Report No. 36453-AL

Albania
Restructuring Public Expenditure to Sustain Growth
A Public Expenditure and Institutional Review

(In Two Volumes) Volume I: Overview and Policy Options

December 2006

Poverty Reduction and Economic Management Unit
Europe and Central Asia Region

Document of the World Bank

CURRENCY AND EQUIVALENT UNITS

Currency Unit =Albania LEK
LEK 1 = 0.0103 US$
US$1 = 97.08
(As of June 30, 2006)

FISCAL YEAR
January 1 – December 31

WEIGHTS AND MEASURES
Metric System

ACRONYMS AND ABBREVIATIONS

ANTP	Albanian National Transport Plan
BEEPS	Business Environment and Enterprise Performance Survey
BOA	Bank of Albania
BOOT	Build Own Operate and Transfer
CEM	Country Economic Memorandum
CFAU	Country Fiduciary Assessment Update
CSL	Civil Service Law
DAT	Directorate of Air Transport
DoPA	Department of Public Administration
ECA	Europe and Central Asia
ECB	European Central Bank
EIB	European Investment Bank
ERE	Electricity Regulatory Authority
G&S	Goods and Services
GDCA	General Directorate of Civil Aviation
GDP	Gross Domestic Product
GDWSS	General Directorate for Water Sewage and Sanitation
GFS	Government Finance Statistics
GNFS	Goods and Non-factor Services
GNI	Gross National Income
GOA	Government of Albania
GP	General Practitioners
GRD	General Road Director
HH	Household
HII	Health Insurance Institute
HSH	Albanian Railways
IDA	International Development Association
IMF	International Monetary Fund
IPS	Integrated Planning System
KESH	Albanian Power Corporation
LAC	Latin America and the Caribbean
LGU	Local Government Units
LSMS	Living Standards Measurement Survey
M&E	Monitoring and Evaluation
MDGs	Millennium Development Goals
MoF	Ministry of Finance
MoH	Ministry of Health
MoLSA	Ministry of Labor and Social Affairs and Equal Opportunities
MoPWTT	Ministry of Public Works, Transport and Telecommunications
MOTT	Ministry of Transport and Telecommunications
MTBP	Medium Term Budget Plan
NE	Ndihme Ekonomike
NPV	Net Present Value
NRW	Non Revenue Water
NSDI	National Strategy for Development and Integration
NSSED	National Strategy for Social and Economic Development
OBL	Organic Budget Law
OECD	Organisation for Economic Co-operation Development
O&M	Operations and Maintenance
PEIR	Public Expenditure and Institutional Review
PFM	Public Financial Management
PPP	Public-Private Partnership
PSAP	Power Sector Action Plan
QFD	Quasi-Fiscal Deficit
SEE	South East Europe
SII	Social Insurance Institute

SSA	Supreme State Audit	VAT	Value-Added Tax
SST	Social Security Tax	WB	World Bank
UNDP	United Nations Development Program	WDI	World Development Indicators
US	United States	WHO	World Health Organization

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ACKNOWLEDGMENTS

This report is based on research and missions conducted by a World Bank team working in Albania during 2005 and the spring of 2006 and covers developments prior to this period. The team wishes to thank the Albanian Government for the cooperation of its senior officials in the Prime Minister's Office, Ministry of Finance (MoF), Ministry of Health (MoH), Ministry of Education and Science, Ministry of Labor and Social Affairs (MoLSA), Ministry of Public Works, Transport and Telecommunications, Ministry of Interior, Department of Public Administration (DoPA), Health Insurance Institute, Social Insurance Institute, and KESH. Special thanks are reserved for Bernard Funck who provided continuous support, guidance and technical advice.

The principal author of the report is Alia Moubayed (Task Team Leader), supported by Camille Nuamah, Sanjay Kathuria, Anna Gueorguieva and Nand Shani, drawing from background papers and contributions prepared by a team composed of Monika Huppi and Dominic Haazen (Health), Anita Schwartz (Pensions), Loraine Blank (Social Assistance), Lorena Kostallari (Health and Social Protection), Keiko Miwa, Sue Berryman, Lindita Xhillari, and Yuli Cabiri (Education), Iftikhar Khalil and Richard Hamilton (Power), Richard Martin Humphreys (Transport), Michael John Webster, Arben Bakllamaja and Andreas Rohde with advice and guidance from Jonathan Halpern (Water), Artan Guxho (Infrastructure), Jana Orac, Jolanda Trebicka, Hugh Grant, and Gary Reid (Civil Service), Junghun Cho and Olav Christensen (Public Financial Management), Andrew Bird (Public Financial Management, Public Investment Management), Andrew Dabalen (Distributional Incidence Analysis), Juan Carlos Ginarte, Olga Vybornaia, (Macroeconomic Analysis) and Caroline Van Rijckeghem (Debt Sustainability Analysis). The team worked with the Country Fiduciary and Accountability Assessment Update (CFAU) team led by Devesh Chandra Mishra given the importance of public financial management issues for both tasks. Early findings of the Public Financial Management and Public Investment Management Chapters were discussed with the Ministry of Finance. Early findings from the Water Chapter were also presented and discussed in a joint workshop with the Ministry of Public Works, Transport and Telecommunications, and relevant donors involved in the water sector.

The team owes a special debt of gratitude to the Department for International Development for its encouragement and generous financial support. It also benefited from close interaction with the DFID financed consultancy team at the MoF, the IMF, USAID, UNDP, the Urban Institute, and the Embassy of the Netherlands, and with the members of the donors' thematic group for public financial management. It wishes to thank the EU-financed project team working on salary reform supporting DoPA.

Useful comments were received from Professor Vito Tanzi (external peer reviewer), Bert Hofman (peer reviewer), Marianne Fay (Lead Economist, ECAVP), and the IMF Albania team led by Istvan Szekely. Comments from various governmental institutions in Albania were received in October 2006, based on which some aspects of the reports were updated.

Finally, the team wishes to thank Nadir Mohammed, Monika Huppi, Piet Van Heesewijk, João Oliveira and Gord Evans for their wise advice and guidance, and Erjon Luci for his support in finalizing the report.

The team gratefully acknowledges the support of Enkelejda Karaj who organized the team's work in Albania as well as that of Mismake Galatis, Ekaterina G. Stefanova, Armanda Çarçani, and Denisa Bilali for their valuable assistance in processing the report.

EXECUTIVE SUMMARY

Albania has seen average annual growth of seven percent over 1997–2005, the highest among transition economies. This growth rates has been accompanied by strong poverty reduction, including over the last three years, when the poverty ratio fell by seven percentage points. Successful macroeconomic management has been an important contributor to growth—the government deficit and debt have been reduced, and inflation has been kept low—while growth has been the critical factor in poverty reduction.

Emerging concerns center on the need to sustain the momentum of growth and poverty reduction. The productivity gains from resource reallocation typical of the first phase of transition are slowing. Albania will need to create a better environment for private investment, further accelerate improvements in human capital, and stimulate new sources of productivity growth, including in the public sector.

Public expenditure policy is at the heart of this challenge to sustain growth. This report finds that Albania's level of spending at 29 percent of GDP is broadly appropriate but that resource mobilization remains distortionary and spending is inefficient. A narrow tax base and high labor taxes concentrate the burden on a small section of the economy and discourage the expansion of formal sector employment. Of particular note is the current socially unsustainable pension system, which is characterized by low benefits and high contribution rates.[1] Its reform will have to take place within a holistic strategy for social protection that rebalances the use of assistance and insurance in line with Albania's demographic and employment profiles. Despite a dramatic reduction since the financial crisis in 1997–98, debt levels remain relatively high at 55 percent of GDP and an over-reliance on short-term domestic debt escalates costs and creates significant rollover risk. Additional fiscal risks arise from burgeoning contingent liabilities and the widespread use of interagency arrears and cross-subsidies, which reduce financial discipline in the public sector.

More importantly, Albania has a substantial opportunity to improve the productivity of public spending, both as an independent source of growth and as a complement to increasing the productivity of private capital. Cross-country analysis of expenditure efficiency shows that the country could achieve much greater outcomes with its current level of spending. The levels of public investment and public employment (wage bill) are broadly appropriate. Nevertheless, severe underfunding of non-wage inputs handicap the accumulation of human capital, leading to low levels of educational attainment and inadequate health care, and result in a relatively high level of private spending on healthcare services. Meanwhile, over-emphasis on expansion versus operations and maintenance (O&M) has perpetuated the poor condition of Albania's infrastructure, especially the road network, water, and electricity transmission and distribution systems. Although allocation of spending across economic and social sectors is broadly in line with other high-growth countries, Albania should accelerate the transition to economic tariffs (in the water sector) and the establishment of institutional frameworks for private investment (in the transport and energy sectors). These steps will enable the elimination of enterprise subsidies and provide fiscal space to increase spending in education and, when operational arrangements improve, in health.

Government spending in Albania has become inequitable with stark variations in expenditures and outcomes at the local level. The authorities need to complete the reform of mechanisms for allocating resources to local governments and service providers so that the latter two respond to local needs; but also create the incentives for efficient use. These reforms are particularly crucial in the health, education, and water sectors.

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[1] This report was prepared prior to July 2006, date at which the new Government reduced social security contribution rates by about nine percentage points. Analysis in this report and the forthcoming Social Insurance Review analyze in further depth the pension sustainability.

Finally, improving the efficiency and equity of public spending in Albania will not be possible without accelerating the institutional reforms aimed at restoring discipline and credibility in expenditure management. These reforms include rationalizing the pay system for public servants and strengthening the civil service management reforms to improve public sector performance and equity.

In the short to medium term, the government should focus on:

1. Further reducing overall levels of public debt by (a) a gradual reduction of domestic borrowing through fiscal consolidation, (b) major efforts to strengthen debt management capacity, and (c) the formulation of a debt management strategy that focuses on increasing the average maturity of public debt.

2. To respond to emerging demographic changes, beginning to adjust the functional and regional allocation of education spending toward secondary education based on careful projections of the impact of demographic changes on school age cohorts and their regional distribution.

3. Completing the review of the social insurance system and then embarking on a comprehensive reform of the pension system, securing a basic safety net for all, with additional benefits for those who actually contribute.

4. Channeling all public sector resources for health care through one agency (Health Insurance Institute), which will pool these funds, allocate them, and purchase health services on behalf of the population.

5. Increasing the allocation of resources to recurrent road expenditures to address backlog maintenance and raise spending on normal maintenance; and strictly adhering to the agreed Albania National Transport Plan by subjecting all proposed transport projects to the full cycle of the new public investment management guidelines.

6. Phasing out operational subsidies to water utilities in the medium-term and transferring the savings to investments and reallocating them based on sector priorities *and* utility performance.

7. Supporting the electricity utility's (KESH) efforts to implement the annually updated Power Sector Action Plan, particularly with respect to reducing network losses and improving bill collections (including government own obligations); and deciding on options for restructuring KESH.

8. Deepening the reform in public expenditure management with a particular focus on strengthening the newly established Integrated Planning System for national and sectoral priority setting, focusing on annual budget preparation and execution (including curtailing use of nontransparent virement, and implementing multiyear procurement for capital projects) and strengthening capacities in line ministries.

9. Designing and starting implementation of robust procedures to identify, select, and appraise public investment projects while ensuring full integration with the Medium Term Budget Plan (MTBP) process.

10. Reviewing existing options to harmonize the pay systems and assessing their fiscal impact in order to enhance performance and equity across the public sector.

OVERVIEW

A. INTRODUCTION

1. **Albania has made significant progress in maintaining macroeconomic stability and reducing poverty.** Through its National Strategy for Social and Economic Development (NSSED 2001–06), the Government of Albania articulated an inclusive long-term development strategy to bring Albania's living standards and per capita income closer to the levels of its neighboring European countries. Organized around two pillars—sustaining high economic growth and improving governance—the NSSED emphasized education, health care, and infrastructure as priorities for addressing poverty and providing a sound basis for long-term growth and competitiveness. At the same time, to improve spending outcomes and strengthen the environment for private investment, it recognized the necessity for stronger public accountability and increased public participation in government decision making.

2. **However, Albania is facing new challenges in sustaining these growth rates and ensuring a more equitable distribution of welfare gains**. The government recently launched the preparation of its new strategy, the National Strategy for Development and Integration (NSDI 2007–13). The government also expressed its commitment to sustain fiscal consolidation, keep government small, and increase its efficiency as the necessary elements of its strategy to improve the competitiveness of the Albanian economy as it progresses toward integration with the European Union. Given ever-present resource constraints and trade-offs, a critical enhancement is required to future resource allocations through a more thorough analysis and detailed prioritization and costing of spending programs.

3. **The Albania Public Expenditure and Institutional Review (PEIR) contributes to this debate by examining the role of expenditure policy in enhancing future growth prospects while improving service delivery outcomes**. Composed of two volumes, this report assesses outcomes from public expenditures in Albania over the past 5–10 years; discusses the current and future challenges facing the government in improving the efficiency of public spending and ensuring the sustainability of the fiscal stance; and proposes an agenda for a public expenditure strategy to address them, at both the aggregate and sector levels. This Overview (Volume 1) synthesizes the detailed findings presented in Volume II.

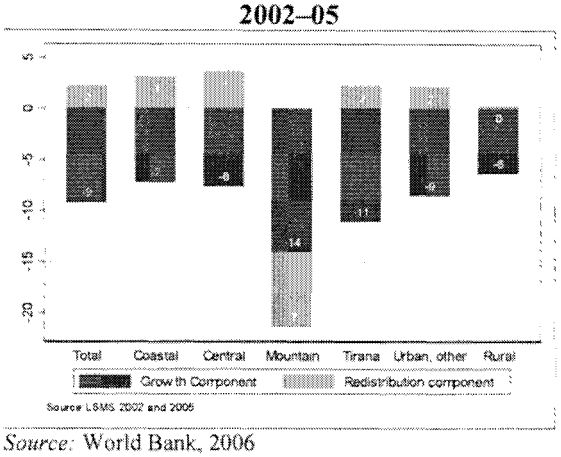
B. TRENDS IN GROWTH AND POVERTY REDUCTION

4. **Rebounding from the financial collapse of 1997, Albania did very well in sustaining high rates of economic growth.** Economic activity recovered and, over 1999–2005, real Gross Domestic Product (GDP) growth rates accelerated to an average annual rate of seven percent, enabling Albania's per capita GDP to approach middle-income country levels. This growth record has been the highest among transition economies. Since transition, Albania's growth has been driven primarily by the improvements in the allocation of resources from low-productivity sectors, firms, and activities to those demonstrating higher productivity.

5. **Much of this economic performance has been underpinned by sustained fiscal consolidation and macroeconomic stability.** The government reduced the overall deficit from 13 percent of GDP in 1997 to 3.4 percent in 2005, while the primary deficit declined from 7.3 to 0.3 percent of GDP during the same period. Lower public sector borrowing requirements resulting from fiscal consolidation sustained the downward trend in interest rates, and kept year-on-year inflation within the Bank of Albania's target range of 2 - 4 percent.

6. **As a result of this sustained growth, poverty has declined significantly in Albania, an impressive achievement.** The absolute poverty headcount rate fell from 25 percent in 2002 to 19 percent in 2005, or 6.8 percentage points, lifting 221,000 people out of poverty (Figure 1). This decline is higher than witnessed recently in most countries in Europe and Central Asia (ECA) and other middle-income countries.[2]

Figure 1. Decomposition of Change in Poverty 2002–05



Source: World Bank, 2006

7. **To sustain its impressive growth rates, Albania will need to find and exploit new sources of productivity growth, while continuing to encourage private investment.** The evidence from a recent growth-accounting exercise indicates that Albania's gains from better resource allocation, typical during the early phase of transition, have been diminishing and that total factor productivity growth has slowed significantly in recent years.[3] Meanwhile, the contribution of factor accumulation (both labor and capital) has picked up only modestly. Consumption growth continues to be kindled by large remittance flows and the growth in private credit.

8. **Many of the structural issues that plague Albania's economy and hamper private sector activity depend heavily on the performance of the public sector.** Poor-quality and outdated infrastructure, and relatively low-skilled labor represent major impediments to doing business.[4] Moreover, high payroll taxes discourage formal employment and dampen labor demand. Combined with weak governance and administrative corruption, firms have a weak foundation for raising productivity and building competitiveness.

9. **Furthermore, Albania's hard-won macroeconomic stability needs to be secured.** The current account deficit has been widening in recent years from 5.8 percent of GDP in 2001 to a projected 8.1 percent in 2006 (excluding grants), due to demand fuelled by a very rapid expansion of credit to the private sector. More recently, the rapid credit growth also has fuelled inflationary pressures. In addition, a parallel deceleration in exports combined with a recent deterioration in the electricity sector performance during the last quarter of 2005, along with a slowdown in the construction sector, are damaging growth prospects for 2006: the latter is projected to slow to 5 percent in 2006.

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

11. **Public expenditure policy is at the heart of these challenges to spur new productivity growth and reduce poverty and inequalities in access to services.** It has a fundamental role in terms of (a)

[2] World Bank, *Growth, Poverty and Inequality* (2005), Chapter 2.

[3] World Bank, "Albania: Sustaining Growth beyond the Transition" Country Economic Memorandum (CEM) (2004).

[4] Business Environment and Enterprise Performance Survey (BEEPS) (World Bank, 2002, 2005).

establishing the broad **macroeconomic** framework for investment and job creation; (b) providing the public services that contribute to human capital accumulation or to private sector productivity growth; and (c) creating conducive institutional and regulatory frameworks for private investment. In particular, the size and resourcing of the state are critical elements in the macroeconomic framework for investment and job creation. In turn, the allocation and efficiency of public spending will affect the delivery of public services that support human capital accumulation and will influence public investments that augment the productivity of private investment.

12. **This report finds that Albania has a substantial opportunity to (a) improve the productivity of its public spending, providing both a complement to raise the productivity of private capital and as also an independent source of economic growth; and (b) to deepen the impact of this growth on poverty by improving the equity of public service delivery.**

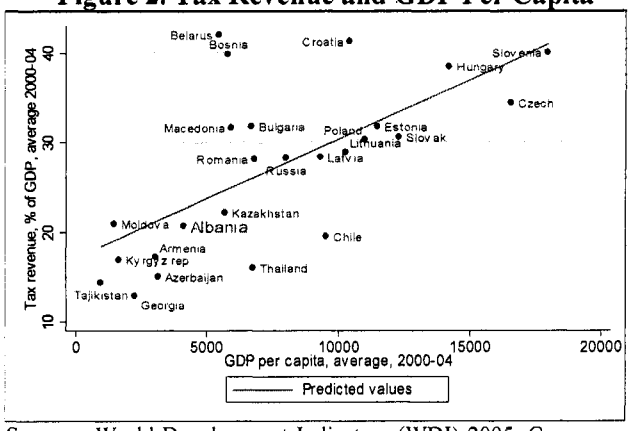
13. **However, achieving a better allocation of expenditures needed to support growth and job creation will not happen "by fiat."** It will require continued improvements in the institutional framework for translating expenditure policies into budget plans and ensuring effective budget execution.

C. Size and Resourcing of Government

14. **The government's current fiscal strategy of keeping government small at approximately 30 percent should be maintained and consolidated.** Cross-country analysis undertaken in this report for a group of high-growth countries of varying levels of income suggests that the size of Albania's government is moderate by international standards. General government spending as a share of GDP at an average 30.5 percent during 2000–04 places Albania within a group of European countries with relatively small governments, such as Estonia, Latvia and Lithuania. In the broader perspective, however, the current level of spending is actually larger than in some model high-growth countries, such as, Chile, Ireland, Korea, Malaysia, and Thailand. More detailed cross-country analysis on the relationship of the level of public spending and growth suggests that Albania's level of spending is only approximately 3 percentage points of GDP more than predicted by the model.

15. **The overall level of tax revenues at 22 percent of GDP is also in line with Albania's level of development, but the structure of revenues has been distortionary (Figure 2).** Except for extremely high labor taxes until July 2006, Albania's tax rates are comparable with those of other high-growth and transition economies.[5] However, weak administration and low compliance result in a very narrow tax base that bears the brunt of resource mobilization and is further disadvantaged by corruption in tax collection. When combined with personal income tax, high social insurance levies on employees and employers of approximately 42 percent of gross wages resulted in a tax wedge of 33 percent of labor costs. Until recently this wedge has been very high when compared with those of low-income countries and has created a disincentive for formal sector job creation

Figure 2. Tax Revenue and GDP Per Capita



Sources: World Development Indicators (WDI) 2005, Government Finance Statistics (GFS) 2005.

[5] The decision of the government to reduce social insurance contributions by 9 percentage point as of July 2006 is a positive step demonstrating government's commitment to curb informal activities.

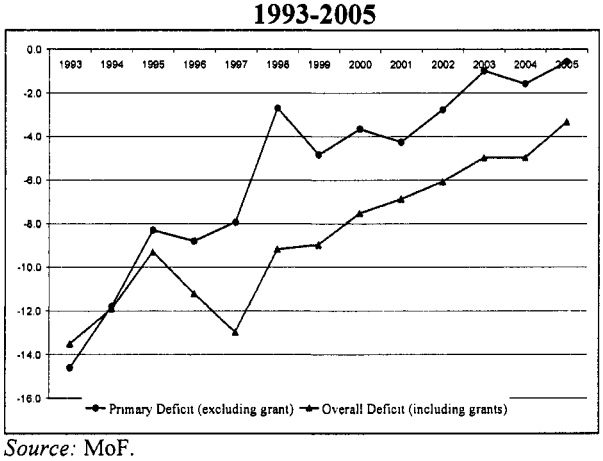
contributing to the growing informalization of the Albanian economy. More than three-quarters of the workforce is employed informally, and unemployed workers are more likely to transit into informal rather than formal employment.[6]

16. **The real issues however, are not ones of levels of spending; they have to do with the efficiency of the spending and the underlying risks in the fiscal position.** Extending recent work by Afonso, Schuknecht and Tanzi (2006),[7] this report finds that the government could achieve current outcomes with fewer resources, or significantly improve outcomes with the same level of resources. This report also shows how the composition of spending, and the way spending is planned and executed undermine its own efficiency. These findings are corroborated in individual sectoral analysis summarized in section F.

D. Sustainability and Efficiency of Public Spending

17. **Albania achieved a significant fiscal adjustment over the last decade, with a sustained reduction in the fiscal deficit over 1999-2005 that lowered public indebtedness.** Since 1993, the overall deficit has been reduced by 13 percentage points of GDP and the primary deficit (excluding grants) by 14 percentage points. The largest and most sustained period of adjustment occurred after the 1997 pyramid crisis and reduced the public debt level from 80 percent in GDP in 1997 to 55 percent in 2005. The latter is still a relatively high level by international standards; thus, further debt reduction is necessary.

Figure 3. Overall and Primary Fiscal Deficit, 1993-2005



Source: MoF.

18. **The quality of that adjustment undermined the efficiency of public spending and increased rigidity in the budget.** Most of the adjustment resulted from cuts in capital and non-wage recurrent spending, including operational subsidies (Table 1). In addition, despite the gradual reduction in interest payments and stable path of wages and transfers, Albania has experienced increasing rigidity in the structure of spending, with nondiscretionary spending rising from 57 percent of the budget in 2000 to 63 percent in 2005.[8] Moving forward the challenge is to adjust the input mix while providing enough flexibility for strategic resource reallocation to meet Albania's changing needs.

Table 1. Size and Distribution of Fiscal Adjustment, 1993–2005 *(change in % GDP)*

Total revenues	1.7
Total expenditures	-8.5
Current expenditures	-4.2
Personnel expenditures	-0.8
Interest	1.0
Operations and maintenance	-2.5
Subsidies	-1.3
Capital expenditures	-4.2
Domestically financed	-0.7
Foreign financed	-3.5
Primary deficit (including grants)	-11.2
Primary deficit (excluding grants)	-14.0
Total deficit (including grants)	-10.2
Overall deficit (excluding grants)	-13.0

Source: MoF.

[6] World Bank, "Albania, Labour Market Assessment" (2006).

[7] A. Afonso, L. Schuknecht, and V. Tanzi, "Public Sector Efficiency: Evidence for New EU Member States and Emerging Markets" (European Central Bank, Frankfurt am Main, ECB, January 2006).

[8] Nondiscretionary spending includes debt service, wages and salaries, and transfers to social security.

19. **Indeed, Albania has a significant opportunity to improve the productivity of its public spending if it adjusts its input mix to support sustained growth.** This conclusion emerges from a comparison of Albania's economic allocation of its public resources with neighbors in the region and two groups of fast growing countries with small and large governments, respectively (Table 2).[9] In particular, while government spending on capital investment as well as the wage bill is appropriate for Albania's growth path, its level of spending on goods and services is critically low, and high interest payments continue to crowd out primary spending.

20. **Public investment, although declining, remains comparable to other fast-growth countries.** Although declining from 8.4 percent of GDP in 1993 to 4.2 percent of GDP in 2005, public investment is not low (Table 2). However, and despite Albania's good progress in upgrading its dilapidated infrastructure, the poor condition and continued inefficiency of key utility sectors continue to pose a significant bottleneck to economic growth. Much of this bottleneck results from deferred maintenance of key networks and systems, the water and electricity sectors in particular, and unfinished reforms to improve operational efficiency in all sectors (transport, health, water). Although Albania does have significant investment needs in infrastructure to meet the demands of its growing economy, the efficiency of these investments rests critically on ensuring adequate operations and maintenance (O&M) and improving operational and financial performance of utilities. The latter also will be instrumental in raising private and external financing.

Table 2. General Government Spending, Economic Classification, Average 1995–2004 (% GDP)

	Total expenditure and net lending[1/]	*Primary expenditure*	*Goods and services*		*Transfers*	*Subsidies*	*Capital*	*Interest*
			Wages	*Non-wage*				
Albania	31.6	26.7	7.0	3.8	9.0	0.7	6.1	4.9
High Growth (HG)	36.4	34.0	7.1	8.2	12.9	2.0	4.4	2.6
HG Big Govt.	44.9	41.5	8.2	8.6	17.2	3.1	5.0	3.4
HG Small Govt.	28.8	27.2	6.1	7.4	7.9	1.0	3.9	1.9
EU8	40.3	38.1	7.1	8.1	17.1	2.8	4.4	2.2
SEE[2/]	40.7	38.1	8.0	8.3	14.5	1.8	5.0	2.6

[1/] 1995 or earliest year available, 2004 or the latest year available.
[2/] (excluding Turkey).
Source: ECA Regional Public Finance Database.

21. **Similarly, the size of the wage bill relative to GDP is appropriate for Albania's growth agenda.** Personnel expenses have been relatively protected during the past fiscal adjustment, yielding a stable level of spending in relation to GDP. However, this stability reflects a substantial downsizing of public employment (by nearly 59 percent during 1993–2005) accompanied by a 3-fold increase in the average wage since 1996. Furthermore, the gains from rightsizing and improving staff remuneration need to be sustained. The persistent low quality of Albania's bureaucracy, weak governance, high levels of administrative corruption, and state capture continue to reduce the effectiveness of Albania's public spending on personnel and call into question the underlying structure and incentives of the existing public employment pay system (section G.3). Moreover, given the broadly appropriate size of the wage bill, any proposed adjustment of the wage structure as part of the ongoing civil service reform effort should be carefully analyzed for its fiscal implications.

[9] In this table, high-growth countries registered an average growth in per capita GDP over 1993–03 exceeding 2.5 percent. The High Growth Small Government (HG Small Govt.) countries include: Albania, Armenia, Chile, Estonia, Georgia, Ireland, Republic of Korea, Latvia, Lithuania, Romania, and Thailand. High Growth Big Government (HG Big Govt.) countries include Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Greece, Hungary, Poland, Slovak Republic, and Slovenia.

22. **Non-wage recurrent spending is critically low and is reducing the efficient use of other inputs: personnel and capital.** From 1993–2005, non-wage recurrent spending fell from 8 percent to 3 percent of GDP and, at 11 percent of general government spending, is extremely low with respect to Albania's high-growth peers and regional neighbors. As noted above, critical underspending on maintenance in the road and water sectors is creating future direct liabilities for rehabilitation and reconstruction that are several times larger in present value terms than the foregone spending. In the road sector, spending on maintenance is some 40 percent lower than required and already has created a backlog of nearly US$ 45 million (0.5 percent of GDP). Meanwhile, 67 percent of the national road network is in poor condition, compared with 22 percent of the national networks in Bosnia and Herzegovina and Croatia (section F.5).

23. **In the education and health sectors, under-funding of complementary inputs is undermining the quality of the services.** In secondary education, only 3 percent of current spending is available for instructional materials and maintenance, and in primary health, fully staffed clinics face severe shortages of materials and poorly maintained equipment. These critical lacks have resulted in low quality of service delivery and an associated reduction in demand. Returns to general secondary education and enrollment rates are alarmingly low at a time at which the economy increasingly needs a more sophisticated labor force equipped with knowledge and workplace skills that cannot be developed through primary or basic education alone. In the health sector, poor service delivery in primary health has led to persons bypassing these facilities for polyclinics and hospital care, resulting in inefficient resource mobilization (sections F.1 and F.2).

24. **Interest payments continue to crowd out primary spending, especially non-wage recurrent spending.** Despite sustained reduction in interest rates and reduction in public sector borrowing requirements, interest payments of approximately 13 percent of government spending continue to severely crowd out primary expenditures and exceed levels in other high-growth countries. This serious imbalance has constrained the government's ability to allocate expenditure according to development and sectoral priorities.

25. **Given these high interest costs, the government should articulate an active debt strategy, of which further debt reduction should be part.** These high interest rates reflect the risk stemming from the current structure and management of public debt. Domestic debt accounts for 70 percent of Albania's public debt and is held in very short-term domestic instruments concentrated in the hands of a few domestic institutions. As a result, the rollover risk is significant, and interest costs are relatively high. Under the IMF-supported PRGF/EFF program, the government recently embarked on the development of a strategy to improve its public debt management. **These efforts should be given the utmost priority to manage and reduce the above risks, lengthen the average maturity of public debt, and contain the government's cost of borrowing.**

26. **Further progress in reforming the state enterprise sector also will be needed to secure the hard-won reduction in subsidies, improve productivity both in the public and private sector, and reduce the risk of emerging contingent liabilities.** Albania has made good progress in reforming the state enterprise sector, thus reducing subsidies and improving operational and financial performance. Privatization of SOEs, price and trade liberalization and enterprise reforms have reduced uneconomic subsidies. However, persistent operational inefficiencies and unfinished reforms, particularly in the water and railway sectors, and recent governance challenges in the power sector (par. 88), may constrain the gains to be made in productivity improvements.

27. **The water sector has increased its dependence on public subsidies over the past few years, as slow progress on tariff adjustments and efficiency improvements have been outstripped by increasing costs.** The power sector critically needs external investment financing to meet rapidly rising

demand, but introducing private participation needs to be managed in orderly way to avoid future liabilities for the government. In addition, a quasi-fiscal deficit on the order of 2.5 percent of GDP (arising from suboptimal tariffs and low collections) reflects perverse consumption incentives for residential consumers leading to excessive household demand for electricity. This deficit renders efforts to reduce theft, improve collections, and gradually raise household tariffs while mitigating the resulting impact on the poor even more critical.

28. **Finally, Albania faces additional fiscal risk from a potential build-up of contingent liabilities, as has happened in several other transition countries.** The nominal budgetary primary deficit of 0.5 percent of GDP in 2005 does not reflect the total public sector deficit, which should account for state enterprise deficits/quasi-fiscal deficits. Nor does it include the outstanding costs of compensation for land restitution, the web of intra-government cross-subsidies, transfers, and arrears that substantially weaken the hard budget constraint for beneficiary agencies and institutions. As mentioned, Albania's pattern of deferred maintenance in several infrastructure sectors is creating future liabilities in reconstruction and rehabilitation costs that are several times larger in present value terms than the foregone spending. Moreover, as Albania seeks to increase the private financing for and participation in infrastructure, both the demand for new state guarantees as well as the risk of government bailouts for nonguaranteed but publicly desired investments is likely to increase the build up of contingent liabilities. As such, the government needs to raise its capacity to appraise and evaluate such projects.

E. Overarching Public Expenditure Strategy

29. **The main thrust of a public expenditure strategy oriented toward growth therefore would be to wrest greater outcomes from the existing levels of spending and limit the risks involved in current fiscal operations.** The report identifies several pillars of this strategy. First, there is a need to alter the input mix, including through a reduction in debt levels (discussed at length above). Second, a review of the current intersectoral and intrasectoral allocation is warranted. Third, this review should be complemented by reforming the existing financing arrangements to reduce regional disparities in spending and by giving a greater role to the private sector in financing and providing certain services.

Alter the input mix

30. **In keeping with the discussion in section D above, some of the key features of such a strategy would be to adjust the input mix to:**

a) **Increase the share of spending on non-wage goods and services**, notably O&M in the infrastructure sectors commensurate with the need for maintaining the capital stock in good condition and clearing backlog maintenance in the transport and water sectors. All of this will demand a significant increase in O&M expenditures. Non-wage recurrent spending in the secondary education and primary health also must increase.

b) **Keep wages and salaries in check**, and manage the cost of the wage bill within a comprehensive approach to civil service reform and restructuring of the state institutions.

c) **Maintain capital spending at current levels while subjecting it to the rigor of investment management procedures**, and ensure that appropriate O&M funding is allocated for planned new investments. All new capital investments also should be subjected to the discipline of the MTBP process, so that they are prioritized and O&M projections are built into the planning of the investment (section G.2).

d) **Alleviate the burden of interest payments on the budget by articulating an active debt strategy.** It should include reducing overall debt levels, increasing domestic maturities, and seeking long-term external (official and private) financing.

e) **Gradually reduce remaining subsidies**, notably in the water sector in the context of an overall plan aimed at achieving cost recovery, and in the railway sector.

Rebalance inter-sectoral allocations

31. **Against a constrained resource envelope, every program in the budget also should be evaluated against the rationale for public intervention in a market economy.** Selection of each program should be made based on whether the public sector could deliver the goods and/or services in a sufficient and efficient manner, or whether this should be left to the private sector.

32. **The above principle means that inter-sectoral allocation decisions should come under scrutiny.** A comparison of the functional composition of Albania's public spending with high-growth comparators reveals three important features: (a) relatively low spending on education; (b) higher than average spending on general public services; and (c) average level of spending in the economic services including infrastructure, health, and social protection (Table 3).

Table 3. General Government Spending, Functional Classification, 2004 (% GDP)

	Total outlays	*General public services*	*Defense and public order*	*Education*	*Health*	*Social security and welfare*	*Economic affairs*	*Other*
Albania	29.1	3.6	2.9	3.1	2.5	7.5	3.6	5.8
High Growth (HG)	34.3	2.8	3.6	4.6	3.8	10.9	4.3	4.3
HG-Big Govt.	43.7	3.4	3.7	5.5	5.5	15.7	5.0	4.9
HG Small Govt.	28.1	2.4	3.6	3.9	2.7	7.7	3.8	3.9
EU8	41.7	3.3	3.3	5.9	5.0	13.8	4.8	5.5
SEE (excl. Turkey)	39.1	4.0	4.8	4.1	4.8	12.8	4.5	4.3

Note: The composition of countries and therefore the average for each group may differ from those in Table 2 because detailed functional classification of expenditure is not available for all countries used in Table 2.
Source: ECA Regional Public Finance Database.

33. Although investment needs are great in **water and electricity**, these sectors have the ability to finance a reasonable share of these expenses from own income or to garner private financing, provided tariffs move gradually to cost recovery levels and an appropriate institutional framework for private participation is established. Given these, operating subsidies should decline over time, and publicly financed investment should be replaced by private investment (section F.4). Moreover, spending levels in **general public services** are larger, by approximately 1.0–1.2 percentage points of GDP, than for comparator countries and often higher than those of bigger governments including Bulgaria, Czech Republic, and Poland. Recent efforts to rationalize spending in this category should be strengthened and based on the ongoing functional review process underpinning the downsizing efforts of government. These efforts should provide some fiscal space to increase spending in **education**, and (when financing and operational arrangements improve) in **health**.

34. Irrespective of the differences in financing levels, expenditure outcomes in all sectors remain below potential for a given level of spending and/or below Albania's emerging needs. The three themes mentioned in paragraph 29 above are those that emerge from the analysis of individual sector spending, and those that should be at the heart of Albania's expenditure strategy are discussed below.

Adjust intra-sectoral allocations

35. **First, there is a recurring need to adjust intrasectoral allocations in response to demographic changes or technical exigencies**:

- In **education**, an emerging decline in primary and secondary age cohorts combined with increasing secondary enrollment could yield a dramatic increase in demand for secondary education over the medium term. This need is also driven by severe under funding of general secondary education (Table 4). In response, Albania will need to reallocate additional spending in the sector in favor of secondary education in the future. Concurrently, quality must improve to stem the flow of poorly educated students who are ill-prepared for the labor market (section F.1).

- In the **health sector**, as the population ages, Albania is beginning to see an increasing incidence of non-communicable diseases. However, the healthcare system is ill prepared to face their increasing incidence and their associated long and costly treatment. The current situation argues for shifting spending from hospital sector, which is relatively over financed, and reducing overspending on pharmaceuticals, to preventive care and key public health functions that could significantly reduce not only the burden of these diseases but also their related treatment costs (section F.2).

- During the past five years, **social protection** spending has shifted from social assistance to social insurance. At the same time, the pension system, given its broad coverage, has had a larger impact on poverty than Albania's main social assistance program—Ndihme Ekonomike (NE)—which has decreased in real spending and real value of benefits. However, the pension system is characterized by low replacement rates and disconnect between benefits and contributions. Therefore, given Albania's demographic and employment profiles, it is necessary to fundamentally rethink the entire old-age security policy and the potential role of social assistance and insurance programs and adjust expenditures accordingly (section F.3).

Table 4. Total Unit Costs by Level of Education, Albania and EU-15 and EU-8 Relative to Primary Education

	Secondary			Tertiary
	All	Gen	VET	
Albania (2002-05)	1.27	0.94	3.07	2.44
Albania (2005)	1.22	0.94	2.75	1.95
Albania (2002)	1.59	0.89	2.29	2.71
EU 15 (2002)	1.29			1.79
EU-8(2002)	1.21			2.32

Sources: MoF, OECD 2005.

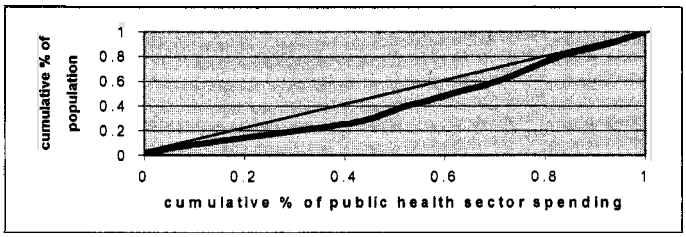
Address regional disparities

36. **The second major theme is the need to address regional disparities and inequities in the delivery of public services.** Albania has a decentralized system of service delivery that varies in structure from sector to sector. However, a common problem across all sectors is the lack of appropriate and (often) objective criteria for allocating resources to local governments, institutions, and service providers. Investment allocations to local government entities also often are based on a nontransparent mix of criteria and negotiations with little connection to poverty or growth needs. In many cases, the financing allocations for recurrent spending are based on input or traditional norms and unrelated to intended outcomes, local needs, or actual patterns of resource utilization. They neither respond to local needs nor create the appropriate incentives for efficient use of resources. Moreover, once resources are transferred, there is little monitoring and oversight of local government expenditure.

- In the **education sector**, large variations in regional outcomes often can be traced to differences in per capita spending. For example, in general secondary education, the best funded region spends more than three times the amount per student of the least funded region. The recent introduction of formulas for determining regional allocations of recurrent spending need to be refined to move gradually toward capitation financing for recurrent spending.

- Per capita public sector spending on **health** varies markedly by district and region, largely due to a skewed distribution of facilities and staffing and an input-based financing system. The result is that the regional allocation of spending is quite regressive (Figure 4). Although general practitioners are funded through Health Insurance Institute (HII) on a capitation basis, this payment is not based on active enrollment nor does it include allowances for nonsalary operating costs (section F.2).

Figure 4. Lorenz Curve of Public Sector Spending on Health and Regional Poverty Incidence



Source: WB staff estimates.

- Decisions to allocate investments to **water** utilities and affiliated local governments also were not based on specific measurable objective criteria, but the variations in access and quality of services are stark. Areas with higher levels of access to water and sanitation services generally receive higher per capita investment (Figures 5 and 6). The introduction of a performance-based transfer system, currently under discussion, needs to be accelerated. In parallel, the central government needs to complete the transfer of assets to local governments in line with their legally mandated responsibility for oversight and/or operation of local water systems as a means to increase the effectiveness of local management of systems and improve equity in access and quality of service. This performance-based transfer system should be implemented once the governance and financial arrangements are clarified.

Figure 5. Albania Water Investments and Running Water Inside the Dwelling, 2002–05

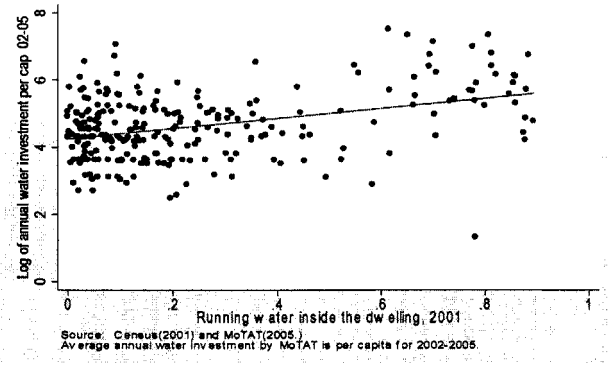
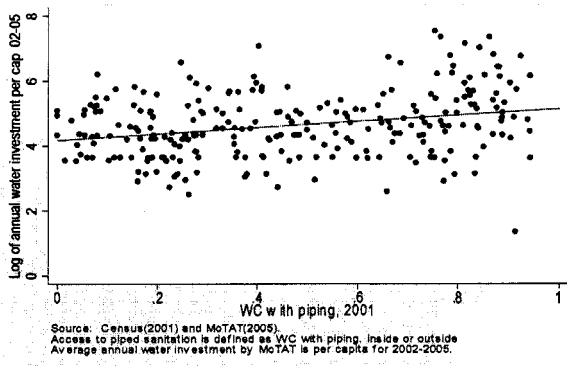


Figure 6. Albania Water Investments and Access to Piped Sanitation, 2001 and 2002–05



Sources: WB staff estimates, INSTAT, MPWTT, MoF.

Rework the public-private financing mix

37. **The third major theme is the need to adjust the public-private financing mix to not only expand the overall envelope of sector resources but also increase technical efficiency and improve outcomes.**

- Given the reduction in concessional aid flows, Albania is seeking to deepen private investment in infrastructure. Participation already has gained ground in civil aviation. However, **establishing clearly defined institutional and regulatory frameworks for private sector participation (PPPs) in roads, ports, energy, water, and, ultimately, railways is a necessity**. A recent thorough assessment of Albania's current Concession Law revealed several shortcomings that will need to be addressed along with other reforms to ensure an appropriate division of risk between government and private sector, and to avoid the emergence of any contingent liabilities and other types of fiscal risks. It is expected that the forthcoming law on concessions and private public partnership will address those issues.

- In both the **social protection and health** sectors, the use of contribution-based insurance systems to finance both pensions and health expenditures have run into serious problems, in part because of a disconnect between benefits and contribution rates that discourages participation and compliance. Both systems will require fundamental reform to address the perverse participation incentives but also to realign public spending with sector goals (sections F.2 and F.3).

- Finally, in **tertiary education,** increasing cost recovery is an important policy option, given the large returns to tertiary education and the consumption profile of the tertiary students (predominantly from the top two quintiles)—so long as access of students from poor families can be protected. Although tuition fees have increased from 2.2 percent of university revenues in 2000 to 21.6 percent in 2005, current financial management arrangements for universities provide little incentive for further increasing such revenues. To date, there has been little use by universities of the (limited) flexibility to move resources among the faculties since the current regulations do not make adequate provisions for strengthening accountability, such as through the establishment of university governing boards (section F.1).

F. Reforming Sectoral Programs

38. **The above strategy for expenditure restructuring derives from a bottom-up approach that builds on detailed sectoral analysis.** The report examines public spending programs and issues in education, health, social protection, transport, water, and power. While the report proposes short- to medium-term recommendations in the areas discussed below, it does not pretend to provide a fully detailed, comprehensive reform blueprint. Instead, it seeks to illustrate the difficult issues that need to be confronted. In each sector, the discussion focuses on reform options that can help to reduce inefficiencies in public spending while improving its effectiveness in supporting the strategic goals of growth, employment, and poverty reduction. The following paragraphs examine how this agenda could be pursued sector by sector. The main policy recommendations stemming from the analysis are presented in section F below. More detailed analysis of each of the six sectors is provided in Volume II.

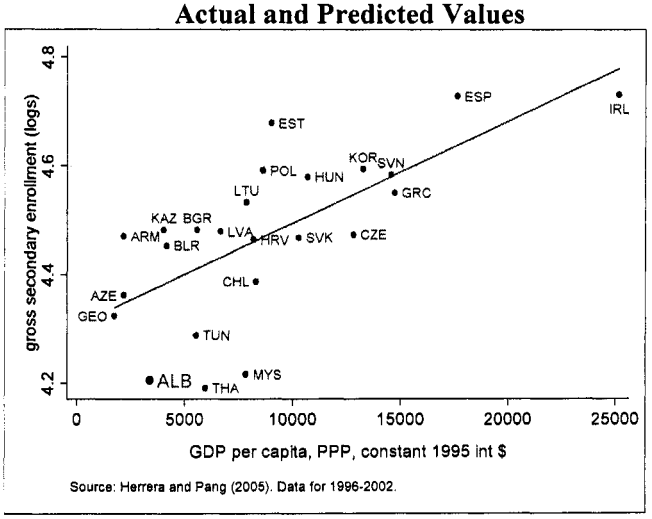
39. **Despite recent improvements in enrollments, the stock, flow, and quality of Albania's human capital are insufficient to support the country's transition to middle income country status.** Albania is close to reaching the objective of universal primary education, a major achievement with expected long-term benefits in poverty reduction. The last three years also have seen signs of improvement in secondary and tertiary enrollments. Yet, Albania's secondary and tertiary net enrollment

at 55 percent and 18 percent, respectively, and average educational attainment at 9.6 years remain comparatively low (Figure 7). Inequality in enrollment is relatively high and rising (between consumption quintiles and within urban areas), and the quality of education is inadequate to equip students with the required skills to meet labor market demands.

F.1 EDUCATION

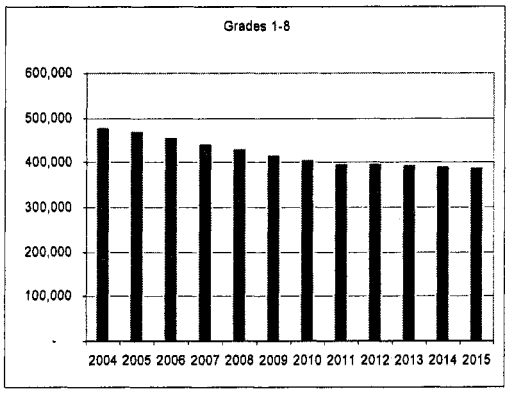
40. **Overall, the education system is underfunded at 3.2 percent of GDP but relatively efficient in its use of inputs.** Teacher-student ratios are reasonable, and there is extensive but declining use of double shifts. Repetition and dropout rates are low. However, some efficiency measures may be critically impacting quality and, ultimately, demand. Observed lower returns to general rather than to vocational secondary confirm that the quality of general secondary education is not meeting market needs.

Figure 7. Gross Enrolment Rate and GDP Per Capita: Actual and Predicted Values



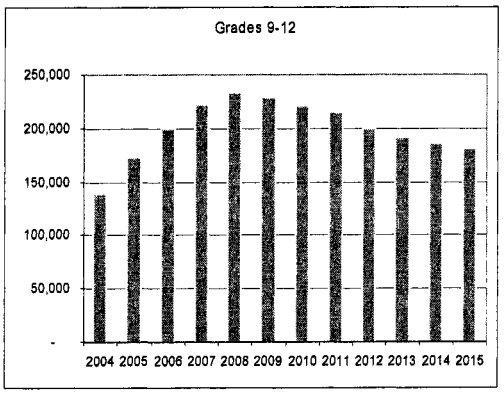
41. **With rapidly declining primary age cohorts and high primary completion rate, over the medium term, Albania could see a dramatic rise in demand for secondary education.** Responding to these changes and the need to address serious under-funding of general secondary education, will require a gradual reallocation of spending between primary, secondary and tertiary education, and improved budgeting and financing practices. Emerging demographic changes may provide an opportunity for reallocating some expenditures to secondary education over the medium-term, while increasing cost recovery and private provision in tertiary can help generate additional, needed fiscal space (Figures 8 and 9).

Figure 8. Enrolment Projection for Grades 1-8, 2004–15



Source: WB staff estimates.

Figure 9. Enrolment Projection for Grades 9–12, 2004–15

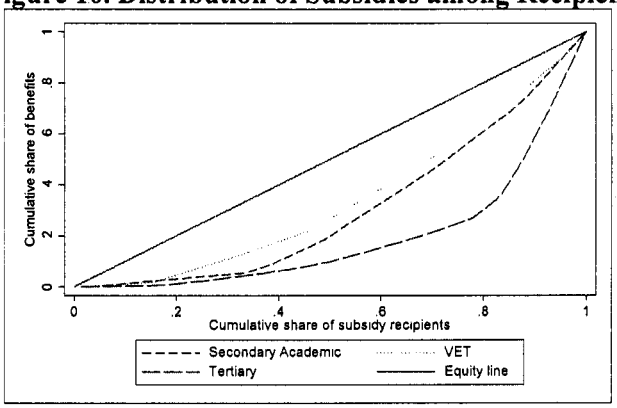


Source: WB staff estimates.

42. **While primary education has received over the past the largest share of the sector's resources, general secondary education is severely underfunded, both in per capita spending and funding for non-wage recurrent spending.** The prospect of gradually reallocating spending on teaching staff in the future from primary to secondary education faces two challenges: there are not enough teachers with the basic qualifications for secondary instruction, and relatively low salaries (in relation to per capita GDP) may need to be raised to accelerate recruitment/replacement. At the same time, international and regional experience shows that small increases in class sizes may yield some savings in this area without affecting quality. A relatively large capital investment program that already has achieved some improvement in school infrastructure will need to be retargeted to accommodate projected enrollment and possible spatial consolidation of schools.

43. **To respond effectively to existing regional disparities and emerging demographic changes, Albania needs to continue reforming the financing formula and arrangements for education spending.** Further refinement of the financing formula, including potentially capitation financing, are key to improve the allocative efficiency and equity. There is also a need to improve planning, coordination, and execution of capital investment across different levels of government.

Figure 10. Distribution of Subsidies among Recipients



Source: LSMS 2005.

44. **Education subsidies, concentrated in tertiary education, are highly regressive and should be retargeted toward secondary education** (Figure 10). Given the large private returns to tertiary education and the consumption profile of the tertiary students (predominantly from the top two quintiles), further increasing cost recovery at this level is an obvious policy option so long as access of students from poor families can be protected. Increasing cost recovery will require major changes in the financial arrangements under which the universities currently operate. Further attention also should be paid to facilitating the expansion of private education.

EDUCATION: SUMMARY OF RECOMMENDATIONS
✓ Increase spending to the sector commensurately with level of other high growth comparators.
✓ Begin adjusting the functional and regional allocation of spending to respond to demographic change, based on careful projections of the impact on school-age cohorts and their regional distribution.
✓ Strengthen across levels of government the coordination of capital investment and non-salary recurrent and salary spending in pre-university education to achieve necessary expansion of secondary schools.
✓ Prioritize the use of any additional recurrent financing to (1) raise non-wage recurrent spending in general secondary education and (2) improve teacher skills and salaries.
✓ Redistribute education subsidies toward poor, rural households.
✓ Gradually introduce per-student or capitation financing formula for recurrent spending.
✓ Increase cost recovery and private participation in tertiary education along with budget autonomy and accountability for public universities.
[1/] See Chapter 6, Volume II for a full list of recommendations.

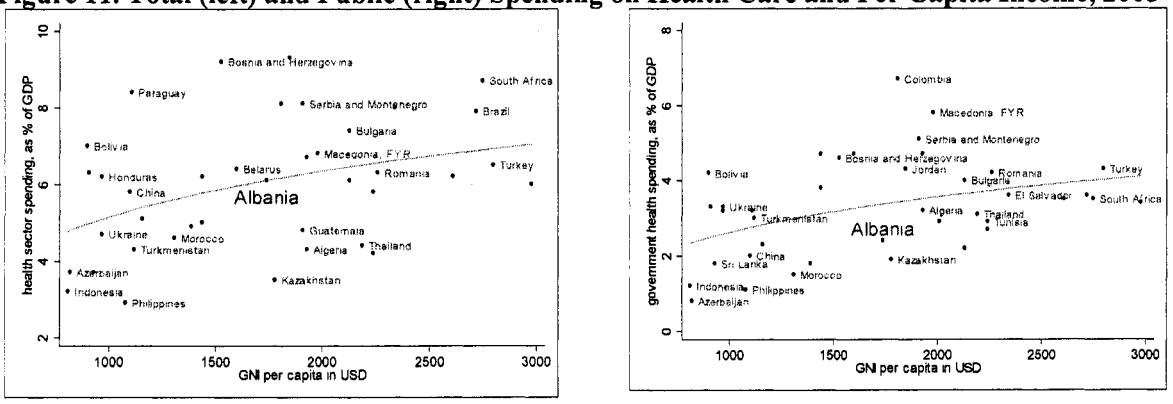
F.2 HEALTH

45. **Albania's health outcomes are commensurate with its health expenditures, but its demographic and epidemiological profile is changing.** In terms of life expectancy and vaccination coverage, Albania compares favorably to other lower middle-income countries. At the same time, the incidence of non-communicable diseases is increasing substantially as the population ages. The health care system is ill prepared to face the increase of these diseases and the lengthy and costly treatment associated with them. It continues to be heavily centered on secondary and hospital care, with insufficient emphasis on primary care, including preventive care and health promotion.

46. **The share of public spending in total health spending is relatively low, resulting in high out-of-pocket spending, reaching approximately 100 percent of private health spending.** Albania spends approximately 6 percent of GDP on healthcare, commensurate with its income level, but the share of public sector spending on health is below that of other countries with similar income levels. At 2.5 percent of GDP in 2005, it remains below that of most European and transition countries (Figure 11). The high share of out-of-pocket spending at the point of service has serious equity and poverty implications. It also reduces the government's ability to drive the reforms needed to improve the quality of service, sectoral efficiency, and, ultimately, health outcomes.

47. **Sectoral funding remains fragmented and does not provide incentives for efficient resource use.** Despite a mandatory contributory health insurance system, general revenues account for 93 percent of public sector funding. Moreover, approximately 70 percent of the health insurance system resources come from public subsidies and contributions for public sector employees. Approximately only one-third of the active work force contributes to the Health Insurance Institute (HII). Incentives for contributing are weak because the scheme covers only primary care (outside polyclinics), reimbursement of some prescription drugs, and certain high-end diagnostic procedures. In contrast, outpatient care in polyclinics and hospitals and inpatient care are financed by general revenues and, in principle, are free.

Figure 11. Total (left) and Public (right) Spending on Health Care and Per Capita Income, 2005



Sources: World Health Organization (WHO), World Development Indicators.

48. **The low utilization of primary care facilities and hospitals is widespread.** The low quality of primary care has resulted in many persons' bypassing primary care facilities in favor of care at polyclinics or hospital outpatient facilities, even for minor health conditions. Inefficient resource utilization also plagues the hospital sector, which has a large number of small hospitals with low occupancy rates. Over 60 percent of Albania's hospitals are too small to exploit economies of scale in the general acute care hospital setting.

49. **This low utilization of primary care facilities and hospitals is explained partly by imbalances in the composition of health spending as reflected in:**

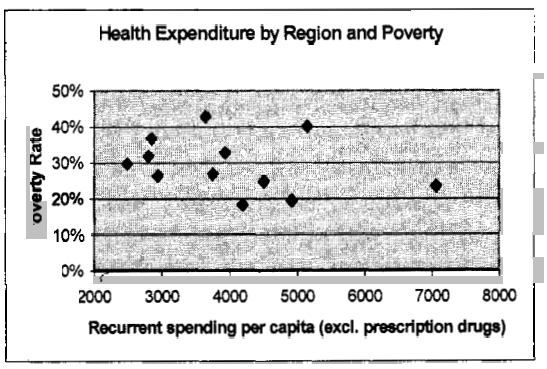
a) *High spending on hospital care*: Hospital care absorbs approximately half of total public sector spending compared with 38 percent in the EU8 countries.

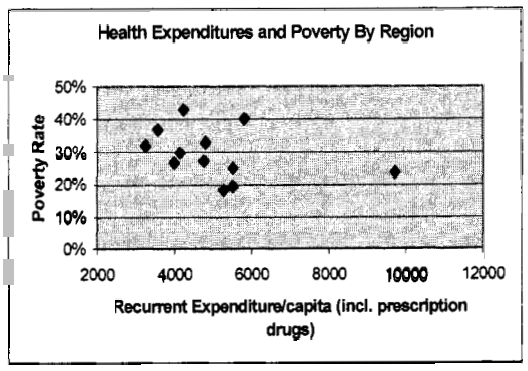
b) *Soaring spending on HII-reimbursed prescription drugs*: After doubling 2 years in a row, prescription drug spending reached 20 percent of recurrent spending in 2005, largely as a result of an imprudent expansion of the positive list of drugs and cancellation of co-payments for most beneficiaries. In early 2006, the government reintroduced a flat co-payment to help stem the rising expenditure.

c) *Underfunding of primary care:* Particularly for low non-wage spending and allocations for basic equipment.

d) *Low spending on preventive care*: If increased, preventive care funding could significantly reduce both the burden of disease and related treatment costs.

50. **Large marked variations in public health spending per capita across districts and regions also explains low utilization of health care facilities.** These variations do not appear to be driven by programs targeted at raising unusual regional health outcomes, by poverty targeted programs, nor by the location of facilities that provide services to a wider area. Instead, the variation is largely due to the skewed distribution of facilities and staffing and an input-based financing system; and results in a regional allocation of spending that is quite regressive (Figure 12).





51. **Changing the input based-financing system will provide incentives for improving the quality and efficiency of service provision.** While general practitioners are funded through HII on a capitation basis, this payment is not based on active enrollment nor does it include allowances for non-salary operating costs. Moreover, strong central control over hospitals and an input-based payment system leave hospital managers without incentives or authority to undertake changes to improve the efficiency and quality of their operations. The contemplated shift toward performance-based payments through a single payer system could substantially contribute toward improvements in the efficiency of resource use, provided this shift is introduced with the proper accountability mechanisms and information systems in place.

52. **Moreover, the establishment and use of a country wide hospital network plan is critical to limit inefficient use of capital investments resources.** The limited investment budget is stretched too thinly and investment decisions often are not subject to rigorous cost-benefit analyses, particularly when external financing is involved. Similarly, no framework has been established to make informed decisions about investments in high-end medical equipment, a key cost driver in the sector.

53. **Finally, the current decentralized allocation of investments in primary care facilities has led to suboptimal use of resources.** Investment allocations are driven in part by arbitrary standards of one health post per 1,000 population and one health center per 4,000 people, instead by regional primary health care development plans based on analyses of existing resource utilization. Moreover, there is little evidence that local governments actually spend toward these objectives once resources are allocated. In the case of the Tirana region, the development of such plans, if based on analysis of the utilization of the existing network and desired efficiency improvements could result in a substantially more consolidated and higher quality network than indiscriminate application of relatively generous coverage coefficients.

HEALTH: SUMMARY OF RECOMMENDATIONS
✓ Channel substantially all public sector resources for health care through one financing agency (HII), which will pool and allocate these funds and purchase health services on behalf of the population.
✓ Proceed towards the elimination of the payroll tax-based health insurance contribution and replacing it with general revenue funding while ensuring a predictable financing stream to HII.
✓ Increase resources allocated to primary care and public health.
✓ Authorize the use of co-payments for a wider range of services to reduce informal payments and control out of pocket-spending, especially for the poor and vulnerable.
✓ Revise the reimbursement policy for prescription drugs.
✓ Develop a master plan for the hospital sector and regional primary health care plans as the basis for additional capital investments.
[1/] See Chapter 7, Volume II for a full list of recommendations.

F.3 SOCIAL PROTECTION

54. **Social protection programs in Albania have played an important role in providing social support to the population and in alleviating poverty.** In the absence of all the social protection programs, the poverty rate in 2005 would have been 20 percent higher for the recipients (Table 5).[11] The pension system has the largest impact on poverty. The main social assistance program, Ndihme Ekonomike, although more appropriately targeted to the extreme poor, has a more marginal impact in coverage and adequacy of benefits. Given the current importance of social insurance in Albania's poverty profile and the general inadequacy of its social assistance programs, any reform of the former clearly must be formulated in conjunction with social assistance reforms.

Table 5. Poverty Impact and Adequacy of Individual Social Protection Programs, 2005[10]

	Poverty levels of recipients (%)		*Value of transfer as % of household consumption*
	Without transfers	*With transfers*	
All Programs	**44**	**24**	**23.5**
Ndihme Ekonomike	50	40	8.5
Urban Old Age Pension	39	14	28.0
Rural Old Age Pension	39	23	14.4
Other Pensions	41	27	19.9
Unemployment Benefits	30	25	15.5
Maternity Benefits	33	23	11.3
Social Care	44	22	16.1

Source: LSMS 2005.

[10] The analysis in Table 5 does not cover disability/invalidity benefits because the LSMS questionnaire does not provide information about the receipt of these benefits by respondents.

[11] Assuming a 100 percent marginal propensity to consume the transfer.

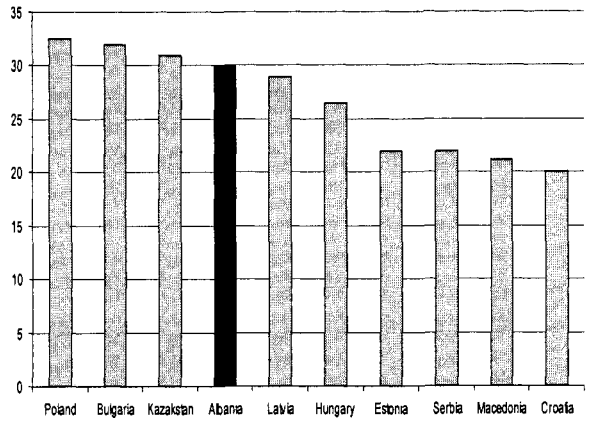
55. **Averaging 7.1 percent of GDP during 2000-05, Albania's spending on social protection is broadly appropriate.** Total spending is in line with regional comparators and countries with similar demographic profiles. However, the direction of social protection spending has been shifting from social assistance to social insurance. During 2000–05, the latter increased from 4.4 percent to 5.4 percent of GDP, while expenditures on social assistance declined in real terms and fell from 2.3 percent to 1.9 percent of GDP.

Pensions

56. **With a third or more of its revenue coming from the State Budget, the pension system is no longer a truly contributory system.** More than half of the contributors come from the rural system, for whom the government budget pays approximately 85 percent of the contributions. Many urban contributors are government employees. The pension system is thus heavily dependent on general revenues to cover the shortfall between contributions and benefits, which averaged 1.6 percent of GDP for the last 5 years.[12] The Social Security Tax (SST) still is not performing well, despite the recent transfer of collection to the General Tax Department. To finance its deficit, Social Insurance Institute (SII) relies on a web of cross-subsidies from other branches of social insurance and often has drawn down its reserve fund.

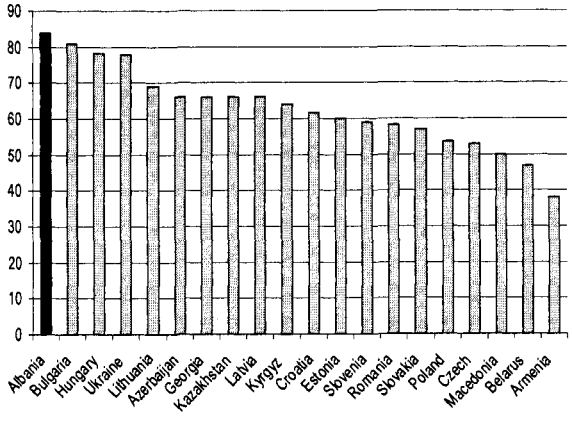
57. **Furthermore, compliance among private firms is extremely low because of a disconnect between one of the highest contribution rates in the world and very low and compressed benefits.** In addition, the indexation formula rapidly erodes the replacement rate, which is felt more acutely as income rises but also is subject to discretionary decisions by the Council of Ministers. Given the perverse incentives and government interventions, the system's 84 percent dependency ratio is very high, while it has the one of the lowest coverage rates in the ECA region (Figures 13 and 14).

Figure 13. Pension Contributions *(% of payroll)*



Sources: WB and OECD.

Figure 14. System Dependency *(%)*



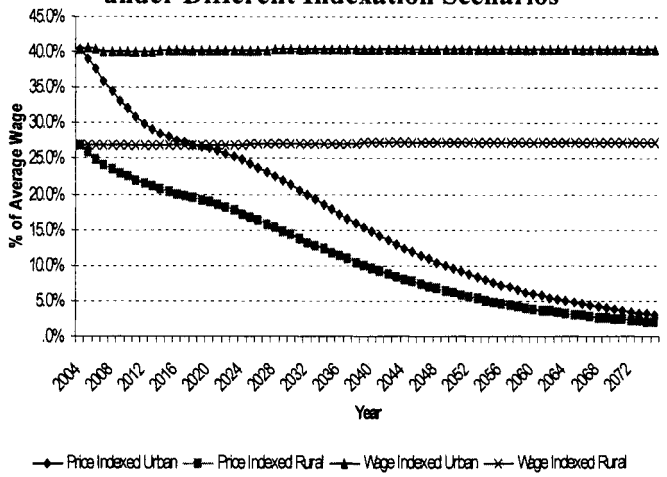
Source: WB staff calculations.

58. **If the pension system stays its current course, both rural and urban pensions will become negligible in the long run, resulting in little or no incentive to either participate or contribute.** If the current inflation indexation and capping of the benefits continue, projections show that the level of pensions may fall from the current average of 40 percent of the average wage for all types of pensions to 20 percent in the next 35 years (Figure 15).

[12] However, this deficit does not reflect accumulated arrears by state institutions and private sector entities, including farmers, which although gradually declining, remain approximately 1.5 percent of GDP. In addition, estimated arrears from the State Budget for rural pension contributions amounted to 3.8 percent of GDP.

59. **Not only will pensions be low, but a large segment of the elderly population will find itself without access to any pension.** Data weaknesses notwithstanding, the majority of the elderly population is collecting pensions of some type.[13] In contrast, only 46 percent of those employed are making contributions.[14] With 35 years of contributions required to collect a full pension, a large number of the future elderly will not be able to collect full pensions, and some will not collect any pensions. As a result, in future, there might be one-third fewer male pensioners as a percentage of the above-65 age group and 20 percent fewer female pensioners as a percentage of the above-60 age group. If left with no pension, this sizable proportion of the population could reverse the current positive poverty trends that Albania is experiencing.

Figure 15. Albanian Pensions Relative to Average Wage under Different Indexation Scenarios



Source: Staff calculations.

60. **There are three ways to approach fundamental structural pension reform in Albania. Each needs to be evaluated in terms of its potential fiscal impact.** This report suggests options for reforms that will be analyzed in further detail in the forthcoming World Bank Social Insurance Review:

a) The first approach would be to fix the disincentives in the system as an attempt to induce individuals to contribute. Three actions are needed: to eliminate the limits on the maximum pension, convert the rural pension system to a social assistance program, and establish a basic minimum retirement income for all. This approach may not be preferable as many individuals will not have sufficient contribution history and will need some support as they become elderly.

b) The second approach would be to recognize that attempts to shore up the contributory system may be either too costly or futile, and simply convert the system into a noncontributory old-age benefit for all individuals of a certain age, funded by a less distortionary tax than social security contributions.

c) A final approach could be a combination of the first two. The government could fund a basic level of benefit to all citizens of a certain age (as under the second approach) and establish a voluntary, contributory scheme for individuals who want a higher level of benefits and are willing to pay for them. However, the feasibility of such a funded scheme would have to be evaluated before proceeding. The key point would be that the voluntary system should not be able to impose additional liabilities on the government.

[13] As noted above, the data provided by the Social Insurance Institute show that well over 100 percent of the population over the age of 65 is currently collecting a pension.

[14] This number is calculated by multiplying the number of people employed in Albania by the share of the population making contributions.

Social assistance

61. **Resource allocation to Albania's only specifically poverty targeted program, Ndime Ekonomike (NE) has been declining in real terms**. Social assistance programs financed via general revenues amount to 1.2 percent of GDP, in line with other comparator countries. However, between 2000 and 2005, direct expenditures on NE declined by approximately 40 percent while the number of beneficiary households declined by only 20 percent—in line with a reduction in overall poverty levels and the introduction of a work requirement.

62. **Yet, NE has substantially increased its coverage among the extreme poor, although further improvement is needed through better targeting.** NE coverage has increased from 25 percent to 33 percent—and among the extreme poor, from 31 percent to 51 percent—between 2002 and 2005, respectively. However, the extreme poor accounted for only 12 percent of the benefits in 2005 (Table 6). Moreover, non-poor households receive an increasing share of the benefits: 64 percent in 2005 as compared to 57 percent in 2002. This deterioration in coverage could be explained by beneficiary households moving out of poverty and the recertification process not doing a good job of screening them out and/or a problem at the application stage. Complex and non-transparent eligibility criteria also hinder access by the extreme poor and increase possibilities for manipulation at local levels. The report finds that if the richest three quintiles of the population are screened out of NE, and assuming no increasing in benefit levels, then nearly another 20 percent of the poor could be covered without increased program funding.

Table 6. Ndihme Ekonomike: Distribution, Coverage, and Adequacy *(% of HH)*

Ndihme Ekonomike	*Year*	*Non-poor*	*All poor*	*Extreme poor*	*Total*
Distribution	2002	55.4	44.6	10.1	100.0
(% of benefits)	2005	61.9	38.1	11.7	100.0
Coverage	2002	7.8	24.6	31.2	11.0
(% of poverty group)	2005	9.5	32.5	50.8	12.7
Adequacy	2002	7.5	11.9	17.1	9.0
(benefit as % of HH consumption)	2005	6.7	11.1	15.7	8.5

Source: LSMS 2002, 2005.

63. **Defining clear and transparent criteria for allocating resources to local authorities should be a top priority.** Benefit levels across local governments vary substantially, and payments are unpredictable. Accordingly, additional increases in the size of the conditional grants allocated to local governments should occur only after objective criteria have been defined and possibly should be linked to poverty status.

64. **In parallel, a careful assessment of the eligibility criteria, disability qualifications, and assessment system of the disability benefits would be advisable**. The real expenditures on the non-targeted disability benefit program almost doubled during 2000–05 with the real value of the benefit increasing by over 60 percent to more than twice the average NE benefit. As the program is not targeted to the poor and eligibility criteria are broadly defined, a careful assessment is advised. It should include a review of whether a separate disability benefits system, independent from an overall Ndihme Ekonomike poverty benefit, is justified and affordable.

65. **Finally, with the expected additional increases in electricity prices, a review of the electricity subsidy program design and implementation arrangements is warranted.** Established in 2003, the electricity subsidy program, supported NE households and other vulnerable consumers by mitigating the impact of higher electricity prices. So far, however, uptake has been less than 20 percent of eligible households, likely due to reverse incentives. The remaining obligation of a NE household after the

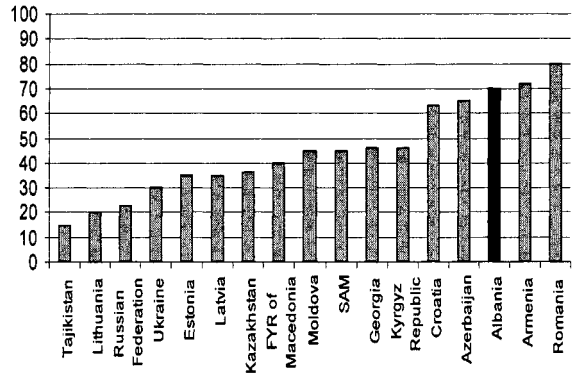
subsidy would absorb approximately 55 percent of its NE benefit, and KESH will not disconnect service to these households in the event of nonpayment.[15] Implementation challenges, including information flows among the Ministry of Labor and Social Affairs (MoLSA), local offices, and KESH, are also affecting the effectiveness of the subsidy. The report suggests exploring whether absorption of the electricity subsidy by the NE program to consolidate social assistance transfers would be more efficient, provided appropriate measures are taken to improve compliance with the payment of electricity bills.

SOCIAL PROTECTION: SUMMARY OF RECOMMENDATIONS
✓ Complete the review of the social insurance system and embark on a comprehensive reform of the pension system, securing a basic safety net for all with a possible differential benefit for actual contributors as one option.
✓ Reverse recent declines in real program spending and in the real value of the benefit for Ndihme Ekonomike; simplify eligibility criteria and link payments to the number of persons in the household but do not preclude an upper limit on benefits.
✓ Define explicit and transparent criteria for the allocation of conditional grants to local governments, including the link to poverty.
✓ Review whether a separate disability benefits system independent from an overall Ndihme Ekonomike poverty benefit is justified and affordable.
✓ Undertake a review of the scheme aimed at mitigating the impact of electricity tariffs increases on the poor to improve its targeting and delivery mechanisms (including the possibility of using the NE).
1/ See Chapter 8, Volume II for a full list of recommendations.

F.4 WATER

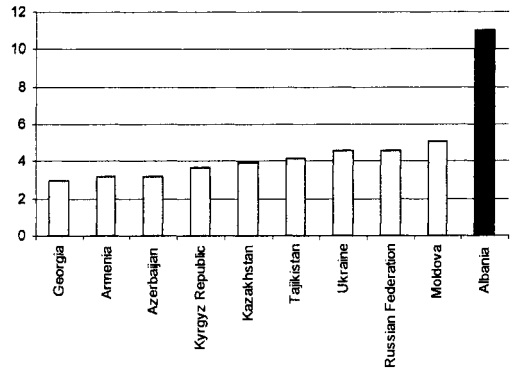
66. **Despite important improvements over the past few years in access to water and sanitation and in the operating efficiency of water utilities, Albania remains one of the poorest performers in the Europe and Central Asia Region.** Access to water supply has increased by 33 percent since 1990 (to 78 percent of households), and utility revenues have more than doubled in the past 5 years. However, these improvements have proceeded at a relatively slow pace, and Albania remains one of the poorest performers in the region in access, service quality, efficiency, and financial performance of its water utilities. For example, consumers receive on average 6–13 hours of water per day compared with an ECA regional average of 19 hours. Within country, disparities in access and service quality also are stark.

Figure 16. Ratios of Non-Revenue Water *(%)*



Sources: WB staff calculations; MoPWTT (M&B Unit); ECA infrastructure.

Figure 17. Staff Numbers Per 1,000 Connections



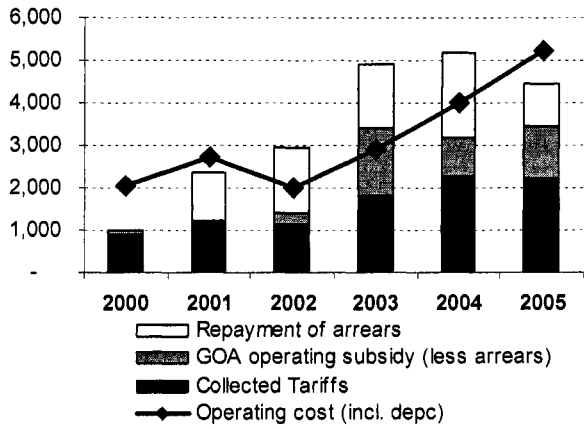
Sources: Danilenko and Child 2005, Water Market database Europe; (World Bank); MoPWTT.

[15] The electricity subsidy scheme was revised in August 2006 in a way to expand the targeted beneficiary group, and raise the subsidy from 0.4 lek per kWh to 500 lek for the first 200 kWh consumed (around 2.4 lek per KWh).

67. **Moreover, the efficiency improvements have already been outpaced by increases in O&M costs.** The majority of utilities perform poorly with very high losses (non-revenue water ratios average 69 percent, the highest in the region),[16] low revenues (tariffs do not cover O&M costs, and collection rates are low at 70 percent with only 20 percent of consumers being metered), over-staffing, and other technical inefficiencies (Figures 18 and 19). Moreover, the current system for allocating subsidies from central government rewards encourages rather than deters these inefficiencies. In addition, the poor and deteriorating state of the infrastructure is creating huge future liabilities for maintenance and rehabilitation costs just to operate at the current low service levels. On the other hand, it is important to note that Albanian utilities vary significantly in operational and financial performance, and that some utilities have achieved close to international standards in both service delivery and efficiency.

68. **Accordingly, the sector's dependency on central government transfers has increased in recent years.** The operating deficit is covered in part by operating subsidies from the central government, in addition to transfers of approximately Lek 1.6 billion per year from the State budget to clear an accumulated stock of arrears to other budgetary and non-budgetary institutions (0.20 percent of GDP). Some 34 percent of these arrears are owed to the state-owned electricity company, KESH; the remainder is owned to the Social Security Institute, General Tax Directorate, and the National Oil Company (Figure 18).

Figure 18. Financing Operating Costs Through Tariffs and GOA Subsidy *(lek million)*



Source: GDWSS

69. **In the medium term, Albania could save up to 0.8 percent of GDP per year if reform measures are accelerated to finance its sector needs.** Conservative estimates suggest that achieving the MDGs will require cumulative investments of approximately 7.4 percent of GDP, or 0.7 percent annually over the next 10 years. This represents more than doubling the recent (2000–05) average *annual* investment of 0.3 percent of GDP. By raising tariffs to economic levels, improving collection ratios, and reducing losses and overstaffing, the report estimates that savings could reach 0.8 percent of GDP annually (Table 7). These reforms will require significant political consensus and strong political will to increase tariffs and collections, and reduce over-staffing.

Table 7. Potential (annual) Savings from Eliminating "Hidden Costs"

Sources of potential savings (annual):	*lek millions*
1. Collection failure (improve collection ratios to 95 percent)	835
2. Under-pricing (raise tariffs to cover O&M costs, including depreciation)	857
3. Excess losses (reduce NRW to efficient level of 20%)[1/]	5,042
Total savings	**6,734**
As share of GDP (%)	***0.8***

[1/] 20% was used as the efficiency frontier for NRW in the Ebinger study; thus, the hidden costs in Albania can be compared with the other countries in the sample.
Source: WB staff calculations.

[16] "Non-revenue water" (NRW) is a measure of sector inefficiency. It measures the percentage of water produced that is not sold (invoiced) and is a combination of technical losses (leaks) and commercial losses.

70. **One approach to achieve these goals would be to maintain current levels of government financing of 0.6 percent of GDP but, over the medium term, gradually reallocate it from operating subsidies to investment financing.** During that time, utilities would be expected to increase revenues to recover O&M costs and depreciation, which would necessitate their improving in service quality. In the long term, once the sector begins to cover some of the capital costs as well to generate net income, the central government could start to withdraw from investment financing of water supply and focus on investments in wastewater collection and treatment.

71. **To make tariff increases more acceptable, water utilities need to make a major effort to improve service standards.** Affordability analyses confirm that there is ample room for increases in residential water tariffs, while the experience of these utilities on the efficiency frontier suggests that the operational goal is achievable within the medium term.

72. **In parallel, accelerating institutional reforms is necessary to strengthen the incentives and capacity for improved performance by utilities and local governments.** In particular, the governance and financial arrangements among the utility, the local government unit (LGU), and the central government need to be clarified to complete the transfer of assets and utility management to local governments. The further corporatization of utilities also needs to be accelerated. In addition, the central government budget allocation system will need to be reformed to respond to development priorities—expanding access—but also to improve incentives for better performance at the local level.

73. **The government's emerging plan for reform in the sector should be accelerated and gather the political support of stakeholders**. The government's strategy is to (a) phase out the operating subsidy; (b) allocate investment subsidy on both needs and system performance, that is, make incremental improvements in a range of financial and technical indicators; and (c) introduce a safety net for poor consumers. Without an acceleration of the reform effort with support from relevant stakeholders, the sector will increase rather than decrease its reliance on the public purse, and achievement of the sector goals will be jeopardized.

WATER: SUMMARY OF RECOMMENDATIONS
✓ Phase out operational subsidies to utilities in the medium term and transfer these savings to investments.
✓ Allocate investment subsidies based on sector priorities and utility performance in the short term.
✓ Raise residential tariffs to cover at least the cost of O&M and depreciation in the short term and the full cost of supply in the long term, and establish a safety net for the poor.
✓ Increase collection rates from 72 percent of bills to at least 95 percent through the development of an electronic customer database (where possible), removal of illegal connections, and universal metering.
✓ Clarify governance and financing arrangements among utilities, local and central governments and then accelerate the asset transfer to local governments.
✓ Rationalize utilities staffing from 11 to 6 staff/1,000 connections.
[1/] See Chapter 9, Volume II for a full list of recommendations.

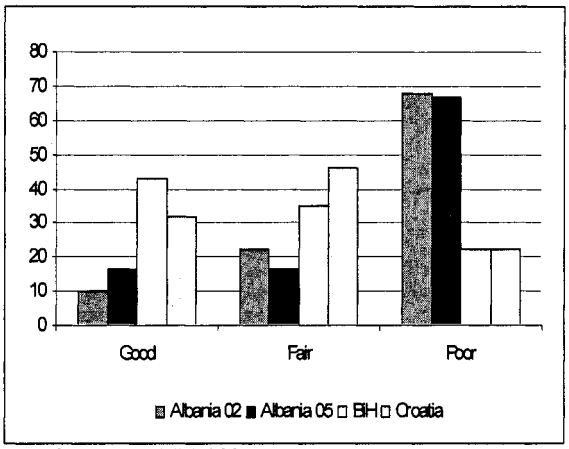
F.5 TRANSPORT

74. **Albania spends a significant share of public resources on the transport sector, a reflection of the importance of the sector for economic development and poverty alleviation**. During 2002–05, the sector's share of total public expenditures averaged approximately 8 percent or 2.4 percent of GDP, and absorbed on average 37 percent, the largest portion, of total budgetary public investment. Of this, the roads sub sector consumed the largest share (89 percent), followed by railways at 5 percent of sector spending.

75. **Despite considerable investment, the condition of the road network remains poor, and quality lags behind regional comparators.** Both perceptions of businesses operating in Albania as well as indicators of outcomes point to deterioration or slow improvement in the quality of infrastructure compared to other countries. A recent survey of the national or main road network undertaken by the World Bank for this report revealed that 67 percent of the network was in poor or very poor condition, compared to 22 percent in Bosnia and Herzegovina and Croatia (Figure 19). Albania's figure represents limited improvement compared to 2002 and reflects primarily the inadequate or insufficient maintenance regime. Municipal roads are in particularly bad condition, especially in rural areas. The government estimates that some 80 percent of the rural regional roads and some 85 percent of the local municipal roads are in poor condition. Moreover, Albania has one of the worst road safety records in the region, with a rate that is almost twice as bad as most neighboring countries (Figure 20).[17]

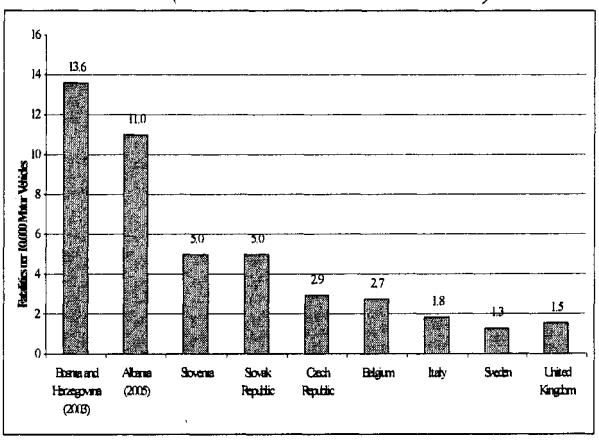
76. **These outcomes reflect large inefficiencies in sector spending.** In the main roads sector, there is a significant imbalance between recurrent and capital spending, with expenditures on maintenance totaling some 40 percent lower than needed. This underfunding of maintenance creates significant future liabilities in the form of future rehabilitation and reconstruction costs. It also raises the costs of transport to road users in terms of increased time and cost for travel and vehicular wear and tear. The recent decision to address this imbalance is a welcome step.

Figure 19. Status of Road Conditions



Source: BEEPS 2005.

Figure 20. Traffic Deaths Per 10,000 Vehicles, 2002 *(unless indicated otherwise)*



Source: BEEPS 2005.

77. **Significant cost savings may be realized from extending contracting to the private sector and better management of the procurement cycle.** Despite an emerging private contracting industry, the government's use of private contractors rather than own force account to undertake the necessary routine and winter maintenance has been limited to the World Bank's Road Maintenance Project. Under the latter, periodic and routine maintenance operations was undertaken on nearly 25 percent of the national road network. The maintenance contracted out to the private sector was on average 20 percent less expensive than equivalent operations on similar terrain undertaken by the General Road Directorate (GRD).

78. **The Albania National Transport Plan (ANTP), which was recently formally approved by the government and agreed with all the donors, confirmed the investment priorities for the road network as rehabilitation, upgrading, and limited network expansion.** The overall financing needs consistent with such a strategy has been estimated at US$ 150 million per year over 2005–09: US$ 45 million per year to clear the maintenance backlog, US$ 65 million per year for normal maintenance, and

[17] Note that the definition of a road accident fatality in Albania differs from the comparators, lowering the indicator considerably.

US$ 40 million[18] to expand the road network. These plans were considered consistent with sound capital management and the fiscal position of the country.

79. **Any additional investments in the road sector beyond those planned in the ANTP need to be assessed very carefully.** In particular, since the Durres-Kosovo road corridor is already part of the ANTP, additional planned investments in this corridor would need to be consistent with current and projected demand and national priorities at this time, or they will crowd out planned or necessary priority expenditures in both this and other priority sectors. Future proposed investments need to be part of the ANTP and the MTBP process (so that the trade-off with expenditures in all sectors is considered), be consistent with the fiscal situation and planned overall capital expenditures, and be consistent with the principles of competitive selection and transparency.

80. **Existing weaknesses in the planning and budgetary processes in the road transport sector still undermine the efficiency of roads expenditures.** In particular, the government needs to develop the capacity to update the ANTP in the future and strengthen procedures and institutional arrangements for public investment management planning, execution, and monitoring (section. G.2). Asset management and prioritization of maintenance needs to be improved by the establishment of a robust information base on the condition and use of the network. Additional priority measures that are necessary to improve the efficiency of expenditures include (a) a review of road classification to rationalize maintenance standards; (b) greater private sector involvement in maintenance and expansion of the road network including through output-based contracting, and (c) improved procurement and contract administration to reduce unexplained variations in unit costs.

81. **In the railway sector, the declining traffic volume and the significant deterioration in the financial position of Albanian Railways (HSH) call for radical measures.** The railway network is small, antiquated, and in a very poor condition. Financial losses are aggravated by serious depreciation of assets due to lack of resources for rehabilitation (Table 8). At the very least, the major loss-making lines and services should be closed in the short run. The continued provision of recurrent expenditures to the railway sector should be assessed against its opportunity cost, both within and outside the sector. ANTP estimates future investment needs of US$ 7–12 million through 2015. Even at such modest scale, these investments should be considered only in the context of a sound business plan for the sector that clearly indicates which lines and services should be closed. Eventual privatization, possibly supported by a public service contract for socially necessary services, remains an important reform option.

Table 8. Profit and Loss Accounts HSH, 2000–05 *(lek 000)*

	2002	*2003*	*2004*	*2005*
Operating expenditures	1,033,651	1,500,529	1,212,350	1,328,401
Operating revenues	443,183	605,683	386,935	305,184
Total operating loss	**191,477**	**647,716**	**633,940**	**863,426**
Operating subsidies	556,773	609,238	638,234	608,633

Source: HSH.

82. **Recent developments in ports and aviation illustrate how the private sector could play an increasing role in meeting Albania's transport infrastructure needs**. Rinas Airport at Tirana was concessioned in 2005 to a consortium, Tirana Airport Partners, under a "Build, Own, Operate and Transfer" (BOOT) concession arrangement with a 20-year term under which some US$ 90 million is expected to be spent on the development of the airport. Reforms to facilitate private participation have started in the maritime sector but implementation has been restricted to Durres Port. While the demand

[18] These figures do not include the costs of recent embellishments to the Milot-Morine nor the costs of the recently proposed central corridor.

for publicly subsidized investment in the port sector is strong, the case for such outlays is weakening. The new Port Authority Law of 2003 sets the stage for moving to a landlord structure under which future investment needs should be met from internal revenues or from private sector participation.

83. **Given current fiscal constraints, it is urgent to improve the framework for private sector participation in financing and providing infrastructure services.** An improved framework will entail higher levels of competition in service provision, as well as better regulation, oversight, and contractual adherence. An enabling environment for public-private partnerships (PPPs) requires political stability, sound macroeconomic policy, the rule of law, and a high degree of transparency within a clearly defined institutional framework. The forthcoming amendments to the Concessions Law are expected to upgrade Albania's Concession legal framework to conform to best international practice.

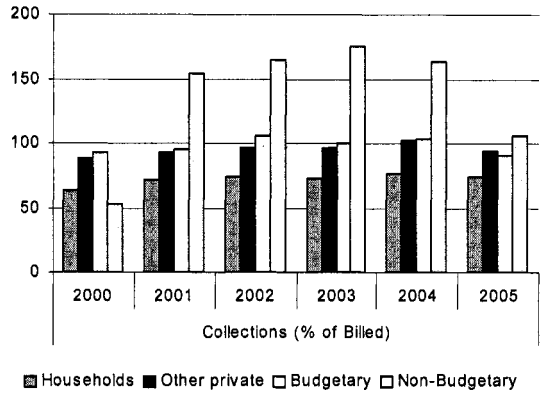
TRANSPORT: SUMMARY OF RECOMMENDATIONS
✓ Establish an Asset Management Information System for the national road network and, within a reformed GRD, revise the existing classification of roads to facilitate the professional management of the network.
✓ Increase allocation of total transport spending to recurrent expenditures on roads to address backlog maintenance and increase spending on normal maintenance.
✓ Adhere to the agreed ANTP by subjecting all transport projects to the full cycle of the new guidelines on public investment management and strengthen technical capacity in project identification and appraisal.
✓ Prepare a sound business plan for the railway sector and terminate major loss-making railway passenger and domestic freight services.
✓ Develop institutional framework for PPPs, strengthening primary and secondary legislation on concessions as well as MoF and MoPWTT's capacity to evaluate proposals, and assess the potential implicit and explicit contingent liabilities.
✓ Move toward contracting out all routine and periodic maintenance works, including through output-based contracts, and strengthening procurement and contract administration processes and practices.
[1/] See Chapter 10, Volume II for a full list of recommendations.

F.6 POWER

84. **Albania relies heavily on domestic hydropower production for its electricity supply and, since 1998, as demand has outstripped domestic production, on imports.** This reliance leaves the sector and the economy vulnerable to hydrological conditions and import availability and price fluctuations. Both financing and transmission constraints have hindered Albania's ability to ensure adequate electricity imports and since 2000 have led to frequent load shedding. To improve security and quality of supply, Albania needs to expand generation, transmission, and distribution capacity both through new investments and further rehabilitation of the network. During 2006–10, the projected investments amount to US$ 1.3 billion, and attracting private investments will be vitally important.

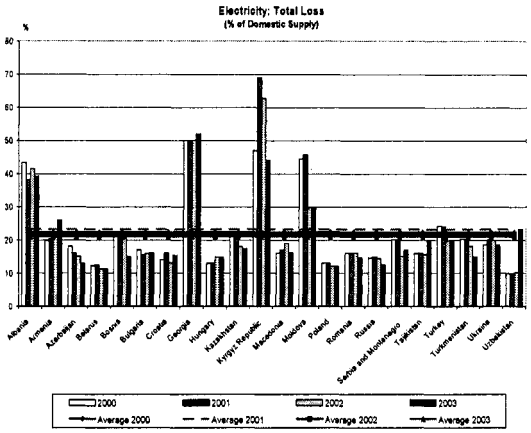
85. **The Albanian power system achieved substantial improvements in efficiency and financial performance during 2001–04 and does not draw heavily on fiscal resources. However, since early 2005, the performance of the electricity sector has deteriorated and presents significant risks to public finances and to macroeconomic stability.** Albania's power sector still has a substantial, although declining, quasi-fiscal deficit (QFD), estimated to have been 2.5 percent of GDP in 2005 based on long-run marginal costs. Despite improvements in sector performance, revenues collected from household consumers are still a small proportion of the true cost, which results in their uneconomic use of electricity and deprives the power sector of resources needed for rehabilitation and expansion. It is therefore critical that efforts to reduce theft, improve collections, and gradually raise household tariffs continue to be given high priority (Figures 21 and 22).

Figure 21. Collection by Type of Consumers (% of Billed) Including Arrears



Sources: KESH and World Bank.

Figure 22. Electricity: Total Loss % of Domestic Supply



Sources: KESH and World Bank.

86. **The government's direct financing of the sector also has been reduced significantly.** It no longer provides a direct subsidy to the power sector due to improved sector performance, but has agreed to provide loans, if required, during subnormal hydrological conditions. However, there is indirect government support: the government guarantees certain loans and credits to KESH. The government also mitigates the impact of electricity tariff increases for socially vulnerable consumers.

87. **Sustaining the past achievements while limiting reliance on the public purse will require meeting several outstanding challenges.** These include the urgent needs to (a) augment domestic generation capacity, primarily through private participation; (b) further reduce technical losses by strengthening the transmission and distribution systems; (c) streamline import processes and solidify arrangements for participating in the regional market; (d) curb growth in household demand for power by reducing implicit subsidies and theft of electricity; and (e) strengthen the sector safety net for vulnerable consumers. Continued implementation of the sector reform program and safeguarding the independence of sector regulators and operators from political interference also are necessary. Unfortunately, the deterioration in sector performance since early 2005 has reinforced the urgent need for improved governance to ensure the sustainability of improvements in sector performance.

88. **In this context, the role of the government in the power market should be limited to** (a) supporting KESH's efforts to implement the annually updated Power Sector Action Plan, particularly reducing network losses and improving bill collection, and to implement appropriate sector reforms; (b) establishing an appropriate market structure and related institutional framework to ensure the provision of an adequate and reliable supply of electricity at a reasonable cost; (c) assuming an appropriate share of the commercial risks aligned with public (versus private) benefits; (d) staying current on its own bills; and (e) ensuring the provision of social safety net that mitigates the potential negative impact of gradual tariff increases on socially vulnerable consumers. The government should respect the autonomy of both KESH and the Electricity Regulatory Authority (ERE), and support KESH's efforts to improve its financial and technical performance and to prepare to participate in a competitive regional market.

POWER: SUMMARY OF RECOMMENDATIONS
1. Provide the conditions for improving KESH's operational and financial performance by:
✓ Supporting KESH's efforts to implement the annually updated Power Sector Action Plan, particularly reducing network losses and improving bill collection, and to implement appropriate sector reforms.
✓ Adjusting the base for VAT payments by KESH for electricity sales from billed to collected revenues, and allowing KESH to write off bad debts to determine profit tax liability in accordance with international practice.
✓ Eliminating all financial arrears of budgetary and non-budgetary entities to KESH and ensuring prompt payment of all current bills.
✓ Undertake a systematic review (including design and implementation arrangements) of the existing scheme aimed at mitigating the impact of electricity tariffs increases on the poor in order to improve targeting and delivery mechanisms (including the possibility of using the Ndime Ekonomike program).
2. Support sector reforms:
✓ Decide on the recommendations of the Power Sector Restructuring Study regarding the KESH holding structure and implement the option selected.
✓ Allow KESH and ERE to operate as an independent commercial corporation and an independent regulator, respectively.
✓ Continue the reforms to implement a competitive market and enable effective participation in the regional market.
[1/] See Chapter 11, Volume II for a full list of recommendations.

G. Institutional Framework for Public Spending and Governance

89. **Achieving a better allocation of expenditures needed for fiscal sustainability and high quality fiscal adjustment will not happen "by fiat."** How successful the government will be in maintaining sustaining its fiscal consolidation efforts, and in its broader efforts to improve the quality of the fiscal adjustment and budgetary outcomes, will depend critically on progress in building the institutions for fiscal management and the capacities needed to design and manage reforms. There are a number of important measures that government can and should take in the short term. However, most of the important measures for maximizing the growth impact of public spending through sustainably raising its efficiency, based on sound program reforms, will require a comprehensive review of the overall expenditure program as outlined above.

90. **This comprehensive review cannot and should not be done at once but should be a continuous process.** This process should entail identifying reforms of the main expenditure programs, prioritizing programs and projects, and undertaking a careful assessment and monitoring of their impact. This process will require, first, an improved public financial management (PFM) system that ensures aggregate fiscal discipline and allocative efficiency and is both strategic in focus and performance oriented. Second, a robust system for selecting, appraising, and managing public investment is critical to rationalize the use of Albania's limited investment resources and improve their efficient use. Finally, an effective and meritocratic civil service will be required to design and implement the ambitious agenda outlined above.

G.1 PUBLIC FINANCIAL MANAGEMENT

91. **Since 2001, Albania has made significant progress in a series of measures to strengthen its PFM system.**[19] These have included the (a) progressive deepening of the medium-term budget planning reforms initiated in 2000; (b) introduction of a program classification to facilitate a more strategic approach to resource allocation within spending agencies; (c) initial steps in a number of ministries to cost major policies under the NSSED; (d) modernization and computerization of the Treasury system; and (e) design and introduction of an Integrated Planning System (IPS).

92. **However, Albania still has a long way to go to achieve two key objectives of a well-functioning PFM system,** namely, operational efficiency and value for money in the use of its public resources. This report, undertaken in parallel to the Country Fiduciary Assessment Update (CFAU), analyzed in detail the various stages of the PFM cycle and identified five priority action areas to complement the government's ongoing ambitious reform plan.

Establish a single strategic planning framework linked to resource constraints

93. **The government's decision to develop and consolidate through the IPS a single strategic framework for national priority and sectoral policy setting that takes due account of public resource constraints is a laudable step.** It also has gathered support from Albania's development partners. This reform should be part and parcel of a broader institutional reform aiming at strengthening policy formulation and coordination across government. It will facilitate the success of reforms at the sector level by better linking policies to budget plans. Moving ahead with the development of the National Strategy for Development and Integration (NSDI) as a single comprehensive strategy covering all sectors should be complemented by a strengthened and credible MTBP process. It follows that the MTBP should constitute the only framework by which expenditure implications of the NSDI are analyzed and within which resource allocation decisions are made. The preparation and evaluation of sectoral strategies and plans must be made against a realistic fiscal resource constraint. For this to take place, the integration and strengthening of capacities for policy analysis, program development, and budget planning in the major sector ministries should top policymakers' agendas.

Consolidate the link between policy formulation and budgeting

94. **The MTBP and budget planning processes do not yet provide an effective vehicle for linking resource allocations to strategic policy and program priorities.** In updating the MTBP, line ministries and spending agencies significantly changed resource ceilings. These divergences can be explained by (a) inadequate analysis in setting the original ceilings; (b) insufficient consultation with line ministries in setting resource ceilings; and (c) the impact of adjustments resulting from updating the macro-fiscal framework. The introduction of a simple budget program classification has improved the policy orientation. However, program budgeting will successfully assist resource allocation only when program budgeting goals are well understood. Then, government operations can be assessed (or at least challenged) in terms of their costs as well as their conformity with stated policies and objectives. Capacity limitations emphasize the need to take a realistic approach toward more fully fledged program budgeting.

Fix budget execution first

95. **In-year reallocations and under-execution of the budget have undercut the government's sustained efforts to establish a more predictable and policy-led budget process.** Constrained cash releases, lack of proficiency in cash management, weak procurement planning, and restrictive

[19] The preliminary analysis and findings were presented and discussed with the Ministry of Finance and other development partners active in the PFM area in February 2005.

procurement procedures are seriously undermining the efficiency of spending, most notably capital investment. In fact:

- ✓ *The absence of commitment control* means that the MoF does not have a full picture of its cash flow demands. In the absence of active short-term borrowing to mitigate in-year revenue fluctuations, the MoF resorts to conservatively setting cash release allocations during the first part of the fiscal year, often resulting in cash rationing and budget cut-backs.
- ✓ *The single-year procurement regulation* requiring that all procurement tendering against budget funds must be completed by 31 July[20] results in most of the expenditure against procurement contracts occurring during the second half of the year and leads to an overuse of direct procurement. Overuse results in higher costs and contributes to a short-term planning outlook that undermines recent initiatives to plan expenditures and public investment within a medium-term context. The new Procurement Law is expected to address this problem.
- ✓ There has been only a *limited increase in the use of open tendering*, from 31 percent of contracts in 2003 to 38 percent in 2005. The remaining procurement (approximately 60 percent of contracts) is conducted through restricted tendering and requests for quotations.

Strengthen the institutional frameworks and capacities for PFM

96. **Until recently, slow progress in reforming institutional structures and in addressing persistent capacity constraints across the PFM system have seriously impeded the implementation of PFM reforms**. Despite the government's best efforts to strengthen capacities with the support of the international community, the MoF continues to face critical shortages of professional staff, while line ministries have made only limited progress toward strengthening policy, planning, and budgeting functions. The last three are critical, given that ongoing revisions of the Organic Budget Law (OBL) will entail further PFM reforms that will require further capacity strengthening at the level of line ministries.

97. **Improved PFM outcomes will depend on more urgent priority being given to addressing these institutional and capacity limitations.** Reducing the disconnect among policy, planning, and budgeting functions in line ministries by involving staff in the design of key sector reform initiatives and the evaluation of their implications for budget planning should be a top priority. Improving the linkages among functions will enable sectoral budgets to reflect planned changes in policy directions. The recent proposal under the IPS to establish a General Directorate for Strategic Planning and Budgeting in each line ministry is a step in the right direction. The MoF should facilitate and support greater engagement of line ministries in strengthening their own PFM capacities and managing better across the PFM cycle. In this context, and when revising the OBL, it would be better if the government and the legislators could avoid setting out the MTBP and annual budget cycle in excessive detail. Rather, it is advisable to specify the overall framework and key events in the budget calendar, leaving the more detailed timetable to subsidiary regulations and guidelines.

Strengthen accountability

98. **While external audit and parliamentary oversight arrangements are fairly sound in design, their effectiveness is severely limited by capacity constraints.** The coverage and quality of the annual audit of the State Budget prepared by the Supreme State Audit (SSA) has shown gradual improvement, but the budgetary institutions continue to do insufficient follow-up on its findings and recommendations. Moreover, scrutiny of the budget by Parliament remains limited mainly because Parliament lacks the technical competencies and time to assess the budget proposals submitted by the Executive. The challenge for the medium term will be to establish a more meaningful and strategic engagement of Parliament and civil society on PFM issues.

[20] October 31 for funds approved under the Supplementary Budget.

PUBLIC FINANCIAL MANAGEMENT: SUMMARY OF RECOMMENDATIONS
✓ Develop and consolidate through the IPS a single strategic framework for national priority and sectoral policy setting that takes due account of public resource constraints.
✓ Strengthen the focus on the outer year MTBP resource ceilings so that they can provide a realistic and credible basis for medium-term budget planning at sector and agency level.
✓ Develop clear and transparent procedures for virement and revision of annual budgets that provide budget users with appropriate flexibility while maintaining the integrity of the process.
✓ Implement full-value multiyear procurement, particularly for capital investment projects following the revision of the Procurement Law.
✓ Finalize and approve (a) the new OBL and (b) updated Treasury regulations.
✓ Establish at MoF a stronger management framework of overall processes in the PFM.
✓ As proposed under the IPS, strengthen policy, planning, and budgeting functions in line ministries.
✓ Further develop the program-based budget classification to strengthen the explicit linkages between the sectoral policies and the budget, in parallel with strengthened capacities.
✓ Allow additional time in Parliament to discuss the Budget by allowing for a timely processing of the MTBP.
✓ Strengthen the Budget Analysis Unit in the Parliamentary Secretariat.
✓ Ensure timelier follow-up by all spending agencies on external audit report queries and recommendations.
[1/] See Chapter 3, Volume II for a full list of recommendations.

G.2 Managing Public Investment

99. **Against declining levels of foreign assistance, Albania can no longer afford delaying upgrading its public investment management systems**. The challenge will be to ensure that these systems help sustain the pace of infrastructure improvement by increasing the efficiency of capital spending, notably domestic investment.

100. **Resources made available for public investment, particularly domestically financed public investment, should be used more effectively and efficiently than in the past**. In fact, domestic resources are currently spread, with little strategic focus or prioritization, across a huge number of small projects. There is evidence that this broad but shallow distribution has contributed to both excessive costs and poor construction standards. Moreover, sectoral analysis discussed in section F confirmed that, in most sectors, particularly infrastructure, capital spending is not used efficiently due to institutional weaknesses and inadequate allocation of O&M.

101. **In this perspective, the government has taken initial steps to strengthen public investment management.** The transfer of responsibility for this function from the Ministry of Economy to the Ministry of Finance, in which a new Public Investment Management Department has been established in the General Directorate of Budget, is a step in the right direction and reflects a comprehensive and integrated approach to overall budgeting and planning which for years has been lacking. This step needs to be backed by a series of measures. Critical actions for the short term are discussed below.

102. **Priority needs to be given to developing procedures for project identification, appraisal, and approval.** Externally financed projects are subject to more rigorous selection and appraisal than domestically financed projects. Introducing a common process for both domestically and externally financed investment projects would ensure that all public investment is subject to a common appraisal requirement regardless of the source of financing. New measures should ensure that public investment planning and procedures are fully integrated within the MTBP procedures for program expenditure and investment planning. New draft procedures applied for the supplementary budget 2006 and 2007 go in that direction.

103. **In parallel, a rationalization of domestically financed projects is warranted,** namely, by (a) consolidating the large number of small investment allocations into fewer, larger projects and (b) eliminating projects that are not consistent with strategic priorities or are determined not to be economically viable. Otherwise, procedures risk becoming engulfed by the sheer number of projects requiring approval and there will be little opportunity to focus on improving the quality of project identification, preparation, and appraisal processes. An additional requirement is to introduce total cost funding approval and accounting that covers the full implementation period of the investment project but with annual funding allocations, which could be aggregated at the program level and sanctioned through the annual budget process.

104. **A weak information base at MoF on ongoing public investment projects also has undermined realistic expenditure planning and execution.** There is no single register of approved investment projects in which annual allocations and expenditures are recorded against the total estimated cost of each project. The MoF should take early steps to establish a register of public investment projects integrated within the public expenditure planning system being developed under the MTBP. The register should be linked to the introduction of the project-level coding structure in the new Treasury system without which it would be impossible to systematically record expenditures against individual projects.

105. **The problems of financing adequate maintenance highlighted above emphasize the importance of further developing the MTBP analysis at the sector level so that it can provide a more integrated and balanced approach to budget planning**. Specifically, the MTBP should consider the appropriate mix between capital and operations and maintenance spending and, in the infrastructure sectors, attach greater priority to ensuring more adequate maintenance provision.

106. **Finally, the incomplete recording of externally financed public investment is undermining budget transparency and the resource allocation processes of the MTBP**. Incomplete recording is a significant factor behind the recorded underspending on externally financed investment. It also reduces public accountability, particularly on projects for which the government is required to make a local financing contribution and provide coverage for import duty and VAT payments. Accurate budgeting and recording of externally financed public investment are essential for the MoF to strengthen public investment management. It is an area in which the MoF will need to seek the assistance and support of the donor community. Externally funded projects should be required to pass through the same identification, appraisal, and approval procedures as domestically funded projects.

MANAGEMENT OF PUBLIC INVESTMENTS: SUMMARY OF RECOMMENDATIONS
✓ Rationalize the portfolio of domestically financed projects by (i) consolidating the large number of small investment allocations into fewer larger projects; and (ii) eliminating projects which are not consistent with strategic program.
✓ Ensure that public investment planning and management are fully integrated within the MTBP procedures for program expenditure and investment planning.
✓ Introduce formally new procedures for project identification appraisal and approval linked to the MTBP process to be applied to both domestically and externally financed projects.
✓ Make cost-benefit and/or cost-effectiveness analysis an appraisal requirement for large investments.
✓ Adopt a full-cost, multiyear funding approval for all public investment projects.
✓ Give priority to more adequate funding the maintenance of infrastructure networks.
✓ Agree with donors on the measures and a timetable that will enable external funding to be channelled through the Treasury Single Account.
[1/] See Chapter 4, Volume II for a full list of recommendations.

G.3 GOVERNMENT EMPLOYMENT

107. **To carry out the challenging reform agenda, the government will need an effective, well managed civil service and public sector.** The size and the cost of Albania's wage bill are in line with regional and similar high-growth-country comparators. Nevertheless, Albania is not reaping benefits commensurate with this spending, as evidenced by the perceptions of corruption in the public administration, poor quality of the bureaucracy, and suboptimal public sector outcomes in various sectors (section F). This report suggests four areas in which broad critical reform challenges need to be met to improve the performance of the public sector.

Strengthening and improving the achievements of past civil service reforms

108. **Between 1999 and 2005, Albania made impressive progress on several key dimensions of public administration reform**. The new Civil Service Law (CSL) passed in 1999. The related secondary legislation subsequently developed set out clear principles to govern relevant processes such as recruitment and selection, performance evaluation, and avoidance of conflict of interest. Improvements in these processes are already evident. Key achievements of the reform include: (a) the establishment of a largely depoliticized civil service; (b) establishment of independent checks and balance mechanisms for civil service management actions; and (c) increased attractiveness of the civil service.

109. **This reform agenda needs to be protected, adjusted to address particular weaknesses in those reforms, and reinforced. First, the de-politicization achievements need to be protected**. Progress in the rationalization of the size and structure of the public sector has been made at a macro level through the functional review process. In few ministries, however, the consultative process underpinning the proposed restructuring has not been very extensive and the implementation of the new structures was hasty. Consequently, a capacity vacuum has been created mainly due to the reduction of 615 public employees[21], being mainly concentrated in the civil service ranks. This outcome constitutes an important risk to the de-politicization and meritocratic civil service management objectives of the reforms undertaken over the last six years. If these achievements are not protected, Albania's public administration will face significantly greater difficulties attracting, retaining, and motivating the human capital it needs to run an effective and efficient public administration.

110. **Second, the performance appraisal process applied to civil servants needs to be revisited and improved** to ensure that the performance appraisal system reliably identifies and rewards good performers while identifying and helping to improve the performance of the poorer performing civil servants. A high proportion of staff (94 percent) is currently rated in the top 2 performance categories.[22] While, in the short run, the existing system has room for adjustments (results-based appraisal, the use of multiple feedback providers), in the longer term, a comprehensive approach to performance management linked to government's objectives could be envisaged. A program of training will need to accompany any changes to the existing system.

111. **Third, the functional reviews need to be pursued to achieve an efficient and lean public sector.** Of particular importance is the need to build on the existing progress and follow-up reviews of subordinate institutions.

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[21] As of the end of April 2006.

[22] There has been some improvement. During 2001–04, the percent of staff rated in the highest category fell from 58 percent to 43 percent, but this decline was counterbalanced by an almost equivalent increase in the percentage rated in the second category from 36 percent to 51 percent.

Broadening the coverage of the civil service reforms

112. **A number of important aspects of the reforms that have been applied to the roughly 3.4 percent of central government employees covered by the CSL need to be gradually rolled out to other sets of personnel within Albania's public administration**. The government needs to take a cautious and measured approach to any such expansion for at least two reasons. First, as can be seen from the previous paragraph, the civil service reforms are still a work in progress. As such, lessons are being learned continuously, and it will be important to build those lessons into any expansion of the coverage of the CSL. Second, since an important part of any such expansion will be reform of salary structures in the rest of the public administration, the fiscal costs of such expansion need to be carefully assessed in advance of any salary reforms, to ensure both that they will actually help to attract, retain and motivate qualified staff (for example, by providing competitive remuneration), as well as that their costs will be fiscally sustainable. This is discussed below.

Reforming the pay system for improved performance

113. **The current pay system is nontransparent and complex to manage**. At present, ***six different pay systems*** coexist across the public sector. The range and structure of total pay vary considerably in different systems, leading to major inequalities in total income for the same level of work. The pay levels applicable to health and education staff are below those applicable for civil servants at equivalent job levels. While the civil service pay system is reasonably decompressed, others are not. Moreover, at a given job level, differences in pay levels are minimal, leaving no room for recognition of improved performance based on growing experience.

114. **There is a consensus on the need to rationalize and harmonize the pay system to improve transparency and provide incentives for improved performance and accountability**. The government supports the principle of equal pay for equal work across the public sector, and two appropriate options have been identified:[23]

a) Common system of job grades and pay ranges that would apply in all public sector institutions.

b) Harmonized pay system in which health, education, and other public sector employees could continue to have separate pay and grading structures as appropriate to their type of work but in which pay equity would be established by deciding agreed relationships among key job levels in the different systems based on proper job classification.

115. **Both options are valid and should go hand in hand with a performance-oriented pay system that is fiscally sustainable and concentrated on promotions and "job level" progression, under a disciplined process**. More specifically, performance bonuses practices need to be curbed by (i) limiting overall fraction of pay coming through performance bonuses; (ii) imposing discipline on awarding of performance bonuses. The cost of achieving pay equity with a revised bonus system under the second option exceeds the available fiscal envelope, which suggests that a phased approach to implementation would be desirable.

116. **Future increases in salaries and wages should follow the reform of the pay system.** Recent improvements in the macro-fiscal conditions could create space for wage increases as opposed to other priority expenditures. However, these increases could be counterproductive if key structural factors that distort incentives for better performance are not properly addressed. Improving the incentive structure would have budgetary implications, but they need not be excessive if they are well targeted and introduced gradually within a medium-term budgetary framework. Accordingly, increases in wages and salaries in the social sectors should be linked to the reform program in the respective sectors.

[23] Based on the work done by DoPA and the EU-financed Ramboll Project.

117. **Finally, however, management of the civil service to deliver required outputs to high quality standards within fiscal limits requires effective and efficient organizational structures and processes.** In addition to the needs to improve merit-based processes to ensure that the best people are appointed to jobs and to have in place a good system for appraising their performance, financial control of staffing costs is critical. Staff planning and budgeting need to be upgraded and require the completion of the automated payroll management system, without which the data on which pay policy is based will remain as inaccurate as it currently is.

Rebalancing wage bill and other recurrent expenditures

118. **To improve the efficiency of public sector human resources employees, adequate complementary inputs are required for effective program design and implementation.** Analysis of sectoral chapters reveals that the overall balance between the wage bill and other recurrent expenditures is atypically heavily concentrated within the wage bill. This wage-heavy imbalance compromises the capacity of staff and the entities within which they work to effectively design and implement policies and programs, such as education and health care delivery. Teachers need books, well maintained classrooms, and other teaching supplies to teach effectively. Health care practitioners need medicines, well maintained healthcare facilities, and other supplies to deliver effective healthcare services. Albania's high wage bill expenditures relative to other recurrent costs almost certainly compromises service delivery capacity by limiting access to complementary inputs. This balance needs to be redressed.

GOVERNMENT EMPLOYMENT: SUMMARY RECOMMENDATIONS
✓ Ensure compliance with the Civil Service Law and gradual expansion of coverage of certain CSL provisions dealing with (i) competitive recruitment and selection; (ii) due process protection; and (iii) redress mechanism.
✓ Continue functional reviews in subordinate institutions and follow up on those reviews while avoiding disproportionate retrenchment of civil service positions.
✓ Proceed with the development and costing of a performance-oriented and harmonized pay system.
✓ Increase concentration of pay in the human capital element of pay to improve internal equity and overall transparency.
✓ Concentrate the performance related pay increases in promotions and "job level" progression, but under a disciplined process. More specifically, performance bonuses practices need to be curbed by (i) limiting overall fraction of pay coming through performance bonuses; (ii) imposing discipline on awarding of performance bonuses.
✓ Establish a job classification framework to provide a rationale for ranking jobs within sectors and to enable objective comparison of jobs across sectors.
✓ Review and improve the current system of performance appraisal and provide extensive training to managers and employees to make the performance appraisal system more effective.
✓ Monitor competitiveness of salaries by (a) carrying out regular market pay research to monitor the competitiveness of public sector pay levels, and (b) regularly monitoring staff turnover and any recruitment difficulties.
✓ Accelerate the establishment of the computerized payroll management system and link it to the Treasury.
[17] See Chapter 5, Volume II for a full list of recommendations.

Table 9. Albania: Selected Economic Indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
				(% change unless indicated otherwise)						
Nominal GDP (billions of Leks)	314.9	322.2	412.3	474.3	530.9	587.7	624.7	682.7	766.4	836.8
Real GDP growth	9.1	-10.2	12.7	10.1	7.3	7.0	2.9	5.7	5.9	5.5
CPI inflation (annual average)	12.7	32.1	20.9	0.4	0.0	3.1	5.2	2.4	2.9	2.4
Lending interest rate, nominal, e.o.p.[a]	28.8	43.0	25.0	25.8	23.7	11.9	16.0	10.5	13.7	12.2
Deposit interest rate nominal, e.o.p.[b]	19.1	27.8	16.5	9.1	7.7	7.8	9.3	7.6	6.0	5.6
Unemployment rate, annual average	12.4	14.9	17.8	18.4	16.8	16.4	15.8	15.0	14.4	14.2
				(% GDP)						
Foreign savings[c]	11.5	8.0	3.3	3.7	3.6	2.8	7.2	5.5	3.8	5.0
Gross domestic savings	4.0	8.8	12.9	16.2	21.1	24.8	17.4	17.9	20.0	18.6
Public[d]	-8.6	-8.8	-4.6	-1.6	-1.6	-0.6	0.0	-0.1	0.1	0.8
Private	12.6	17.6	17.4	17.8	22.6	25.4	17.4	18.0	19.9	17.8
Gross Investment	15.5	16.8	16.2	19.9	24.6	27.6	24.5	23.4	23.8	23.6
Public	4.5	4.3	5.8	7.8	6.6	7.3	6.7	4.6	5.0	4.6
Private	11.0	12.5	10.4	12.1	18.0	20.2	17.8	18.8	18.8	19.0
				(% GDP)						
Total rev & grants	18.3	18.3	24.2	25.5	23.8	23.7	24.7	24.5	24.1	24.0
Total exp & net lending	30.4	31.4	34.5	34.9	31.9	31.6	31.4	29.0	29.2	27.4
Interest payment	3.1	5.8	8.8	7.5	5.8	4.3	4.0	4.4	3.7	3.1
Primary balance	-9.0	-7.3	-1.6	-1.9	-2.4	-3.6	-2.7	-0.2	-1.4	-0.3
Overall fiscal bal	-12.1	-13.1	-10.3	-9.4	-8.2	-7.9	-6.6	-4.5	-5.1	-3.4
Public & publicly guaranteed debt		84.6	75.9	72.7	72.8	67.6	65.0	61.8	56.5	54.5
Domestic		46.5	43.5	43.4	42.6	41.0	41.7	41.1	38.5	37.9
External		38.1	32.4	29.3	30.2	26.6	23.3	20.7	18.0	16.6
				(% GDP unless otherwise indicated)						
Export GNFS	11.6	11.1	10.3	17.3	19.0	20.4	20.5	20.8	21.5	21.7
Imports GNFS	36.0	37.3	35.8	41.9	40.6	42.9	46.3	45.9	43.2	44.3
Current account bal.	-9.1	-11.1	-6.3	-7.6	-6.6	-5.8	-10.0	-8.1	-5.5	-6.5
FDI, net	3.4	2.1	1.5	1.1	3.9	5.0	3.0	3.2	4.6	2.9
Worker remittances	14.1	11.6	16.1	9.5	12.1	13.2	13.0	14.0	13.8	14.2
Official reserves [months of imports]	3.1	4.5	3.7	3.8	4.1	4.6	4.4	3.9	4.1	4.2
				(% GDP unless otherwise indicated)						
Broad money	49.1	61.6	58.1	61.7	61.8	67.1	65.3	65.0	65.7	68.5
Domestic credit	3.5	4.0	3.6	3.6	4.2	4.7	6.4	7.7	9.3	14.5
In local currency			2.3	1.7	1.4	0.8	1.5	1.6	2.0	3.6
In foreign currency			1.3	1.8	2.8	3.8	4.9	6.1	7.3	10.9
Private domestic credit growth	30.5	19.0	14.7	13.3	31.8	23.4	41.0	31.0	37.0	74.9
Exchange rate Lek/US$, e.o.p.	105.0	150.7	150.3	138.2	143.9	143.5	140.4	120.9	102.5	100.2
Exchange rate Lek/Euro, e.o.p.				147.5	133.5	130.6	138.5	142.6	132.5	124.0

[a/] Refers to interest rate on 6–12 month loans in lek.
[b/] Refers to interest rate on 12-month deposits in lek.
[c/] Negative of current account including official transfers.
[d/] Revenue including grants less current expenditure and net lending.
Sources: NSI, MoF, BOA, INSTAT, World Bank, and IMF databases.