

**PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE**

January 22, 2015
Report No.: 94625

Operation Name	Albania Public Finance Policy Based Guarantee
Region	EUROPE AND CENTRAL ASIA
Country	Albania
Sector	General Public Administration (100 percent)
Operation ID	P149765
Lending Instrument	Policy Based Guarantee
Borrower(s)	GOVERNMENT OF ALBANIA
Implementing Agency	Ministry of Finance
Date PID Prepared	January 22, 2015
Estimated Date of Appraisal	January 29, 2015
Estimated Date of Board Approval	March 27, 2015
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of this operation.

I. Country and Sector Background

1. **Albania's sustained high economic growth in the decade prior to the 2008 global financial crisis helped it achieve a middle income status and reduce poverty.** During 1998-2008, annual growth averaged 6 percent in real terms with a fivefold increase in per capita GDP to above US\$4,000, propelling Albania from being one of the poorest countries in Europe to middle income status. Between 2002 and 2008 alone, Albania's poverty was halved, falling from 25.4 percent in 2002 to 12.8 percent in 2008. Since 2008, however, poverty is again on the rise.

2. **The global financial crisis and the subsequent Eurozone crisis led to a significant slow-down in Albania's growth.** In the years preceding the global crisis, 2005-08, the economy grew at an average annual rate of 6.2 percent enabling an increase in household expenditures of the bottom 40 percent by 2.6 percent per year. The global financial crisis in 2008 and the subsequent Eurozone crisis slammed the brakes on Albania's growth. Albania was able to avoid a recession but GDP growth slowed to less than 3 percent on average between 2009 and 2013 as exports, remittances and inflows suffered, in particular from Albania's close ties with Greece and Italy.

3. **As growth slowed down, public debt surged and arrears accumulated.** Albania's public debt has surged from 54.7 percent in 2008 to 70.0 percent in 2013. The government also accumulated arrears of around 5.2 percent of GDP by end-December 2013. Arrears and high public debt are weighing heavily on Albania's growth prospects and threatening to reverse the significant progress in reducing poverty. Clearance of arrears and prevention of future arrears will help boost private investment and reduce the high levels of non-performing loans (NPLs) that are currently stifling credit to the private sector. Strengthening budget preparation and execution will increase transparency and credibility of public finances, limit the accumulation of new arrears and improve the efficiency and effectiveness of public spending. In parallel, raising

revenues, reforming the pension system and reducing fiscal risks emanating from the energy sector are important for putting Albania's public debt on a sustainable long-term trajectory and safe-guarding macro-fiscal stability. Without reforms, Albania's pension system would have been fiscally and socially unsustainable while the energy sector will pose a large threat to the budget and absorb increasing fiscal resources.

4. **Domestic and external vulnerabilities are high and continue to pose risks to macroeconomic stability.** Public debt and fiscal financing needs are among the highest in the region. Heavy trade, financial and remittance dependence on Italy and Greece remain important potential sources of vulnerability. Albania also faces significant fiscal risks related to the energy sector, which suffers from high distribution losses, low collection rates and tariffs which are below cost recovery. Governance challenges could also slow down fiscal consolidation and structural reforms.

II. Operation Objectives

5. **This operation supports strengthening public financial management to address arrears and tax, pension and energy sector reforms to improve fiscal sustainability.** This proposed Public Finance Policy Based Guarantee (PBG) is the second in a series of two programmatic Development Policy Financing (DPF) operations. The series addresses weaknesses in public finance management that have resulted in the accumulation of general government arrears of 5.2 percent of GDP in 2013 and a surge in public debt from 54.7 percent in 2008 to 70.0 percent in 2013.

6. **This operation supports the following measures:**

Prior action #1: The Ministry of Finance has reduced central government arrears (excluding those to the energy sector) accumulates prior to end-December 2013 by at least Lek 14 billion, following the criteria specified in the Arrears Clearance and Prevention Strategy. Clearing arrears in a transparent manner is an important step towards building public confidence in the Government's fiscal policy and its ability to meet future obligations.

Prior action #2: Parliament has established mandatory expenditure ceilings for each budget user for the years 2015, 2016 and 2017. A comprehensive approach to budgeting and greater discipline in the preparation and execution of medium-term budget plans is important for preventing new arrears.

Prior action #3: The Ministry of Economic Development, Tourism, Trade and Entrepreneurship has issued instructions to all line ministries to submit monthly execution reports of all ongoing projects larger than EUR5 million to the Ministry of Economic Development, Tourism, Trade and Entrepreneurship and has published the annual execution report for 2014. The objective of these reports is to monitor the current level of commitments, ensure that executed projects are in line with budget ceilings and improve budget execution. Better monitoring should help prevent arrears accumulation and enable best use of available funds.

Prior action #4: The Ministry of Finance has upgraded the software of the Treasury system to record all multi-year contractual commitments and has established a database to record all commitments for 2015, 2016 and 2017. These are important steps towards enabling the Government to monitor commitments and impose hard commitment controls.

Prior action #5: The Ministry of Finance has established a Tax Compliance Risk Management model which relies upon Life Data; and commenced the production of risk reports on taxpayers' compliance using the Compliance Risk Management model. The implementation of a New Tax Compliance Strategy with a focus on increasing compliance of high-risk tax payers and evidence-based evaluation is likely to improve tax compliance.

Prior action #6: Parliament has enacted a new pension law. The new pension law improves the fiscal and social sustainability of Albania's pension system by strengthening the link between contributions and benefits and introducing a social pension for the elderly poor.

Prior action #7: The collection rate of energy bills in 2014 increased by at least 10 percent relative to 2013 in accordance with the Energy Sector Arrears Clearance and Prevention Strategy. Improving the collection rates of energy bills is essential for improving the financial situation in the energy sector.

Prior action #8: The Ministry of Finance has cleared at least 60 percent of arrears from the central government, public water utilities and public schools to the energy sector as of end December 31, 2014 in accordance with the Energy Sector Arrears Clearance and Prevention Strategy. Settling and preventing arrears of Albania's energy sector, which encompasses private as well as public enterprises, is important for resolving the energy crisis.

Prior action #9: The Council of Ministers has approved and submitted to Parliament a revised Power Law that: (i) limits regulated tariffs to low voltage customers only; (ii) replaces the wholesale public supplier by a new market based mechanism for small Independent Power Plants and eligible consumers, including concessionaire and private medium-sized enterprises. The new power law is an important step towards restoring the financial viability of the energy sector

III. Rationale for Bank involvement

7. The Albanian Government has signaled a strong commitment to structural reforms. The Government has acknowledged the existence of payment arrears and has been implementing a comprehensive arrears clearance strategy since the start of 2014. It has cleared Lek 33.7 billion of arrears in 2014 and has significantly slowed down the re-emergence of new arrears. It has implemented a prudent fiscal consolidation path in 2014. Public debt is expected to decline in 2015 for the first since 2010. The Government has adopted a new pension law and has taken several important steps to address the energy sector crisis, including the settling of the dispute with CEZ Sh., improving energy revenue collection, revising the Power Law and developing an energy sector recovery program. The Government has also started to strengthen the regulation and supervision of the banking sector and has created a working group to revise Albania's

property compensation law. The Government reforms of the business environment are paying off, with Albania's Doing Business ranking improving by more than of any other country in the world in 2014.

8. The Bank has collaborated closely with the IMF and the European Commission (EC) on this program. The policy measures supported by this DPF series have been discussed with both the IMF and the EC to ensure that they reinforce and complement their support to Albania. The World Bank, the IMF and the EC are also providing coordinated technical assistance for further strengthening Public Financial Management.

21. Albania has reached an agreement for an Extended-Fund Facility (EFF) with the International Monetary Fund (IMF). The EFF was approved by the IMF Board on February 28, 2014. The arrangement is intended to provide budget support in the amount of EUR330.9 million (around US\$457.1 million) over a three-year period of which EUR52.9 million (around US\$73.0 million) was disbursed as of end July 2014. The IMF program is on track. It supports structural reforms related to arrears clearance and prevention, NPL resolution, financial sector supervision, domestic debt market development, tax policy, tax administration and the social security system.

IV. Tentative financing

Source:	(\$m.)
Borrower	0
International Bank for Reconstruction and Development	0
Private creditor	280
Total	280

V. Tranches (if applicable)

	(\$m.)
First Tranche	
Total	

VI. Institutional and Implementation Arrangements

9. The World Bank works closely with the offices of the Prime Minister, the Ministry of Finance, the Ministry of Youth and Social Welfare and the Ministry of Energy to monitor and assess reform progress and impacts during the course of the operation. Monitoring and evaluation will be supported by various ministries as well as budgetary, legislative and economic data provided by the authorities and verified in official disclosures, directives and regulations. Baseline and updated data are provided by the Ministry of Finance and the respective line ministries.

VII. Risks and Risk Mitigation

10. **The overall risks to the operation are substantial.** Key risks are related to the macro-economic outlook, in particular, in the Euro area; the realization of contingent liabilities, specifically related to energy imports; and governance.

11. **Macroeconomic risks stem from a potential deterioration of the Euro area economic outlook.** A slower than projected pace of recovery in the Euro area could lead to lower than expected output growth and revenue collection and more sluggish fiscal consolidation. Albania has a relatively high exposure to neighboring countries, especially Greece and Italy, through remittances, exports and foreign investment. A prudent fiscal consolidation path combined with growth-enhancing structural reforms, in particular related to the business climate, and significant financial support from the World Bank, the IMF and the EU are likely to largely mitigate macro-economic risks. Medium-term fiscal policy is calibrated to accommodate a gradual recovery of real growth while steadily reducing public sector debt from 2014 onwards.

12. **The government is facing significant fiscal risks.** Albania's energy generation relies almost entirely on hydropower and recurrent energy shortages due to fluctuations in rainfall coupled with persistently high distribution losses result in high import bills for the public wholesale supplier (KESH). In the past, such losses typically led the government to step in. The government can mitigate this fiscal risk by diversifying generation sources, reducing distribution losses, improving the energy market model and implementing appropriate tariff levels.

13. **Political risks could arise from governance issues and public discontent with reforms.** Sustained efforts are required to tackle governance issues, such as a weak rule of law and corruption, which could undermine, for example, the arrears clearance process and measures to increase collection of utility bills. A mitigating factor is that the government has accelerated structural reforms related to strengthening public administration and the judiciary, which are requirements for reaching the EU candidate status.

VIII. Poverty and Social Impacts and Environment Aspects

14. **The policies supported by this DPF series are expected to have a neutral or positive gender, poverty and social impact over the medium and long term.** Overall, the reforms supported under this operation will contribute to achieving the World Bank's twin goals of poverty reduction and shared prosperity by: (i) providing a foundation for macro and fiscal stability which is a necessary condition for sustainable growth and thus for poverty reduction and shared prosperity; and (ii) improving fiscal sustainability so that gains in poverty reduction, as well as achievements in boosting shared prosperity, will be sustained in future and not achieved at the cost of prosperity of future generations. The proposed reforms are expected to improve the predictability of fiscal policy - limiting *ad hoc* fiscal adjustments at the expense of social policies and programs – and to open fiscal space to strengthen social programs for the poor, such as the Ndihme Ekonomike.¹

15. **Arrears clearance and improvements in PFM are expected to have a positive poverty and social impact.** Although data limitations prevent a quantitative analysis of the impact on the

¹ Ndihme Ekonomike is Albania's means-tested social assistance program which aims at raising the real incomes of the poorest households above a minimum subsistence requirement.

twin goals, arrears clearance is likely to boost growth through fiscal stability, but also as the government repays construction companies for past projects and refunds VAT. Payments to government contractors are likely to reduce unpaid obligations to sub-contractors. These financial flows to the private sector are likely to increase domestic demand. Moreover, the proposed PFM measures are likely to improve the cash flow of businesses by increasing the predictability of government payments. The government has also incurred Lek 6 billion in arrears on disability insurance. Of individuals receiving the urban disability benefit, 11 percent are poor and 32 percent are in the bottom 40 percent, while of individuals receiving the rural-disability benefit, 24 percent are poor and 56 percent are in the bottom 40 percent. The clearance of disability insurance arrears will thus likely boost income of these households. Improving the targeting of the disability program is currently supported under a World Bank social assistance project.

16. The poverty impact of the new Compliance Management Risk (CMR) model is expected to be neutral. The CMR model identifies registered enterprises which are most likely to be large tax evaders. Since these are registered enterprises, their owners are unlikely to belong to the bottom of the income distribution. However, increasing tax compliance could potentially affect firms' profits and, thus, job creation and through this channel shared prosperity and poverty. This effect is, however, likely to be limited. First, a large share (48 percent according to the 2012 LSMS) of the population at the bottom 40 of the income distribution is self-employed. Self-employed are unlikely to be registered at the General Department of Taxation (GDT) and hence, inspected. Second, tax rates are very rarely cited as an obstacle by formal firms in Albania. Only 10.8 percent of firms cited it as a constraint in 2013 compared to an ECA average of 17.9 percent. Finally, firms are likely to benefit from arrears clearance, especially of VAT refunds and contract arrears and improvements in Public Financial Management will reduce the likelihood of future arrears.

17. The poverty and social impact of the pension reform is expected to be positive. These positive effects are expected to materialize mostly over the medium and long term. First, the reform stipulates the indexation of pensions benefits based on a reference consumption basket. This will ensure that the real value of pensions is not eroded, including for the poor, while preventing fiscally unsustainable *ad hoc* pension increases. In addition, a social pension will be introduced for all citizens without pension rights, providing income to elderly people who currently do not receive any kind of transfer. The social pension scheme stipulates that the elderly would receive about US\$60, which is close to the poverty line (at Lek 6,407 per month in 2012 prices). Pensioners receiving the minimum pension today will receive the social pension in future together with additional benefits which are linked to their earnings and contributions. While the introduction of the social pension may currently not affect a large number of people (as most elderly today comply with the eligibility requirements given their pre-transition work history), it is likely to become more relevant in the future and keep the elderly who have not accrued sufficient pension benefits out of poverty. It is estimated that around 4,900 people will become social pensioners in 2015, which is a relatively small number compared to the contributory pensioners (around 554,000). In the future, however, a larger share of the population is projected to enter retirement age without meeting the eligibility criteria for the contributory pension (estimated at as many as 20,000 by 2030). This future cohort will now be eligible to benefit from the social pension scheme, thus providing them with enough income to keep them out of old age poverty.

18. **While energy sector reform will contribute positively to poverty reduction and shared prosperity by helping to sustain growth and reducing fiscal risks, higher energy bill collection could have potentially negative effects on poor households.** This could be mitigated through energy subsidies to the poor. Household survey data suggests that poor households are more likely to report not having an electricity meter (4.9 percent) compared to non-poor households (1.1 percent). Of the self-reported 1.8 percent of non-metered households, 77.2 percent are in the bottom forty percent while only 4.9 percent are in the top quintile. Further, 77.7 percent of poor households reported paying an electricity bill in the last 12 months compared to 90.5 percent of non-poor households. About one in every five poor households (19.5 percent) reported running arrears on their electricity bills, which compares to about one in every ten non-poor households (11.5 percent). If poorer households are more likely not to have paid their electricity bills and as the share of electricity expenditures in their households' total expenditures is larger, enforcing collections could potentially translate into a higher burden for this group.² The Albanian government provides energy subsidies to the poor through the subsidy which is implicit in the block tariff and through direct transfers through the social assistance system, which reimburses eligible households for the difference between the current tariff and the 2003 tariff. The Government now provides Lek 640 directly to vulnerable households, including poor households, families without incomes, retired people and civil servants with low wages, for their energy bills.

19. **Finally, limiting regulated tariffs to low voltage customers and the new energy market model is expected to have no or limited direct poverty impact.** Given that the reform will maintain regulated tariffs for households and small enterprises, the expected direct impact on electricity expenditures for these groups are expected to be limited. The indirect impact on poverty, through effects on firm's growth and job creation, is likely to be mixed. On the one hand, firms might face higher electricity costs from higher tariffs. On the other hand, the reliability of power supply would increase. The latter would likely have a particular positive impact on firms, as electricity is reported by most firms as a major constraint to conducting business and the current high levels of electricity outages reflect significant losses in their annual sales, as self-reported, firm-level data illustrates. According to Enterprise Survey data, Albanian firms are significantly more likely to report that electricity services are overall poor than average firms across Eastern Europe and Central Asia. As with the pension reform, further analysis on the potential poverty and social impact of the energy sector reform will be carried out once full reform details become available.

20. **The DPF series is expected to have an overall positive gender impact.** The gender impact of PFM reforms and energy sector reforms is expected to be neutral. The reform of the pension system includes the equalization of the retirement age for men and women. Under the old pension law, women and men retired at age 60 and 65, respectively. The lower retirement age for women delinks women earlier from the labor market, thus reducing their pensions relative to men and increasing their probability of old-age poverty. The new pension law envisions a gradual increase of the retirement age of women from 2015 onwards until reaching 67 years in 2056. The retirement age of men is expected to start to increase from 2032 onward to 67 years by 2056. The relative increase in the retirement age of women compared to men is

² However, data constraints limit the analysis since these are self-reported numbers and household surveys usually do not capture households at the top of the income distribution.

expected to have a positive impact on reducing gender inequality by reducing poverty among elderly women.

21. Policies supported by the proposed DPF series are not expected to have significant effects on Albania's environment, water resources, habitat or other natural resources. Policies in support of improving public finance management, raising revenue collection and reforming pensions are unlikely to have any significant environmental impact. Moving medium-voltage customers into the market is likely to increase incentives for energy efficiency and energy savings, reducing the need for importing energy from thermal power sources which could contribute to a reduction in regional emissions. Improving energy bill collection of households is likely to increase electricity expenditures of households who avoided paying the bills in the past. On the one hand, this is likely to increase the uptake of energy efficiency applications and encourage energy savings in the residential sector, which would have a positive environmental impact. On the other hand, this may potentially induce some poor households to switch to environmentally inferior alternatives for heating, such as wood, with a potentially adverse effect on forests and air quality. This risk is unlikely to be significant and will be mitigated through a targeted energy subsidy that the government will provide to the poor

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