting the priority setting exercise in the SCD. It comprises sequential two-stage logic (Figure 88): **Stage I Extensive Margin** identifies the broad areas, key constraints, and policy priorities for progress toward the twin goals, based on the evidence and analysis in the SCD; **Stage II Intensive Margin** derives a qualitative impact (based on experts opinions) of the policy priorities on the twin goals. The process is described in details below.

Figure 88: Selectivity in the Prioritization Process



First, based on the conceptual framework and the evidence in this diagnostic report, 12 critical constraints are identified for Albania to advance the welfare of its population and to reduce poverty. Specifically, at this *extensive margin* of selectivity, a long list of constraints identified directly from the analysis in the building Blocks of the SCD is narrowed down to 12 **key constraints**, signaled in each of the Emerging Issues sections of the report. They relate, therefore, to the patterns of economic growth and the distribution of the benefits of growth necessary to strengthen the foundations of the Albanian economy (SCD Block 1); the build-up and more effective use of the assets that households and firms require to enhance their capacity to generate income (Block 2); promoting an enabling environment for supporting the accumulation and efficient use of resources by firms and households (Block 3); and ensuring that the results are lasting by managing well macroeconomic, social and environmental risks to sustainability (Block 4).

The key identified constraints and the corresponding policy priorities for unlocking them are presented in Table 7. For example, the diagnostic shows that the constraints in the buildup and accumulation of education as human capital in Albania are centered on the “*inequitable access to quality preprimary and higher education; overall poor learning outcomes stemming from weak quality of the education system; and the weak links of education and training systems with labor demand*”. Accordingly, the high-level policy priority from removing this constraint would be “*Improving quality, access and relevance of education and training systems*”. Similarly, the key constraints in the accumulation of financial assets is identified in terms of “*limited access to finance and savings, given low penetration of financial services, and low financial inclusion especially for some groups and rural areas*”, calling for an “*Improving inclusiveness of access to financial*

markets”. Unlocking the key selected constraints in each of the 12 areas leads to the formulation of the top **policy priorities** which Albania needs to address to make a notable leap in reducing poverty and boosting the incomes of the less well off

Second, at the “**intensive margin**” of selectivity, we drill down into the policy priorities by identifying the top priority areas for Albania and detailing country-specific policy actions that have the highest payoff in terms of potential impacts on accelerating poverty reduction and shared prosperity in a sustainable manner. Assessing the maximum impact of the policy priorities in achieving progress toward reducing poverty and boosting the incomes of the bottom 40 is at the core of the prioritization process. To do so, we qualitatively evaluate the potential **overall impact** of the realization of the policy priorities on the twin goals.

The intensive margin of the prioritization exercise uses the SCD conceptual framework to assess the impact on the twin goals along two filters:

- a. **Overall economic growth**, that is, capturing the impacts of reigniting overall economic growth (expanding the “size of the pie”)
- b. **Equitable growth**, that is how the policy priorities affect income growth of the bottom 40, including through improvements in the quality of the labor market engagement.

Based on the experts’ scoring, the policy priorities are grouped on the basis of their overall impact score (index) and ranked. Three groupings emerge: fundamental policy priorities, supporting policy priorities and sustaining impact policy priorities. Further, we propose **specific policy actions** (or *What would it take?*) to achieve each one of the policy priorities, giving more specificity to the policy agenda.

While assessing the impact of each of the policy priorities through the two filters, the impact of managing effectively the risks identified in Block 4 on the twin goals is considered (where relevant). As such, the **sustainability dimension** is taken into account to ensure that the impacts of the 12 policy priorities are lasting.

The **evidence** presented in the SCD was used to assess the impact on each of the policy priorities on the twin goals. In addition, we carried out a complementary **scoring exercise** to assess the potential size of the impact in each priority area (the policy priorities). A team that included the SCD task team leaders and additional SCD contributors—who had specific knowledge of the country, but who were not associated directly and solely with only one area of the analysis—used a scale of one through five to rate the potential impact of the removal of the constraints and the achievement of the policy priorities and its effect on overall and equitable economic growth (the two filters). These two filters are weighted equally for the quantitative analysis of the scores presented below. The conclusions of the intensive-margin analysis taken in to account in this prioritization exercise are based on results obtained using different weighting schemes to which results are robust. The rating

was performed for the short term and the medium to long-term dimensions of the impacts of the 12 policy priorities. Table 6 summarizes the results of the prioritization exercises.

Table 6: Impact Assessment of Policy priorities on the Twin Goals

	<u>Equitable growth</u>		<u>Mean growth</u>		<u>Equitable growth</u>	<u>Mean growth</u>	<u>Overall Impact</u>
	<i>Short term</i>	<i>Mid/long term</i>	<i>Short term</i>	<i>Mid/long term</i>	<i>Overall</i>	<i>Overall</i>	<i>Overall</i>
Restoring fiscal sustainability and maintaining financial stability							
Establishing a high quality business environment							
Providing clean, efficient, equitable and financially sustainable energy							
Formalizing and enhancing inclusiveness and sustainability of the land market							
Enhancing governance, transparency and accountability of government							
Increasing the quality and inclusiveness of labor market engagement							
Improving quality, access and relevance of education and training systems							
Improving efficiency, access and quality of public services delivery							
Improving inclusiveness of access to financial markets							
Enhancing effectiveness and efficiency of social protection systems							
Ensuring sustainable use of natural resources and stewardship of the environment							
Improving quality, efficiency and equity of health services							

Note: Impact scores range between 1 (minimum) and 5 (maximum) for each policy priority as well as for the short and the medium to long term, consolidated in a *Overall Impact Index* per policy priority. The indices assume equal weights of impacts between the short and the medium term and the two filters (mean growth and inclusive growth), taking into account sustainability. ■ (green) indicates low impact and comprises scores less than 1.67; ■ (yellow) indicates medium low impact and comprises scores in the range (1.67 and lower than 2.5]; ■ (orange) indicates medium high-impact and comprises scores in the range (2.51 and lower than 3.3]; ■ (red) indicates high impact and comprises scores higher than 3.3.

The *overall impact* scores have been constructed based on the consolidated summary ratings of the through the two filters (economic growth and equity), taking into account also sustainability considerations where relevant in each policy priority. The indices range between 1 (min) and 5 (max) for each policy priority as well as for the short and the medium to long term. The overall index combines the impact of the achievement of the policy priority. Impact indices assume equal weights of impacts between the short and the medium term, and the two filters. Low impact (marked in green) comprise scores less than 1.67; Medium-low impact (marked

in yellow) comprise scores higher than 1.67 but lower than 2.5; Medium-high impact (marked in orange) comprise scores higher than 2.51 but lower than 3.3. High impact (marked in red) comprise scores higher than 3.31. The conclusions of the intensive-margin policy analysis are based on results obtained using different weighting schemes to which results are robust, in particular when it comes to addressing short-term versus long-term policy priorities. The results from the scoring exercise are robust, using different weighting schemes, in particular when it comes to addressing short-term versus long-term policy priorities. Namely, we have constructed overall potential impact indexes (I) formed as $I = w_1 * I_{ST} + w_2 * I_{MT}$, ST and MT indicate short and medium- to long term, respectively and w_1 and w_2 are the weights. The analysis is based on $w_1 = w_2 = 0.5$, and in the robustness check weights varied ($w_1, w_2 = 0; .25; 0.5; 0.75; 1$).

Based on the impact, the policy priorities are ranked to form **three distinct groups**, summarized in **Table 5**:

- **Fundamental:** These are policy priorities assessed to have “high” overall impact index (red cells). This group of policy priorities covers the identified challenges in the areas of: macroeconomic stability, improvement in the quality of the business environment, energy security, formalization of land markets, governance and the application of the rule of law.
- **Supporting:** This group comprises policy priorities assessed to exert medium-high impact on the twin goals. It includes specific priorities in four areas: and in the labor market engagement of households, education, delivery of public services, financial inclusion. Importantly, this group of policy priorities amplifies the effect of the fundamental impact group of priorities.
- **Sustaining:** This group comprises the rest of the policy priorities. The impact they exert is rather in the medium- to long- term, through promoting sustainability for the build-up, accumulation and use of assets by households and firms as an input to the economic growth process. They are seen as critical for enhancing economic, social, and environmental sustainability. The group includes addressing challenges in three areas: social protection, the environment, and health,

There are **complementarities** and **trade-offs** in the process of identifying priorities. The benefits or costs that arise from unlocking the constraints can affect more than one of the policy priorities. In addition, there are trade-offs (particularly in terms of the time horizon) in addressing or in sequencing the proposed areas for reform. Where possible, the prioritization exercise has accounted for these complementarities and trade-offs. However, there are often also second-round effects of policies that are difficult to capture *ex ante*. In addition, there is path dependence among policy choices, and where possible, these have also been taken into account. Lastly, the prioritization comes with its **design limitations**: while the impact assessment was performed at the level of policy priorities, within each of the 12 policy priorities, the individual specific policy actions may ultimately have different impact on the twin goals. There are high priority policies that can be found within lower overall policy priority and vice versa.

Table 7. Summary Table of Broad Areas, Key Constraints, Policy priorities, and Specific Policies for Advancing Progress to the Twin Goals in Albania

POLICY PRIORITY: RESTORING FISCAL SUSTAINABILITY AND MAINTAINING FINANCIAL STABILITY		
Fundamental	KEY CONSTRAINTS Macroeconomic imbalances related to high public debt, structural fiscal deficits, public sector arrears, potential external imbalances, and high NPLs	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Implement sound fiscal policies by improving the efficiency of public spending, enhancing revenue measures, tackling the outstanding public arrears, addressing pension sustainability, eliminating quasi-fiscal deficits (especially in energy through a time-bound recovery plan), strengthening the management of public debt, and strengthening public financial management • Strengthen public investment decision making, reflecting improved planning and the prioritization of capital spending (for example, by rebalancing new investment in roads toward maintenance, developing financing mechanisms for infrastructure, and addressing environmental externalities such as wastewater treatment and waste management) • Maintain financial sector stability by reducing NPLs, reviving sustainable credit growth, increasing the reserves of the deposit insurance fund, safeguarding the credibility of monetary policy, and strengthening the autonomy of the financial regulatory authorities
POLICY PRIORITY: ESTABLISHING A HIGH-QUALITY BUSINESS ENVIRONMENT		
Fundamental	KEY CONSTRAINTS Large regulatory barriers to economic agents harm firm growth and job creation	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Cut the regulatory burden across the board (for example, construction permits, trade logistics, inspections, property and land registration, and so on) and ensure the nondiscriminatory implementation of regulations among all economic agents • Strengthen the policy, legal, and institutional framework to attract FDI and the entry and protection of FDI to maximize the benefits and spillovers of FDI among local economic agents (firms, farms, entrepreneurs) • Improve trade logistics and facilitation and deepen international and regional integration • Improve corporate governance and the financial reporting practices of banks and firms through streamlined rules, procedures, disclosure practices, the role of boards of directors, and financial reporting and auditing standards
POLICY PRIORITY: PROVIDING CLEAN, EFFICIENT, EQUITABLE, AND FINANCIALLY SUSTAINABLE ENERGY		
Fundamental	KEY CONSTRAINTS High economic dependence on hydro resources for energy provision, resulting in vulnerability to weather patterns; pervasive waste of energy resources; and high reliance on imports	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Reduce waste and increase energy efficiency through reduction in distribution losses and improved collection from consumers • Reduce weather vulnerability through preparation and implementation of Risk Management Strategy, including among others, diversification of generation sources, regional integration and insurance instruments. • Improve the management of hydro resources through integrated water basin approaches

POLICY PRIORITY: FORMALIZING AND ENHANCING INCLUSIVENESS AND SUSTAINABILITY OF THE LAND MARKET		
Fundamental	KEY CONSTRAINTS Widespread informality and weak enforcement of property rights in land markets in both rural and urban areas Lack of urban planning and enforcement leading to an inefficient allocation of land, land uses and space (density)	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Increase land formalization and promote inclusionary practices through streamlined and transparent administrative procedures of land legalization (including for b40 and women), land and property valuation following international standards, digital land cadaster registration lined to a fiscal cadaster • Address land restitution/compensation scheme in fiscally sound and fair manner in line with best international practices; • Develop a land and farm consolidation program to help increase farm productivity and improve land management • Improve land planning and management to protect endowment and foster agglomeration economies
POLICY PRIORITY: ENHANCING GOVERNANCE, TRANSPARENCY AND ACCOUNTABILITY OF GOVERNMENT		
Fundamental	KEY CONSTRAINT Institutional weaknesses, inefficient judicial system and application of the rule of law, perceptions of corruption leading to high informality	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Increase transparency and accountability of decision-making, including through an integrated e-Government system, strengthened the independence and depoliticization of public institutions • Enhance the independence, accountability, professionalism of the judiciary/courts and executive agencies to ensure non-discretionary and consistent implementation of laws and regulations • Expand consensus building in Parliament in the adoption of reform strategies, laws and regulations
POLICY PRIORITY: INCREASING THE QUALITY AND INCLUSIVENESS OF LABOR MARKET ENGAGEMENT		
Supporting	KEY CONSTRAINTS High overall informal employment and high joblessness (from both inactivity and unemployment) among bottom 40, women, youth, minorities	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Improve policy incentives and remove barriers for formal employment, particularly for the b40, youth and women, including by strengthening the evidence base • Strengthen active labor market programs to promote activation of particular groups (e.g. youth, women, minorities) • Enhance labor market information systems to improve education, training, and job matching, including through enhanced coordination between government and private sector, strengthened linkages with active labor market measures, and regular collection and use of labor market information • Promote formal sector firm registration by reducing barriers to registration and reducing personal income tax disincentives to formal sector employment

POLICY PRIORITY: IMPROVING QUALITY, ACCESS AND RELEVANCE OF EDUCATION AND TRAINING SYSTEMS		
Supporting	KEY CONSTRAINTS Inequitable access to quality preprimary and higher education; overall poor learning outcomes stemming from weak quality of the education system; weak links of education and training systems with labor demand.	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Improve access and equity in access to pre-primary and higher education, by targeting b40 children and youth • Improve quality of formal education system in an equitable manner from preprimary to higher education, by ensuring that graduates at each level acquire requisite cognitive, non-cognitive, and technical skills • Enhanced management, efficiency, and quality of higher education system through targeted scholarships and institutional performance based/competitive grants • Strengthened management and governance of education system, including resource allocation and decentralized autonomy and accountability
POLICY PRIORITY: IMPROVING EFFICIENCY, ACCESS AND QUALITY OF PUBLIC SERVICES DELIVERY		
Supporting	KEY CONSTRAINTS Socio-economic and spatial inequalities in public services provision; Significant inefficiencies in public spending; Low quality provision of public services	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Strengthen institutions and build human capacity for reinforcing financial discipline, improving governance/management/accountability in service delivery • Strengthen the efficiency and equity in managing public resources (e.g. in health, education, water, transport, sanitation, etc) to improve access to, quality of and equity in public services • Improve the legal and regulatory framework for public services delivery, including through enhanced level of accountability and management as well as fiscally-sound PPPs
POLICY PRIORITY: IMPROVING INCLUSIVENESS OF ACCESS TO FINANCIAL MARKETS		
Supporting	KEY CONSTRAINTS Limited access to finance and savings, given low penetration of financial services, and low financial inclusion especially for some groups and rural areas	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Encourage development of non-bank financial institutions (SCAs, insurance, leasing, investment funds and asset management companies, etc.) • Strengthen financial infrastructure (deposit insurance, payment system, collateral registries, the insolvency regime, etc.) as well as the availability of long-term debt and equity financing (e.g. domestic capital market activities) • Improve financial inclusion, particularly for b40 and women, by providing new saving, lending and money payment opportunities to the unbanked population through both banks and non-bank financial sector channels (e.g. through SCAs, MFIs, Albanian Post, mobile money providers, etc.)

POLICY PRIORITY: ENHANCING EFFECTIVENESS AND EFFICIENCY OF SOCIAL PROTECTION SYSTEMS		
Sustaining	KEY CONSTRAINTS Poor targeting, coverage and low benefit levels of the main poverty-focused program; Poor targeting of truly-disabled people and inefficient spending of the disability assistance program	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Continue the reform agenda to improve the poverty targeting of Solidarity Albania Program and the targeting of the disability program on the disabled, rebalance spending between programs, and modernize the administration of benefits, while consolidating social assistance by channeling various benefits through the Solidarity Albania Program • Continue the agenda to reform the pension system and focus on the implementation of the recent pension law • Link social assistance to human capital and economic activation measures and improve the institutional capacity to implement economic activation measures so as to promote the inclusion of marginalized groups within the growth process
POLICY PRIORITY: ENSURING SUSTAINABLE USE OF NATURAL RESOURCES AND STEWARDSHIP OF THE ENVIRONMENT		
Sustaining	KEY CONSTRAINT Non-sustainable use of natural resources, on which livelihoods and key economic sectors (energy, agriculture, tourism) depend Growing pressure on environmental assets and climate risks in water resources	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Improve capacities and the governance framework for managing natural, environment and climate risks, and protecting valuable ecological resources and natural assets • Increase the value of ecosystem services from land and forest management, focusing on upland rural areas • Improve management of hydro resources through integrated water basin approaches, including regional cooperation • Shift to a more sustainable production trajectory by focusing on climate smart farm practices, and improvements in the irrigation infrastructure
POLICY PRIORITY: REFORM HEALTH FINANCING TO LOWER PATIENT RISKS AND IMPROVE QUALITY OF HEALTH CARE		
Sustaining	KEY CONSTRAINTS Inequitable access to quality health services; inequities in health outcomes for poor, bottom 40%, and ethnic minorities; increasing burden of non-communicable diseases; very high out of pocket expenditures; and high informal payments, particularly for poor and b40	SPECIFIC POLICY ACTIONS <ul style="list-style-type: none"> • Strengthen preventive medicine and primary care to provide equitable access and quality services, particularly for poor and b40, including through provider training, payment reforms, and upgraded equipment and infrastructure • Reform hospital services and enhance critical support services to improve quality of care and efficiency, including through rationalization of the hospital network, payment reforms, increased autonomy and accountability, improved monitoring of quality and efficiency, and selective upgrades in infrastructure and equipment, as well as improved health management information systems, laboratories, emergency services. • Strengthen pharmaceutical policies and accountability mechanisms to reduce costs, informal payments, and out-of pocket spending • Increase coverage of health insurance, particularly for the b40, while ensuring sustainability of the public health insurance benefits package

ANNEX 2: Desired Policy Results and Capacity to Develop and Implement Policies

We assess the capacity of Albania to develop and implement the twelve revealed priorities using **clustering analysis**. Clusters of priorities can be identified according to the combination of policy priorities and capacity scores. Threshold estimation techniques can be applied to each one of the two dimensions to identify high-impact, high-capability policy pathways. The outcomes of clustering the policy priorities (equally weighted for short-term and long-term horizons) and the capacity scores according to this technique are shown in Figure A2.1. Among the twelve policy priorities spelled out above, the capacity to carry out reforms aimed at restoring fiscal sustainability and ensuring financial sector stability (the policy priority with the highest score) appears to be present. The results of the prioritization analysis highlights also the importance of policies targeted at enhancing the quality of the business environment, achieving a formalized and inclusive land market, removing barriers for formal employment and strengthening the quality of labor market engagement (that is the top right quadrant in Figure A2.2). Thus, if we prioritize the impacts associated with short-term and long-term outcomes in line with the fulfillment of the twin goals, we find the following ordering within the high-impact, high-capability cluster: the need for macroeconomic stability, improving the business environment, reforming the land market and expanding the quality of engagement on the labor market.

Figure A2.1: Overall Policy Priorities, unweighted average, and Implementation Capacity Scores

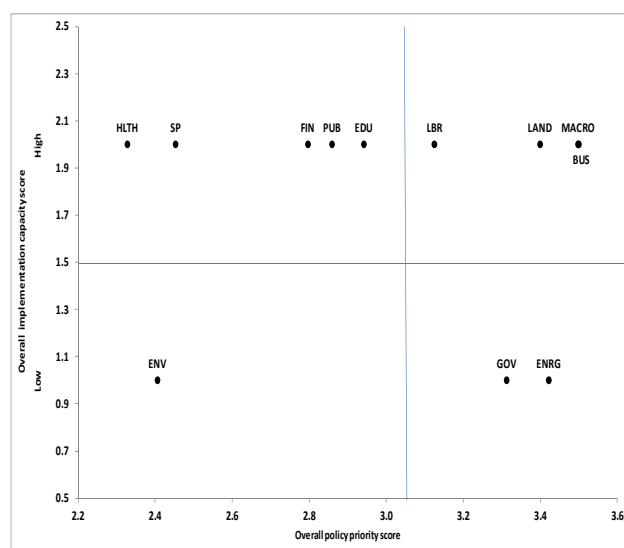
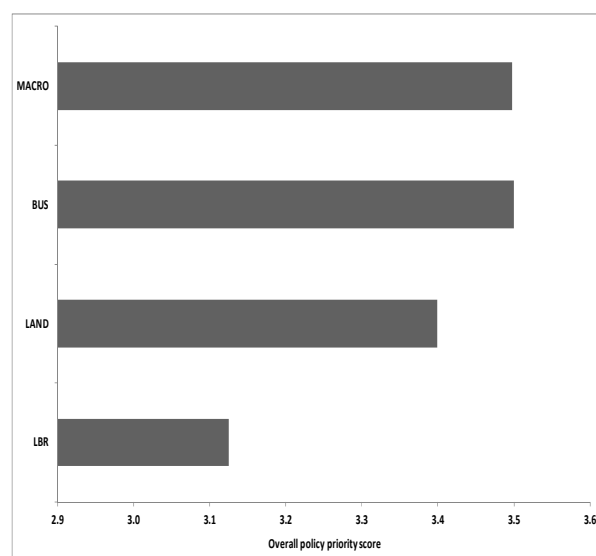


Figure A2.2: Score Vectors among High-Impact Priorities and High-Capacity, robust across all weighting schemes



Note: Capacity to develop and implement policies is ranked from 1(low) to 3 (high). Potential impact of policy priorities for the advancement toward the twin goals is assessed from 1(low) to 5(high). See Box 1.

ANNEX 3: SCD Consultations

The Albania SCD preparation benefitted from extensive public consultations that were held throughout the country and attended by diverse groups of stakeholders. The main objectives of the consultations were to solicit stakeholders' views on the development priorities, challenges and opportunities of Albania. The input and feedback received during the SCD consultations from Albania's partners and citizens informed the identification and assessment of the country's development challenges and opportunities. The consultations helped enhance the broad ownership base of the document.

Two round of consultations were conducted by the World Bank Group (see Table 6 for a summary). In the first round stakeholder nine consultations were held in July 2014, including sessions with the Council of Ministers, central and local government representatives, members of parliament, opposition, development partners, the business community, academia, think tanks, civil society organizations, citizens, and media outlets. Five more consultations were held in November 2014 to discuss the priorities emerging from the Diagnostics.

Table 8: Albania SCD Consultations

No.	GROUP CONSULTED	DATE	LOCATION
FIRST ROUND			
1	Government	July 21, 2014	Tirana
2	Parliament (majority MPs)	September 26, 2014	Tirana
3	Opposition MPs	September 26, 2014	Tirana
4	Development Partners	July 21, 2014	Tirana
5	Academia, think-tanks, private sector, civil society	July 21, 2014	Tirana
6	Local government, private sector, NGOs	July 22, 2014	Shkodra
7	Local government, private sector, NGOs	July 23, 2014	Vlora
8	Local government, private sector, NGOs	July 25, 2014	Korca
9	Local government, private sector, NGOs	September 26, 2014	Berat
SECOND ROUND			
10	Government	November 14, 2014	Tirana
11	Development Partners	November 14, 2014	Tirana
12	Academia, think-tanks, private sector, civil society	November 14, 2014	Tirana

In the first round of consultations, the process was opened with a high level event chaired by the Deputy Prime Minister with all Ministers participating. To guide the discussions, the team presented Albania's the proposed conceptual framework and the emerging the key constraints and challenges from the existing analytical work conducted by the World Bank Group and other stakeholders. The discussions centered around accelerating economic growth in a sustainable manner for poverty eradication and boosting shared prosperity for bottom 40. The stakeholders appreciated the work

initiated under the SCD for its evidence-based, data-driven and consultative approach for understanding Albania's growth opportunities and challenges. They welcomed the proposed framework and the early findings presented during the consultative forums. The stakeholders agreed with the main proposition of the SCD for a need for a new economic model for achieving lasting poverty reduction and shared prosperity, based on propelling exports and increasing employment opportunities for Albanians. The stakeholders agreed that identifying development priorities for Albania will help achieving sustainable economic growth for reducing poverty, increasing the living standards of the population and supporting Albania's EU aspirations.

The regional consultations in the first round were organized to ensure representative regional engagement. The consultations were conducted in a workshop format, with groups guided by a set of questions on Albania's growth priorities, opportunities, and challenges. All regional consultations revealed largely similar findings with minor variations. The consultations highlighted the need to focus on growth enhancement and job creation activities, with careful natural resources management. While the first round consultations presented the direction of the SCD as well as the emerging priority areas for the country, stakeholder groups also indicated priority areas for future World Bank Group future support, noting the need for focusing on growth enhancing and job creating areas.

The second round of consultations focused the discussion on the SCD draft report's findings and the priorities emerging from the SCD. The SCD emerging conclusions and priorities were broadly endorsed by stakeholders.

ANNEX 4: Data Annex

Table A4.1: Key macroeconomic variables, 2000–14 (percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
														Est.	Est.
Population (million)	3.06	3.06	3.06		3.03	3.02	3.00	3.0	3.0	2.9	2.9	2.9	2.9	2.9	2.9
Inflation (eop %)	0.05	3.13	5.22	2.37	2.87	2.37	2.37	2.9	3.4	2.3	3.6	3.5	2.0	1.9	1.9
GDP Deflator	4.02	3.33	2.41	5.41	2.39	2.59	2.70	3.6	3.9	2.4	4.5	2.3	1.0	0.8	1.4
Exchange rate /USD (Average)	143.7	143.4	140.1	121.8	102.7	99.86	98.10	90.4	83.9	95.0	103.9	100.9	108.2	105.7	105.0
Exchange rate /Eur (Average)	133.5	127.8	131.8	137.8	127.7	124.3	123.0	123.9	122.8	131.6	137.7	140.5	139.0	140.3	140.0
Real GDP Growth	6.62	7.94	4.23	5.74	5.67	5.75	5.43	5.9	7.5	3.4	3.7	2.5	1.6	1.4	2.1
GDP USD billion	3.64	4.07	4.44	5.70	7.31	8.16	8.99	10.7	12.9	12.0	11.9	12.9	12.3	12.9	13.5
GDP per capita USD	1,190	1,327	1,453	1,871	2,409	2,702	2,994	3,589	4,355	4,101	4,087	4,434	4,254	4,458	4,648
GDP per capita USD PPP	4,213	4,638	4,880	5,393	5,680		7,045	7,642	8,737	9,331	9,553	9,841	10,123	10,364	10,737
Unemployment rate									13.8	14.2	14.3	14.1	17.1	17.5	
Domestic Savings	27.02	30.78	28.41	33.46	31.41	28.00	32.40	28.1	18.3	17.4	17.1	16.1	15.7	15.5	14.7
Public	-0.44	0.80	0.45	0.10	0.60	2.12	3.46	3.0	4.0	2.6	3.3	2.6	1.7	0.6	0.7
Private	27.47	29.97	27.95		30.82	25.88	28.94	25.1	14.3	14.8	13.9	13.5	14.0	14.9	14.0
Foreign Savings	4.71	7.58	9.50	7.02	5.79	8.99	6.58	10.6	15.7	15.3	11.3	13.2	10.2	10.6	11.9
Investment	31.73	38.36	37.90	40.47	37.20	36.99	38.98	38.7	33.9	32.7	28.4	29.4	25.8	26.2	26.6
Public	7.20	7.73	6.54	4.99	5.67	5.57	6.79	6.6	9.6	9.6	6.3	6.1	5.1	5.5	5.6
Private	24.53	30.63	31.36	35.49	31.53	31.41	32.19	32.1	24.4	23.1	22.1	23.2	20.7	20.7	20.9
Total Revenues	24.98	24.97	24.83	24.09	24.55	25.06	26.01	26.0	26.9	26.1	26.2	25.4	24.7	24.0	26.0
Total Expenditures	32.62	31.89	30.92	28.98	29.62	28.51	29.34	29.5	32.5	33.2	29.3	28.9	28.2	28.9	31.2
Overall Fiscal Balance	-7.64	-6.93	-6.09	-4.89	-5.07	-3.46	-3.33	-3.5	-5.6	-7.1	-3.1	-3.5	-3.4	-4.9	-5.2
Primary Fiscal Balance	-1.99	-2.88	-2.11	-0.59	-1.29	-0.26	-0.49	-0.9	-2.7	-3.9	0.3	-0.4	-0.3	-1.7	-2.4
Total Net Borrowing	6.32	4.71	5.73	4.11	2.91	3.25	2.96	2.3	5.0	4.6	3.1	3.5	3.5	4.1	5.2
Total Public Debt	61.11	58.22	62.84	58.82	56.45	57.45	56.06	53.4	55.1	59.7	57.7	59.4	62.1	70.0	70.9
General Government Public Debt	61.11	58.22	62.84	58.82	56.45	57.45	56.06	50.6	51.8	55.7	54.0	55.7	58.1	61.0	64.1
Broad money (M3)	62.7	67.6	65.5	63.9	67.0	70.3	75.5	78.3	75.5	76.2	79.1	82.3	84.1	84.1	
Growth	12.0	20.2	3.5	8.7	13.5	13.9	16.3	13.7	7.7	6.8	12.5	9.2	5.0	2.3	
Velocity	1.6	1.5	1.5	1.6	1.5	1.4	1.3	1.3	1.3	1.3	1.3	1.2	1.2	1.2	
Credit to the nonfinancial private sector	4.2	4.7	6.4	7.6	9.6	15.4	22.2	30.0	35.5	37.5	38.2	40.2	39.8	38.3	..
Growth	31.8	23.5	45.7	31.1	36.9	73.6	57.2	48.2	32.1	10.3	10.1	10.4	1.4	-1.4	..
Credit interest rate 5 years and over (end-of-year)							10.9	13.7	13.6	13.8	10.6	10.8	9.6	9.5	..

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
														Est.	Est.
Current Accounts	-4.71	-7.39	-9.50	-7.02	-5.79	-8.99	-6.58	-10.6	-15.7	-15.3	-11.3	-13.2	-10.2	-10.6	-11.9
Trade Balance (Goods & Services)	-22.12	-23.06	-26.11	-24.91	-22.41	-24.68	-23.57	-26.7	-26.8	-24.5	-20.6	-22.8	-18.6	-17.8	-18.3
Goods	-22.62	-25.26	-26.00	-23.46	-21.72	-22.53	-23.14	-26.9	-27.6	-26.5	-23.1	-24.2	-20.8	-17.7	-19.7
Exports	7.02	7.49	7.43	7.85	8.26	8.09	8.79	10.1	10.4	8.6	13.0	15.2	15.9	18.0	17.1
Imports	-29.64	-32.75	-33.43	-31.31	-29.98	-30.63	-31.93	-37.0	-38.0	-35.1	-36.1	-39.4	-36.7	-35.7	-36.7
Balance of Payments	0.00	3.57	0.64	1.75	3.98	1.90	2.88	2.1	2.2	-0.3	2.0	-0.3	0.8	1.1	2.2

Table A4.2: Public expenditure breakdown

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
TOTAL REVENUE¹	25.0	25.0	24.8	24.1	24.5	25.1	26.0	26.0	26.7	26.0	26.6	25.8	24.9	24.1
<i>Grants</i>	1.9	1.7	0.7	0.4	0.3	0.8	0.9	0.1	0.4	0.4	0.4	0.3	0.4	0.4
<i>Tax Revenue</i>	19.9	19.6	20.7	20.9	22.1	22.6	23.3	23.6	24.3	23.6	23.6	23.7	22.7	22.1
From tax offices and customs	15.5	15.0	15.8	15.7	16.4	16.6	17.6	18.3	18.8	18.2	18.2	18.4	17.5	16.9
V.A.T	7.3	7.1	7.4	7.3	7.7	7.9	8.4	9.1	9.8	9.6	9.3	9.3	8.8	8.2
Profit Tax	1.6	1.8	2.0	1.9	2.2	2.4	2.5	2.2	1.7	1.5	1.4	1.5	1.3	1.1
Excise Tax	1.7	1.6	1.5	1.8	2.1	2.3	2.6	3.0	3.0	2.9	3.2	3.2	2.7	2.8
P.I.T.	0.9	1.1	1.0	0.9	0.9	0.9	1.0	1.5	2.2	2.3	2.2	2.2	2.1	2.2
National Taxes and others	1.4	1.3	1.8	1.8	1.6	1.5	1.5	1.5	1.3	1.2	1.5	1.7	2.2	2.1
Custom Duties	2.6	2.2	2.1	2.0	1.8	1.7	1.6	1.0	0.8	0.7	0.6	0.5	0.5	0.4
Revenues from Local Gov.	0.6	0.7	0.8	1.1	1.3	1.5	1.3	1.0	1.0	1.1	1.0	0.9	0.8	0.8
Social Ins. Contributions	3.8	3.9	4.1	4.1	4.4	4.4	4.5	4.3	4.4	4.3	4.4	4.4	4.3	4.4
<i>Nontax Revenue</i>	3.2	3.6	3.5	2.8	2.1	1.7	1.8	2.3	2.1	2.1	2.6	1.8	1.8	1.6
TOTAL EXPENDITURE	32.6	31.9	30.9	29.0	29.6	28.5	29.3	29.5	32.3	33.1	29.7	29.3	28.4	29.0
<i>Current Expenditures</i>	25.5	24.1	24.8	24.4	24.5	23.8	23.2	23.2	23.0	24.7	24.6	23.8	23.6	24.2
Personnel expenditures	6.4	7.1	6.7	6.4	6.5	6.6	6.4	6.1	6.1	5.4	5.4	5.3	5.2	5.2
Wages	4.9	5.6	5.4	5.1	5.2	5.3	5.2	5.1	5.1	4.6	4.7	4.6	4.5	4.5
Social insurance contributions	1.4	1.4	1.4	1.3	1.3	1.3	1.3	1.0	1.0	0.8	0.7	0.7	0.7	0.7
Interest	5.7	4.0	4.0	4.3	3.8	3.2	2.8	2.6	2.9	3.2	3.4	3.2	3.1	3.2
Domestic	5.5	3.9	3.6	4.1	3.6	3.0	2.6	2.4	2.6	2.7	2.9	2.7	2.6	2.6
Foreign	0.1	0.2	0.4	0.2	0.2	0.2	0.2	0.2	0.3	0.4	0.5	0.5	0.6	0.5
Operational & Maintenance	3.7	2.7	3.3	3.2	3.2	3.0	2.6	2.6	2.6	2.8	2.8	2.6	2.4	2.4
Subsidies	1.0	1.4	1.0	0.7	0.7	0.4	0.4	0.4	0.2	0.2	0.3	0.3	0.1	0.1
Support for energy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Social insurance outlays	6.0	6.2	6.5	6.5	6.7	6.9	6.8	7.2	7.0	8.4	8.7	8.9	9.1	9.4
Local Budget	1.1	1.3	2.0	2.1	2.1	2.5	2.6	2.2	2.5	2.9	2.5	2.2	2.1	2.2
Other expenditures	1.6	1.5	1.4	1.3	1.5	1.3	1.6	1.6	1.6	1.8	1.5	1.5	1.6	1.7
<i>Reserve fund/contingency</i>	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>Capital expenditures</i>	6.9	7.4	6.1	4.5	5.1	4.7	5.8	5.9	8.6	8.4	5.5	5.5	4.6	4.8
Domestic financing	3.5	4.1	3.1	2.6	3.7	3.0	4.0	5.0	4.6	6.6	3.8	3.2	2.1	2.7
Foreign financing	3.4	3.3	3.0	1.9	1.4	1.7	1.8	0.9	4.0	1.8	1.7	2.2	2.6	2.1
Other transfers	0.2	0.3	0.0	0.0	0.0	0.0	0.3	0.4	0.7	0.0	-0.5	0.0	0.2	0.0
OVERALL DEFICIT	-7.6	-6.9	-6.1	-4.9	-5.1	-3.5	-3.3	-3.5	-5.5	-7.0	-3.1	-3.6	-3.5	-4.9
Deficit Financing	7.6	6.9	6.1	4.9	5.1	3.5	3.3	3.5	5.5	7.0	3.1	3.6	3.5	4.9
Domestic	5.7	4.8	3.4	3.4	4.1	2.9	2.7	3.0	2.2	6.2	1.1	2.0	2.0	4.1
Privatization receipts	1.7	2.2	0.1	0.1	1.9	0.1	0.2	1.4	0.5	2.2	0.0	0.0	0.1	1.0

¹ Source: Ministry of Finance

	200 0	200 1	200 2	200 3	200 4	200 5	200 6	200 7	200 8	200 9	201 0	201 1	201 2	201 3
Domestic Borrowing	3.8	2.9	3.1	2.9	1.9	2.5	2.4	1.8	1.7	3.8	0.9	2.2	1.9	3.4
Other	0.2	-0.3	0.2	0.4	0.3	0.2	0.1	-0.2	0.1	0.2	0.1	-0.2	0.0	-0.3
Foreign	1.9	2.1	2.7	1.4	1.0	0.6	0.7	0.5	3.3	0.9	2.0	1.5	1.5	0.8
<u>MEMO:</u>														
Total Public Debt	61.1	58.2	62.8	58.8	56.5	57.4	56.1	53.4	54.7	59.5	58.5	60.3	62.5	70.5
Public Debt from the budget (stock)	61.1	58.2	62.8	58.8	56.5	57.4	56.1	50.6	51.3	55.5	54.8	56.5	58.4	61.4
Domestic (stock)	43.2	41.3	41.9	40.5	39.3	40.2	39.6	38.2	36.3	35.7	32.9	33.5	34.3	36.9
Foreign (stock), from which:	17.9	16.9	21.0	18.4	17.1	17.3	16.5	12.4	15.0	19.8	21.9	22.9	24.1	24.5
Extra-budgetary public debt (stock)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	2.8	3.4	4.0	3.7	3.8	4.1	9.2
Local government (stock)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Guarantied public debt (stock)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	2.8	3.4	4.0	3.7	3.8	4.0	3.8
Unpaid bills and arrears (stock)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	5.3

ANNEX 5: CPIA Assessment

The World Bank's Country Policy and Institutional Assessment (CPIA) assesses the conduciveness of a country's policy and institutional framework to poverty reduction, sustainable growth, and the effective use of development assistance. It rates countries against a set of 16 criteria grouped in four clusters: (a) economic management; (b) structural policies; (c) policies for social inclusion and equity; and (d) public sector management and institutions. For each of the 16 criteria, countries are rated on a scale of 1 (low) to 6 (high).

Albania's most recent overall CPIA rating in 2013 was 3.6. Its highest score among the clusters is with regard to structural policies (3.8). Its relative policy weaknesses are in the areas of: fiscal policy conduct (2.5), property rights and rule-based governance (3.0) and policies and institutions for environmental sustainability (3.0).

Table 5.1: Albania CPIA 2013

No.	Question	CPIA 2013
1	Monetary and exchange rate policies	4.0
2	Fiscal policy	2.5
3	Debt policy and management	3.5
Aver.	A. Economic management	3.3
4	Trade	4.5
5	Financial sector	3.5
6	Business regulatory environment	3.5
Aver.	B. Structural policies	3.8
7	Gender equality	4.0
8	Equity of public resource use	3.5
9	Building human resources	4.0
10	Social protection and labor	3.5
11	Policies and institutions for environmental sustainability	3.0
Aver.	C. Policies for social inclusion/equity	3.7
12	Property rights and rule-based governance	3.0
13	Quality of budgetary and financial management	4.0
14	Efficiency of revenue mobilization	3.5
15	Quality of public administration	3.0
16	Transparency, accountability and corruption in public sector	3.5
Aver.	D. Public sector management and institutions	3.4
	Overall CPIA	3.6

ANNEX 5: Roster of background analysis

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