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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A PROPOSED

PUBLIC FINANCE POLICY BASED GUARANTEE

IN THE AMOUNT OF EUR 200 MILLION
(USD 226,700,000 MILLION EQUIVALENT)

TO

THE REPUBLIC OF ALBANIA

March 5, 2015

Macroeconomics & Fiscal Management Global Practice (GMFDR)
South East Europe Country Unit (ECCU4)
Europe and Central Asia (ECA)

ALBANIA – GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of February 13, 2015)

Currency Unit	LEK
US$1.00	LEK123.28

Weights and Measures
Metric System

ABBREVIATION AND ACRONYMS

BoA	Bank of Albania	MTBP	Medium-term Budget Plan
CEZ sh.	CEZ Distribution Albania	MoF	Ministry of Finance
CIT	Corporate Income Tax	NPL	Non-performing loan
CPF	Country Partnership Framework	NSDI	National Strategy for Development and Integration
DPL	Development Policy Loan	OSHEE	Albanian Electricity Operator
DPF	Development Policy Financing	OST	Albania Transmission Operator
EC	European Commission	PBG	Policy Based Guarantee
ECA	Europe and Central Asia	PFPBG	Public Finance Policy Based Guarantee
ERE	Albania Energy Regulator	PEFA	Public Expenditure and Financial Accountability Assessment
EU	European Union	PFM	Public Financial Management
FDI	Foreign Direct Investment	PFR	Public Finance Review
FSAP	Financial Sector Assessment Program	PPG	Public and publicly guaranteed
GDP	Gross Domestic Product	SCD	Systematic Country Diagnostic
GDT	General Directorate of Taxation	TA	Technical Assistance
IBRD	International Bank for Reconstruction and Development	TSA	Treasury Single Account
IFC	International Finance Corporation	VAT	Value-added tax
IMF	International Monetary Fund	WB	World Bank
IPS	Integrated Planning System	WBG	World Bank Group
IPA2	Instrument for Pre-Accession Assistance	VAT	Value-added tax
KESh	Albania Power Corporation	WB	World Bank
LSMS	Living Standards Measurement Study	WBG	World Bank Group

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REPUBLIC OF ALBANIA
PUBLIC FINANCE POLICY BASED GUARANTEE

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SUMMARY OF PROPOSED POLICY BASED GUARANTEE AND PROGRAM

REPUBLIC OF ALBANIA

PUBLIC FINANCE POLICY BASED GUARANTEE

Borrower	Republic of Albania
Implementing Agency	Ministry of Finance (MoF)
Financing Data	IBRD Policy Based Guarantee The Guarantee will cover a portion of up to EUR 200 million of principal or principal and interest of a bank loan on commercial terms. Terms: Expected to be 10 years maturity. Front end fee: 0.25% of the guaranteed amount.
Operation Type	Programmatic (2nd of 2), Policy Based Guarantee
Main Policy Areas	Public finance, public financial management, pensions, energy
Pillars of the Operation and Program Development Objective(s)	The proposed Development Policy Financing (DPF) series supports: (i) *strengthening public financial management* to address arrears; (ii) *tax, pension and energy sector reforms* to improve fiscal sustainability.
Results Indicators	• More than 70 percent of central government arrears at end-December 2013 cleared by end-December 2015. • No new central government arrears accumulated in 2015. • Revenues from CIT increased by 0.5 percent of GDP between 2013 and 2015. • The productivity of VAT increased by 10 percent between 2013 and 2015. • Government financing of the pension system remains below 3.45 percent of GDP in 2015. • Government guarantees for non-weather related energy imports are 30 percent lower in 2015 compared to 2013.
Overall risk rating	Substantial
Operation ID	P149765

IBRD PROGRAM DOCUMENT FOR A PROPOSED PUBLIC FINANCE POLICY BASED GUARANTEE TO THE REPUBLIC OF ALBANIA

I. INTRODUCTION AND COUNTRY CONTEXT

1. **This proposed Public Finance Policy Based Guarantee (PFPBG) of EUR200 million in support of a commercial loan is the second in a series of two programmatic development policy financing 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. This series originally consisted of two DPLs.[1] The Government of Albania requested the conversion of the second operation into a Policy Based Guarantee (PBG) to reduce roll-over risks in 2015 as the full principal repayment of a EUR300 million Eurobond falls due and as demand for medium- and long-term Lek denominated domestic government securities has declined in recent months due to policy changes by the parent banks of the key holders of domestic government debt. The PBG is expected to: a) reduce Albania's borrowing costs; b) alleviate government funding pressures and risks; and c) free up commercial bank resources for credit to the private and the energy sector, as the Government implements a fiscal consolidation path that puts public debt on a downward trajectory.[2]

2. **This operation supports strengthening public financial management (PFM) to address arrears and tax, pensions and energy sector reforms to improve fiscal sustainability.** 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 dampening 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. The government recognizes that steps to strengthen PFM and reduce long-term fiscal pressures are critical for Albania to protect the fiscal space for growth-enabling investment and poverty-alleviating social services. The reforms supported by this operation have benefitted from a close coordination between the EC, the IMF and the World Bank and have been supported by target technical assistance (TA).

3. **A new Socialist-led coalition government with a stronger than usual majority assumed office in September 2013 and has started to tackle a long overdue reform agenda**. The government has acknowledged the existence of payment arrears and has been implementing a comprehensive arrears clearance strategy since the start of 2014. The Government has cleared 33.7 billion (or 2.4 percent of GDP) of arrears and has significantly slowed down the re-emergence of new arrears. It has implemented fiscal consolidation in 2014. Public debt is expected to decline in

[1] The Albania First Public Finance DPL was approved by the Board of the World Bank in May 2014.
[2] Annex 5 provides an in-depth discussion of the rationale for a PBG.

2015 for the first time 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 current property restitution and compensation regulation provides for 100 percent compensation, thus posing significant fiscal risks and constraints to private investment. 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.

4. **Albania's long-term goal is to join the EU and in June 2014 it was granted EU candidate status.** Since the early 2000s, Albania has implemented a range of institutional and structural reforms on the road to the EU. The first meeting of the EU-Albania High Level Dialogue on Key Priorities was held in November 2013. The European Council concluded in December 2013 that Albania's reform agenda should focus, in particular, on intensifying efforts in strengthening the rule of law through i) judiciary reforms; ii) fight against organised crime and corruption; iii) protection of human rights and anti-discriminatory policies, including for minorities; and iv) implementation of property rights.[3] Following the granting of the candidate country status, EU and Albania launched the Joint Working Group on the five key priorities in September 2014. The European Commission (EC) adopted Albania's Indicative Country Strategy Paper for the Instrument for Pre-Accession Assistance (IPA2) in August 2014.[4] It focuses on democracy, governance and rule of law, public administration reform, PFM, competitiveness and growth. In particular, public administration, PFM, the justice sector, property rights and civil society are considered areas in need of reforms. This series complements the EU's efforts to strengthen PFM.

5. **Thanks to strong growth and integration into the global economy, Albania made significant progress in poverty reduction until 2008 but that progress has since been reversed.** Albania was propelled from being one of the poorest countries in Europe in the 1990s to middle-income status in 2008. From 2002 until 2008 alone, Albania's poverty was halved to 12.5 percent. Since 2008, Albania real GDP growth has slowed down significantly as a result of the global financial crisis and the subsequent anemic Eurozone growth. The growth slow-down affected, in particular, sectors that employed low-skilled workers, such as construction and some non-tradable services and led to a rise in poverty. Results from the latest available LSMS data show an increase in poverty to 14.3 percent in 2012. This increase translates into 28,900 people being pushed into poverty. Extreme poverty, defined as having difficulty meeting even basic nutritional needs, decreased from about 5 percent in 2002 to 1.2 percent in 2008, but increased to 2.2 percent in 2012. Most of the poverty increase was in urban areas, narrowing the gap in living standards between rural and urban areas.[5]

6. **Similarly, shared prosperity - consumption growth of the bottom 40 percent compared with the average increase in consumption - improved between 2005 and 2008 but has**

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[3] See http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/genaff/140142.pdf for additional information.

[4] http://ec.europa.eu/enlargement/pdf/key_documents/2014/20140919-csp-albania.pdf

[5] In 2012, poverty is higher for male-headed households (15 percent) than for female-headed households (10 percent). These estimates, however, mask self-selection, as women heading households (less than 9 percent of all household heads) tend to have different characteristics than other women.

deteriorated since then. Household expenditure[6] increased from 2005 to 2008 for all, but particularly for those in the bottom 40 percent. The mean expenditure of the bottom 40 percent grew at an annualized rate of 2.6 percent, exceeding the growth rate of the country's average household expenditure of 1.3 percent. Between 2008 and 2012 consumption[7] fell by 1.3 percent per year, including by 1.2 percent for those in the bottom 40 percent, as growth slowed down.

7. **The reforms supported under this Development Policy Finance (DPF) series are expected to support the achievements of the World Bank's twin goals of poverty reduction and boosting shared prosperity.** Improvement in Albania's fiscal outlook, for example, will help ensure that gains in poverty reduction, as well as achievements in sharing prosperity, are not achieved at the cost of prosperity of future generations. In addition, improving the transparency and predictability of fiscal policy will reduce the probability of ad hoc fiscal adjustments, which often come at the expense of social programs. The PFPBG is also expected to have a positive gender impact as a result of the pension reform. The PFPBG supports macro-fiscal sustainability which according to the Albania Systematic Country Diagnostic (SCD)[8] is of the highest priority, since it has a fundamental impact on Albania's ability to accelerate and sustain growth.

8. **There are several risks to this operation.** First, the Albanian economy has close trade, finance and remittance links to European economies, particularly Greece and Italy, whose growth prospects remain uncertain. A slower than currently projected pace of recovery in the Euro area could lead to lower growth, revenue collection and fiscal consolidation. A prudent fiscal consolidation path, combined with growth-enhancing structural reforms and significant financial support from the World Bank, the IMF and the EU can help mitigate these macro-economic risks. Second, Albania faces significant fiscal risks related to the energy sector. Albania's energy generation relies almost entirely on hydropower, making it highly vulnerable to weather patterns and requiring emergency power imports during dry seasons. The sector also suffers from persistently high distribution losses and, as a result, often needs to import energy even when weather conditions are favorable. As regulated tariffs are below energy costs and collections are low, the financial situation of the sector is weak and energy imports are often financed with government guarantees. In addition, the publicly owned distribution company OshEE faces an unfunded deficit of over US$550 million which, in the absence of an aggressive loss reduction program, would reach about US$800 million by 2018. The government is taking steps to diversify generation sources, reduce distribution losses, improve the energy market model and implement an appropriate tariff level in order to contain the fiscal pressures emanating from the energy sector. These reforms are supported through this PFPBG and the World Bank's Albania Power Sector Recovery Program. Third, Albania is facing serious governance challenges. Further efforts are required, particularly within the framework of EU accession, to strengthen the rule of law, ensure security of property rights, minimize widespread public sector corruption, strengthen bank and non-bank supervision

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[6] Expenditure includes consumption and non-consumption expenditures as a proxy of household income.
[7] As measured by the LSMS.
[8] The SCD presents the diagnostics to identify the most important challenges and opportunities at the country level for reaching the two goals of ending extreme poverty and increasing shared prosperity in a sustainable manner. It informs the Country Partnership Framework (CPF) which determines and prioritizes the financing, advisory, and other support from the World Bank (IBRD, IDA), the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA).

and improve government effectiveness across the board. These risks are only partially mitigated by current reforms of the judiciary, the High State Control and banking sector supervision.

II. MACROECONOMIC POLICY FRAMEWORK

A. Recent Economic Developments

9. **The global financial crisis and the subsequent Eurozone crisis have led to a significant slow-down in Albania's growth.** Albania had the best growth performance of any non-oil exporting European country prior to 2009. Real GDP growth averaged 6 percent a year between 1998 and 2008, catapulting Albania from the poorest country in Europe to middle-income status in 2008. Even after the 2008 global financial crisis, Albania's growth remained relatively strong, averaging 3.2 percent between 2009 and 2011, largely driven by remittances-fueled consumption. Growth slowed down to 1.6 percent in 2012 and 1.4 percent in 2013, as exports, remittances and to some extent foreign direct investment (FDI) suffered, in particular from Albania's close ties to Greece and Italy. Public investment became the key driver of growth as consumption stagnated and net exports declined. On the production side, services were the largest contributor to economic growth, followed by construction. Growth is expected to reach 2.1 percent in 2014 as improved credit growth, clearance of domestic government arrears and a rise in business confidence stimulate domestic demand.

10. **Large external imbalances that accumulated in the years preceding the 2008 crisis gradually corrected but external vulnerabilities have started to reemerge in 2014.** The current account deficit peaked at 15.9 percent of GDP in 2009 before declining to 10.6 percent in 2013 as exports grew from 28.4 percent of GDP in 2009 to 35.0 percent in 2013 and imports changed little as a share of output (Table 1). Current transfers, however, including remittances declined sharply from 10.8 percent of GDP in 2009 to 7 percent in 2013. The downward trend in the current account deficit is expected to have been reversed in 2014. It is projected to reach 14.0 percent of GDP as exports contracted due to declining oil and mineral prices[9] and imports, in particular of intermediate goods for manufacturing, grew. In addition, electricity imports increased significantly between 2013 and 2014 due to weak rainfall in the first quarter of 2014. The current account deficit was largely financed through FDI, which amounted to 8.3 percent in 2014. External debt has increased since 2009, but remains at a manageable 36.7 percent of GDP in 2014.

[9] The share of mineral and oils in total exports is 34 percent as of January October 2014.

Table 1: Key Macro-economic Indicators

	Actual				Est.	Projected				
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Output, labor and inflation	Annual percentage change unless otherwise indicated									
Real GDP	3.7	2.5	1.6	1.4	2.1	3.0	3.5	3.5	3.5	3.5
Contributions										
Consumption	*1.9*	*1.6*	*0.9*	*0.0*	*1.9*	*2.2*	*1.0*	*1.3*	*2.0*	*2.2*
Public investments	*-3.0*	*-0.1*	*-1.0*	*0.5*	*0.3*	*-0.1*	*0.9*	*0.2*	*-0.1*	*-0.1*
Private investments	*0.2*	*1.8*	*-2.0*	*0.3*	*0.7*	*1.3*	*1.8*	*2.2*	*1.7*	*1.6*
Net exports	*4.6*	*-0.8*	*3.7*	*0.6*	*-0.8*	*-0.4*	*-0.2*	*-0.2*	*-0.1*	*0.1*
Unemployment rate 1/	14.2	14.3	13.9	16.1	17.2					
GDP Deflator	4.5	2.3	1.0	0.8	1.4	2.5	2.8	3.0	3.0	3.0
CPI (period average)	3.6	3.4	2.0	1.9	1.6	2.2	2.6	2.9	3.0	3.0
Fiscal accounts	Percent of GDP unless otherwise indicated									
Expenditures 2/	29.3	28.9	28.2	28.9	31.6	32.4	30.8	28.7	28.6	28.1
of which: arrears clearance					2.4	1.3	1.0			
Revenues	26.2	25.4	24.7	23.7	26.0	27.6	28.2	28.2	28.2	28.2
General government balance 3/	-3.1	-3.5	-3.4	-5.2	-5.6	-4.8	-2.6	-0.5	-0.4	0.1
Primary deficit (- is deficit)	0.3	-0.4	-0.3	-2.0	-2.8	-1.5	0.6	2.6	2.5	3.0
Public and publicly guaranteed debt	57.7	59.4	62.0	70.0	71.0	70.7	68.1	64.4	60.9	57.1
Selected monetary indicators	Annual percentage change unless otherwise indicated									
Broad money growth	12.5	9.2	5.0	2.3	3.8	5.5	7.0	7.6	7.5	7.3
Credit to non-government	10.1	10.4	1.4	-1.4	3.1	4.5	6.6	7.4	7.7	8.0
BOA repo rate (in percent)	5.0	4.8	4.0	3.0	2.3	...	...	...	...	...
Balance of payments	Percent of GDP unless otherwise indicated									
Current account balance	-11.3	-13.2	-10.2	-10.6	-14.0	-15.2	-15.1	-13.4	-10.6	-8.9
Imports of G&S 4/	53.2	56.8	52.1	52.9	56.1	56.6	56.5	55.2	52.9	51.6
Exports of G&S 4/	32.5	34.0	33.4	35.0	36.3	36.0	35.9	36.3	36.9	37.4
Foreign direct investment (net)	8.8	6.6	6.8	9.5	8.3	10.2	11.3	10.3	8.1	7.2
Gross reserves:										
in billions of US$, eop	2.5	2.6	2.6	2.6	2.8	2.7	2.8	3.1	3.2	3.3
in months of imports of G&S 4/	4.3	4.6	4.6	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Exchange rate (Lek/US$, average)	103.9	100.9	108.2	105.7	106.7	...	...	...	...	...
Other memo items										
Nominal GDP in billions of lek	1,240	1,301	1,335	1,366	1,413	1,491	1,586	1,700	1,830	1,967
Nominal GDP (in millions of US$)	11,928	12,890	12,345	12,921	13,252	13,980	14,874	15,937	17,157	18,445

Source: INSTAT, Albanian Ministry of Finance and Bank of Albania; IMF; WB Staff estimations and projections.
1/Unemployment rate is calculated using labor forces survey. 2/ Expenditures include energy sector subsidies after 2013. 3/ General government balance is on cash basis. General government debt in 2013, 2014 and 2015 includes arrears. 4/ G&S refers to goods and services. Data as of mid-February 2015.

11. **While the financial sector has remained largely resilient to the global crisis, with solid liquidity ratios and strong provisioning requirements, continued vigilance is needed.** Increased financial intermediation in the pre-crisis period, coupled by an easing of credit standards, excessive unhedged borrowing in foreign currency and overexposure towards some sectors such as construction led to a buildup of vulnerabilities in the balance sheets of the commercial banks. As the crisis hit, problems of portfolio quality came to the fore and the NPL ratio climbed from 6.5 percent in 2008 to almost 25 percent in Q3 2014, the highest in South East Europe.[10] Rising government arrears, cumbersome court processes and difficulties with collateral execution also contributed to NPLs, which in turn depressed credit demand. Credit growth has recovered slightly in 2014, reaching an estimated 3.1 percent. The decline in profitability, the high degree of euroization, strong financial links between banks and the government, and potential deleveraging

[10] Non-performing loans are defined as loans payments on which are delayed for more than 90 days. No collateral value is netted out in their accounting.

in a system dominated by subsidiaries of foreign banks, including from Austria, Greece, Italy and Turkey, increase the vulnerability of the financial sector.[11] Some of the major banks face constraints from their foreign parents to improve capital adequacy – by reducing the size of the risk weighted assets in the bank portfolios–thereby reducing bank demand for lek-denominated government securities in recent months.

12. **Inflation has remained low.** The Bank of Albania maintains an inflation-targeting monetary policy and a flexible exchange rate regime with relatively little intervention. These policies, along with flexible wage setting, have been effective in containing inflation and unit labor costs in the past. With below-target inflation due to declining producer prices, a persistent negative output gap and low labor demand, monetary policy has remained accommodative throughout 2013 and 2014.[12] In January 2014, the Bank of Albania's policy rate reached a historical minimum of 2 percent. Yet, a full transmission to credit markets has been weakened due to the high euroization, high risk premia, and sluggish credit demand. The Lek exchange rate against the euro has been little changed since 2011. The IMF assessed in January 2014 that the exchange rate appears broadly in line with fundamentals to modestly overvalued.

13. **Since the global financial crisis, Albania fiscal position has deteriorated.** Albania's fiscal deficit widened significantly to 5.2 percent of GDP in 2013 from 3.4 percent in 2012 (Table 2). Revenues as a share of GDP declined from 26.7 percent in 2008 to 23.7 percent in 2013 due to a reduction in the corporate income tax (CIT) rate in 2009, increases in VAT exemptions and declining revenue collection. As revenues fell, so did budgeted spending. Personnel expenditures declined from 6.1 percent in 2008 to 5.2 percent in 2013. Capital expenditures also contracted. However, social transfers – already on a rising trajectory since 2000 – increased from 8.6 percent in 2008 to 9.3 percent in 2013. The government contribution to the pension system, including rural subsidies, reached 3.45 percent of GDP in 2013 largely as a result of contribution rate cuts in 2006 and 2009, unfunded increases in benefits, and perverse incentive effects that threaten the longer term financial stability of the system despite the relatively young population. In 2013, a slowdown in the economy together with the general elections in June 2013 led to an expansionary fiscal policy during the first half of 2013. In addition to higher expenditures and underperforming revenues, the government accumulated significant arrears related to public works, health (mostly drugs), education, water, VAT refunds, CIT repayments, electricity bills and social benefits. The total stock of arrears amounted to Lek 70.7 billion at the end of 2013, or 5.2 percent of GDP.

[11] Still, credit risks appear mitigated by solvency ratios that are above international norms and stringent provisioning rules, but stress tests show that banks are vulnerable to shocks. The World Bank has been supporting financial sector reforms through technical assistance and a Financial Sector DPL.

[12] Inflation accelerated slightly in 2014 but remained consistently below the lower limit of the tolerance band of the Bank of Albania's target of 3 percent

Table 2: Fiscal Operations of the General Government [1/]

(In percent of GDP)

	2009	2010	2011	2012	2013	Est. 2014	Proj. 2015	2016	2017	2018	2019
Total revenue and grants	**26.1**	**26.2**	**25.4**	**24.7**	**23.7**	**26.0**	**27.6**	**28.2**	**28.2**	**28.2**	**28.2**
Tax revenue	23.7	23.3	23.4	22.5	21.7	23.8	25.3	25.7	25.7	25.7	25.7
Non-tax revenue	2.1	2.5	1.7	1.8	1.6	1.5	1.5	1.7	1.7	1.7	1.7
Grants	0.4	0.4	0.3	0.4	0.4	0.7	0.8	0.8	0.8	0.8	0.8
Expenditures	**33.2**	**29.3**	**28.9**	**28.2**	**28.9**	**31.6**	**32.4**	**30.8**	**28.7**	**28.6**	**28.1**
Current expenditure	24.8	24.3	23.5	23.4	24.1	24.7	25.9	24.7	23.7	23.7	23.4
Personnel cost	5.5	5.3	5.2	5.2	5.2	5.0	5.1	4.7	4.7	4.9	5.1
Goods and services	2.8	2.8	2.5	2.4	2.4	2.2	2.7	2.6	2.5	2.5	2.5
Interest payments	3.2	3.4	3.2	3.1	3.2	2.8	3.3	3.2	3.1	3.0	2.9
Subsidies 2/	0.2	0.3	0.3	0.1	0.1	0.7	1.1	0.7	0.5	0.5	0.2
Social insurance outlays	8.5	8.6	8.8	9.0	9.3	9.8	9.6	9.5	9.3	9.2	9.2
Local government expenditure	2.9	2.5	2.2	2.0	2.2	2.3	2.5	2.5	2.2	2.2	2.2
Social protection transfers	1.8	1.5	1.4	1.5	1.7	1.8	1.6	1.5	1.4	1.4	1.4
Capital expenditure	8.4	5.4	5.4	4.6	4.8	4.4	4.5	4.5	4.5	4.5	4.5
Reserve and contingency funds 3/	0.0	0.0	0.0	0.0	0.0	0.0	0.4	0.3	0.3	0.2	0.2
Clearance of arrears	0.0	0.0	0.0	0.0	0.0	2.4	1.3	1.0	0.0	0.0	0.0
Others: loans to energy sector	0.0	-0.5	0.0	0.1	0.0	0.0	0.2	0.3	0.2	0.2	0.0
Overall Balance	**-7.1**	**-3.1**	**-3.5**	**-3.4**	**-5.2**	**-5.6**	**-4.8**	**-2.6**	**-0.5**	**-0.4**	**0.1**
General government financing	**7.1**	**3.1**	**3.5**	**3.4**	**-5.2**	**5.6**	**4.8**	**2.6**	**0.5**	**0.4**	**-0.1**
External (net)	0.9	2.1	1.4	1.6	0.8	2.0	3.9	1.8	0.4	0.0	0.0
Domestic (net)	6.2	0.9	2.2	1.8	4.4	3.6	0.9	0.8	0.1	0.5	-0.1
of which privatization	2.2	0.0	0.0	0.1	1.2	0.0	0.1	0.0	0.0	0.0	0.0

Source: Albanian Ministry of Finance; IMF; WB Staff estimates and projections. Data as of mid-February 2015.
1/On a cash basis. 2/Subsidies include energy sector subsidies after 2014. 3/ /Reserve and contingency funds are reported according to their spending category at outturn.

14. **The fiscal deficit widened to 5.6 percent of GDP in 2014 as the government spent 2.4 percent of GDP to clear a significant part of its arrears.** The fiscal deficit without arrears clearance is 3.2 percent of GDP in 2014 which compares to a deficit of 5.2 percent in 2013. The fiscal consolidation was achieved through a variety of revenue measures, such as an increase in the CIT rate from 10 percent to 15 percent, a hike in the excises tax rates on tobacco products, alcoholic drinks and coffee; a higher circulation tax; and increased property tax rates paid by businesses (local tax). As a result, Albania's revenue to GDP ratio is estimated to have reached 26.0 percent in 2014. Fiscal consolidation measures on the expenditures side included a freeze of public sector salaries, with the exception of police officers, and limits to pension increases to around 2 percent. Excluding arrears clearance, government spending rose by 0.3 percent of GDP because of subsidies to the energy sector and higher transfers to municipalities; with the arrears clearance, it increased from 28.9 percent in 2013 to 31.6 percent in 2014.

15. **Public debt has surged since the 2008, reaching 71 percent in 2014**. In 2008, Albania amended the Organic Budget Law to include a legal limit on public debt equal to 60 percent of GDP. At that time, public debt was about 54.7 percent of GDP but loose fiscal policy, combined with a depreciation of the Lek, caused public debt to climb to 59.4 percent by 2011. Fiscal pressures rose further during the energy shortage in 2012, as the government provided support to the power generation company KESh in the form of guarantees. *Ad hoc* increases of pensions and declining revenues also added to a widening of the fiscal deficit. In the run-up to the 2013 elections the government requested Parliament to revoke the 60 percent of GDP public debt limit. In December 2012, the Parliament did so, without proposing any other fiscal or debt anchor. Public debt has since

climbed to 71 percent of GDP due to a large fiscal deficit in the run-up to the 2013 elections and the recognition – i.e., inclusion in the stock of public debt -- of the government payment arrears.[13]

16. **Continued fiscal consolidation and sound debt management will help reduce interest rate and rollover risks.** In 2014, about 55.4 percent of Albania's public debt has a floating interest rate and 65.8 percent of government debt will need refixing in 2015, exposing Albania to significant interest rate risk. Spending on interest, at about 2.8 percent of GDP in 2014, is relatively high compared to other South East European countries. Moreover, around 30 percent of total debt or 19.6 percent of GDP is short-term domestic debt that needs to be rolled in 2015, exposing the government to changes in market conditions. Commercial banks are the main holders of Albania's domestic debt, with 44.3 percent of domestic debt held by only three foreign banks or funds (BKT, Raiffeissen, and Raiffeisen's Prestige Fund). Albania's secondary market for securities is undeveloped. Albania, thus, relies on a few domestic financial entities to hold government securities, making it vulnerable to changes in parent bank policies. The Government is continuing its efforts to reduce its reliance on short-term domestic debt and to develop its domestic debt market. Albania's government bond rating is a below-investment grade B1 with a stable outlook by Moody's and B with a positive outlook by Standard & Poor's.

17. **The energy sector poses significant fiscal risks and requires serious reforms.** About 98 percent of Albania's energy is generated from hydropower. Recurrent energy shortages due to fluctuations in rainfall, persistently high distribution losses (about 43 percent in 2013) and regulated tariffs below energy costs, have resulted in sustained fiscal support from the government, in the form of guarantees for power imports and liquidity injections, to the energy generation company KESh.[14] In the distribution sector, the low collection rates from households, businesses and public institutions have contributed to the financial woes of the publicly owned distribution company (OShEE) which faces an unfunded deficit of US$550 million. The government has approved a Power Sector Financial Recovery Plan in February 2015 which focuses on: i) changes in legislation through a New Power Sector Law; ii) improving management of the energy sector companies and bill collection; and iii) technical improvements in sub-transmission, distribution, system metering and the billing system, which is financed through the World Bank's Energy Sector Recovery Project.

B. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

18. **Thanks to sound fiscal policies and structural reforms, growth is expected to increase gradually over the medium term but will remain significantly below its pre-crisis levels and its potential.** Real GDP growth is projected to rise moderately from 2.1 percent in 2014 to 3 percent in 2015 and 3.5 percent in 2016 supported by an increase in FDI. Domestic private investment is also expected to gradually pick up in response to arrears clearance and credit expansion as well as sustained improvements in the business climate. As the government strengthens public investment management and improves capital execution, the contribution of public investment spending to growth is also expected to increase. The output gap is estimated to be around 1 percent 2014 and expected to close gradually over the medium-term.

[13] Nominal GDP numbers in 2011, 2012 and 2013 were revised downwards due to a methodological change in the treatment of implicit subsidies to the energy sector.
[14]As of mid-2014, the commercial overdraft of KESh was US$340 million (about 2.5 percent of GDP).

19. **The current account is projected to widen in 2015 due to FDI-related imports but external financing is sustainable**. The current account deficit is expected to increase due to FDI-related imports related to a gas pipeline and a power plant in 2015 (Table 3). The current account deficit without these projects is, however, expected to decline. External debt as a share of GDP is projected to peak at 39.9 percent in 2017 before trending downwards.[15]

Table 3: Balance of Payment Financing Requirements

(In percent of GDP)

	Actual 2009	2010	2011	2012	2013	Est. 2014	Projected 2015	2016	2017	2018	2019
Current account	**-15.9**	**-11.3**	**-13.2**	**-10.2**	**-10.6**	**-14.0**	**-15.2**	**-15.1**	**-13.4**	**-10.6**	**-8.9**
Balance of goods and services	-25.1	-20.6	-22.7	-18.7	-17.8	-19.7	-20.7	-20.6	-18.9	-16.0	-14.2
Exports of goods and services	28.4	32.5	34.0	33.4	35.0	36.3	36.0	35.9	36.3	36.9	37.4
Imports of goods and services	53.6	53.2	56.8	52.1	52.9	56.1	56.6	56.5	55.2	52.9	51.6
Income balance	-1.6	-1.0	-0.3	-0.7	0.2	-0.9	-1.2	-1.0	-1.1	-1.1	-1.0
Current transfers	10.8	10.3	9.8	9.2	7.0	6.6	6.7	6.7	6.6	6.5	6.3
Capital and Financial account	**11.8**	**9.7**	**10.3**	**8.1**	**8.6**	**9.9**	**7.0**	**11.7**	**11.3**	**8.8**	**7.1**
Capital transfers	1.0	1.0	0.9	0.9	0.5	0.7	0.9	0.7	0.7	0.6	0.6
Direct investment, net	7.9	8.8	6.6	6.8	9.5	8.3	10.2	11.3	10.3	8.1	7.2
Foreign borrowing, net	4.6	3.4	4.2	2.5	0.8	2.3	-0.8	1.5	1.3	1.8	1.7
Other flows	-1.8	-3.4	-1.3	-2.0	-2.1	-1.3	-3.2	-1.8	-1.1	-1.7	-2.3
Of which: Commercial bank NFA	-1.9	-1.5	-1.0	-2.1	-2.4	-2.0	-2.5	-2.5	-2.5	-2.3	-2.1
Errors and omissions	3.8	3.0	2.6	2.9	3.1	3.0	2.9	2.8	2.7	2.6	2.5
Net balance	**-0.3**	**1.3**	**-0.3**	**0.8**	**1.1**	**-1.0**	**-5.3**	**-0.6**	**0.6**	**0.8**	**0.7**
Available financing	**0.3**	**1.3**	**0.3**	**-0.8**	**-1.1**	**1.0**	**5.3**	**0.6**	**-0.6**	**-0.8**	**-0.7**
Change in net reserves (increase = -)	0.3	-2.0	0.3	-0.8	-1.1	-1.2	-1.3	-1.1	-0.9	-0.8	-0.7
IMF (budget support)						0.5	1.4	0.9	0.3	0.0	0.0
World Bank						1.7	0.0	0.7	0.0	0.0	0.0
European Commission								0.2			
Commercial loans (Eurobond)		3.3	0.0	0.0	0.0	0.0	5.1	0.0	0.0	0.0	0.0
of which: Eurobond							2.8				
of which: PBG							2.3				
Memorandum items:											
Current account excl. FDI imports 1/	-15.9	-11.3	-13.2	-10.2	-10.6	-13.4	-13.1	-12.1	-11.1	-10.0	-8.9
GDP in (millions of Euros)	8,683	8,978	9,261	9,573	9,734	10,096	10,650	11,331	12,141	13,070	14,051
External debt stock (percent of GDP)	33.8	33.6	34.8	35.6	34.3	36.7	42.4	45.0	46.5	48.3	50.0

Source: Bank of Albania; IMF; World Bank staff estimates and projections.

1/ Excludes imports related to the Transadriatic pipeline.

21. **The fiscal deficit is projected to decline to 4.8 percent of GDP in 2015 and further to 2.6 percent in 2016, reflecting a gradual completion of spending on arrears clearance and continued fiscal consolidation.** The latter will be achieved through spending constraint combined with further revenue measures and the pension reform which will take effect in January 2015. In 2015, fiscal consolidation will fall largely on revenue measures, in particular, increases in the excise tax on cigarettes, the circulation tax, the withholding tax for income from interest, rent, dividends and capital gains. On the expenditure side, the budget foresees a decline in social spending, resulting from a reform of the disability assistance system and a reduction in the unconditional transfers to local governments.[16] Fiscal consolidation in 2016 and 2017 is expected to be driven by further

[15] These macro-economic projections are broadly aligned with the IMF's macro-economic framework. There a two key differences: i) the IMF forecasts faster real GDP growth after 2016; and ii) it shows unidentified fiscal measures in the fiscal tables. The financing assumptions presented here are in line with the government's draft medium-term debt management strategy. The World Bank is providing TA for developing this strategy.

[16] The number of beneficiaries of disability benefits increased by 50 percent between 2007 and 2013, the benefits do not necessarily favor the most severely disabled and the benefits are quite generous compared to Ndihma Ekonomike,

increases in non-tax revenues, a decline in the public sector wage bill in line with the government's medium-term fiscal framework and a reduction in social insurance outlays as a result of the recent pension reform.[17] The government also aims at gradually reducing government guarantees to the energy sector as a result of the ongoing energy sector reforms.

22. **Albania's public debt is projected to fall below 60 percent by 2019.** Sustained fiscal consolidation combined with solid GDP growth are expected to put public debt on a steep downward trajectory. This path is, however, vulnerable to changes in the fiscal policy stance, GDP growth, financing terms and the exchange rate as well as the realization of unexpected contingent liabilities from the energy sector (see Annex 6 for a public DSA). The government's gross financing needs are expected to decline from 30.9 percent of GDP in 2015 to 18.8 percent in 2019. Meeting the large gross financing needs in 2015 poses a challenge for the government as demand for longer-term domestic government securities has declined in recent months due to a change in parent bank policy of the largest holder of domestic government securities. External financing is expected to reach a historically high of 8.4 percent of GDP in gross terms and 3.9 percent in net terms as a result of this PBG, the issuance of a Eurobond and IMF disbursements of about EUR150 million.

23. **Downside risks to the macroeconomic outlook are substantial.** Slow progress of energy sector reforms could hit the budget, negatively affecting fiscal indicators and growth. Rainfall sharply affects the supply of electricity and has a direct impact on import needs and government guarantees. The fiscal risks emanating from the energy sector would be reduced over time if the energy sector reforms, which are outlined in the energy sector recovery program, would be fully implemented. A slower than projected pace of recovery in the Euro area could lead to lower than expected growth, revenue collection and fiscal consolidation.[18] Further deleveraging of commercial financial institutions and a deterioration of their portfolio asset quality could force banks to shift their holdings into low risk assets and reduce credit to the private sector, depressing growth.

24. **The macroeconomic policy framework is considered adequate for this operation.** The government is committed to fiscal consolidation, putting public debt on a downward trajectory. The 2015 budget includes significant fiscal consolidation measures with immediate effect and the 2014 fiscal targets are likely to be met. The government has also made good progress with arrears clearance and has taken decisive steps to strengthen the medium-term fiscal framework. Fiscal policy is calibrated towards accommodating a gradual recovery of the real sector while steadily reducing public sector debt from 2014 onwards. Achieving a faster debt reduction would entail even deeper fiscal consolidation that is not recommendable due to possible negative implications for growth and poverty. The planned pace of fiscal consolidation is supported by structural policies in support of growth, such as reforms of the judiciary, the energy and financial sector as well as improvements of the business climate.

Albania's social assistance program for the poor. The World Bank is working with the Ministry of Social Welfare and Youth to strengthen the effectiveness of the disability assistance program.

[17] The Government plans to mitigate the potentially growth dampening effects of fiscal consolidation through further improvements in the business environment, focusing on reforms to improve the resolution of insolvency, starting a business, registering property, enforcing contract and trading across borders.

[18] Albania has a relatively high exposure to developments in neighboring countries, especially Greece and Italy, through remittances, exports and foreign investment.

C. Relations with the IMF

25. **The Board of the IMF approved an Extended Fund Facility arrangement for Albania on February 28, 2014**. The arrangement will 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.

III. GOVERNMENT'S REFORM PROGRAM

26. **The draft government National Strategy for Development and Integration (NSDI) 2014-2020 is currently being discussed with various stakeholders and civil society.** It is expected to be finalized in April 2015. The NSDI provides the strategic framework for all sector and cross-sector strategies and is the backbone of the Integrated Planning System (IPS) – a set of operating principles to ensure that government policy planning, budgeting and monitoring are linked. The NSDI rests on four pillars: (i) restructured public finances to ensure fiscal and macroeconomic stability; (ii) increased competitiveness; (iii) innovative governance; and (iv) efficient use of natural resources. Improving governance and the rule of law constitute its foundation. This PFPBG supports the first pillar which focuses on arrears clearance, fiscal consolidation and establishing a solid record of macro-economic management. The fourth pillar of the NSDI aims to secure Albania's energy supply in the long term through diversified domestic power generation, reduced transmission and distribution losses, improved energy bill collection, and better integration with regional and European energy systems. Achieving these goals will entail significant investments. This, in turn, requires that the financial viability of the sector improves which this operation supports in tandem with the World Bank's Albania Energy Sector Recovery Project.

27. **The proposed operation has incorporated lessons from the Bank's experience in Albania to date**:

- ***Need for focus and selectivity.*** Given Albania's small size and limited implementation capacity, operations should focus on a limited number of areas. The proposed operation focuses on four key areas: strengthening PFM, tax reform, pension reform, and energy sector reform. Reforms in all four areas are supported through tailored World Bank technical assistance.
- ***Need for realistic macroeconomic and fiscal forecast.*** As a consequence of overly optimistic growth and revenue projections, liberal spending plans were approved during budget preparations in the past. Between 2010 and 2012, nominal GDP growth was on average 2.3 percentage points higher and tax revenues as a share of GDP on average 1.7 percentage points lower than projected. This resulted in *ad hoc* expenditure cuts, especially of capital investments, during the budget year as revenues fell short of budgeted amounts, as well as the accumulation of arrears. The 2014 budget was based on realistic macroeconomic and fiscal assumptions, enabling the government to meet its fiscal target.

- ***Need for government ownership.*** Strong government ownership is critical for moving the reform agenda forward. This operation has direct collaboration and support of the top leadership, including the Prime Minister, the Minister of Finance, the Minister of Energy, the Minister of Economic Development, Trade and Entrepreneurship and the Minister of Youth and Social Welfare.
- ***Timing matters.*** The current government was elected in 2013. The next general elections are scheduled to take place in 2017. This will give the government time to tackle difficult reforms in areas such as pensions and energy. The previous government had formed a pension reform commission in 2010 which developed a pension strategy, but with the parliamentary election approaching, the political landscape and the appetite for reform changed before the strategy could be translated into a legislative act.
- ***Need for coordination among development partners.*** The Bank team has worked closely with the IFC, the IMF, the EC, and bilateral development partners (Austria, France) to prepare this operation and coordinate technical assistance, in particular, in the area of PFM.

IV. PROPOSED OPERATION

A. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

PRIOR ACTIONS AND RESULTS

28. **This Public Finance DPF series focuses on two pillars:**

A. Strengthening public financial management to address arrears; and
B. Tax, pension and energy sector reforms to improve fiscal sustainability.

Pillar A: Strengthening public financial management

29. **In September 2013, the Government acknowledged the existence of significant government payment arrears.** In October 2013, it appointed an independent external company to verify the outstanding balance for obligations of ministries on works, goods and services as of end-August 2013. These payment arrears were estimated at Lek 28.5 billion (US$280.2 million or 2.1 percent of GDP). In addition, the government has accumulated arrears on utility bills, VAT and CIT refunds, disability benefits and other spending items (Table 4). The total stock of central government arrears is estimated to have amounted to Lek 70.7 billion (5.2 percent of GDP) at the end of 2013. During 2014, the government cleared Lek 33.7 billion of these arrears.

Table 4: Central Government Arrears and Payments as of end December 2014
(in LEK billion)

	Total	Paid 1/
Capital Investment 2/	17.3	9.6
Goods& Services	7.7	5.2
VAT refunds	18.6	12.7
CIT arrears	8.4	
Excise refunds	0.2	0.2
Court orders	5.4	3.2
Expropriation	1.7	0.3
Child registration	0.6	
Civil emergency	1	0.2
Disability benefits	4.8	2.3
Energy bills3/	5	
Total	70.7	33.7

Source: Albanian Ministry of Finance.
1/Paid as of December 31, 2014.
2/Includes Lek 2.1 billion of local government centrally financed contracts.
3/Regular energy bills have been cleared through netting off – a prior action under the Albania First Public Finance DPL

***PBG prior action #1**: The Ministry of Finance has reduced central government arrears (excluding those to the energy sector) accumulated prior to end-December 2013 by at least Lek 14 billion, following the criteria specified in the Arrears Clearance and Prevention Strategy.*

30. **The government has proceeded quickly with arrears clearance.** After clearing Lek 33.7 billion in arrears during 2014,[19] the Government's Medium-term Fiscal Framework foresees further arrears clearance of Lek 20 billion in 2015 and Lek 16.5 billion in 2016. Arrears clearance is an important step in building public confidence in government's fiscal policy and its ability to meet its future payment obligations. It can also contribute to reducing NPLs in the banking system,[20] thereby improving the ability of firms to raise financing from the banking sector and support domestic demand. External auditors report that for a sample of these arrears that their payment has been broadly in line with the Government's Arrears Clearance and Prevention Strategy that was approved by the Council of Ministers in February 2014 and supported under the Albania First Public Finance DPL.[21] Arrears with incomplete or inconsistent information, which as of end December 2014 amount to Lek 22 billion, are being assessed by an external forensic auditor.[22]

[19]Additional Lek 5 billion of arrears to the energy sector were cleared. Arrears to the energy sector have not been covered by the Arrears Clearance and Prevention Strategy.
[20] Government contractors and their sub-contractors are more likely to be in a position to service bank loans once the government pays the contractors for services provided.
[21]The Arrears Clearance and Prevention Strategy specifies: (i) criteria for prioritizing the clearance of different types of arrears; (ii) the verification process for assessing different types of arrears; (iii) mechanisms for repayment; (iv) responsibilities of different actors involved in the clearance process; (v) measures for the prevention of future arrears; and (vi) timelines for the implementation of the strategy. It is publicly available at http://www.financa.gov.al/al/program/shlyerja-e-detyrimeve-te-prapambetura .
[22] The call for tender of this auditor was a prior action under DPL1. The audit is financed by the European Commission.

31. **Expected result**: More than 70 percent of the December 2013 stock of central government arrears are cleared by the end of December 2015.

PBG prior action #2*: Parliament has established mandatory expenditure ceilings for each budget user for the years 2015, 2016 and 2017.*

32. **A comprehensive approach to budgeting and greater discipline in the preparation and execution of medium-term budget plans is important for preventing new arrears.** Although expenditure ceilings were set in previous years, these tended to be seen by budget users as a minimum baseline for their plans and considerable effort was spent by both the Ministry of Finance and line ministries in negotiating final budget limits. By making clear to budget users at the outset of the 2015 budget process that the approach has changed, and that hard limits will be placed on budget plans, budget users will not waste time on preparing overly optimistic proposals for new spending. They will concentrate on designing and prioritizing activities within the prescribed limits. The Ministry of Finance issued in March 2014 a budget circular, notifying line ministries that commitments for 2015 to 2017 cannot exceed by more than 30 percent the medium-term fiscal ceilings for current expenditures and by more than 50 percent of domestically financed capital expenditures in order to avoid over-commitments and the accumulation of future arrears. Parliament has approved the Medium-term Fiscal Framework for the years 2016 and 2017 together with the 2015 budget in November 2014. The Government plans to amend Albania's Organic Budget Law, the Law on Management of the Budget System in 2015 in order to reflect, among other things, the changes to the medium-term fiscal framework. These changes are also embedded in Albania's PFM strategy, which has been approved by the Council of Ministers and published in December 2014.[23]

PBG 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 EUR 5 million to the Ministry of Economic Development, Tourism, Trade and Entrepreneurship and has published the annual execution report for 2014.*

33. **In the past, a major source of pressure on the budget arose from large multi-year capital investment.** New investment projects were approved which committed the government well beyond the budget year and often needed to be cut back during the year due to inadequate funds to meet all obligations. Where commitments exceeded available budgets, arrears accumulated. Prioritization of investment projects within approved budget ceilings will thus be important for preventing arrears. Clear prioritization criteria would ensure that poorly prepared and ill-conceived projects are not financed and ensure that resources are applied where they will provide maximum benefit in achieving the Government's fiscal and other objectives. The World Bank is providing technical assistance to improve the prioritization of transport projects and strengthen road asset management in the context of the Albania Results-Based Road Maintenance and Rehabilitation project.

34. **Monthly reporting on expenditures and commitments of major projects will be supported under the PFPBG.** 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. The Ministry of Economic Development, Tourism, Trade and Entrepreneurship

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[23] The European Commission, the IMF and the World Bank provided coordinated inputs. The strategy is available at http://www.financa.gov.al/al/raportime/strategjia-per-menaxhimin-e-financave-publike-2014-2020.

will publish detailed annual execution reports in order to increase transparency around the government's public investment program. In addition, the World Bank team is also providing TA to strengthen Public Investment Management at the request of the Government.

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 multi-year contractual commitments for 2015, 2016 and 2017.*

35. **The Treasury system is currently not capable of imposing hard commitment controls**. Currently, five institutions are connected to the Treasury system and can directly enter multiyear commitments.[24] Budget institutions which are not yet connected to the Treasury system have to record commitments in the Treasury District Office within three days of signing a contract.[25] Commitments beyond the budget year are, however, lumped into one year, making it difficult for the Ministry of Finance to track commitments. The Ministry of Finance has therefore put in place a new software in the Treasury system (AGFIS) which disaggregates multi-year commitments by individual outer years. Rolling-out this new software and connecting additional institutions to the Treasury system will require a new hardware, which is expected to be in place by summer 2015. In addition, the Ministry of Finance has collected information on all contracts which have not been previously submitted to the Treasury and recorded them in the Treasury system as an additional effort to strengthen the commitment management and control system. The PFM measures that have been put in place to curtail arrears a bearing fruits. Quarterly surveys of five central government ministries (Health, Justice, Transport and Infrastructure, Defense, and Education and Sport) and the General Directorate of Taxation (GDT) show that Lek 1.1 billion (or 0.8 percent of GDP) of new arrears have been incurred between January and October 2014. The bulk of government arrears were accumulated by the GDT and the Ministry of Transport (Albania Road Authority). All arrears accumulated in 2014 have been repaid.

36. **Expected result**: These combined measures are expected to prevent the accumulation of a stock of new central government arrears by end 2015.

Pillar B: Improving fiscal sustainability through tax, pensions and energy sector reforms

37. **Improving Albania's fiscal outlook will require enhancing revenues while reducing long-term fiscal pressures.** Albania has one of the lowest tax revenues in Eastern Europe. Given the limited scope for cutting expenditures, raising revenues will be important to improve Albania's fiscal outlook. The old pension system lacked fiscal sustainability, fairness and incentives. Its total deficit, including both urban and rural pension schemes, was projected to increase over the medium term. Relative to the average wage, minimum pensions were higher in Albania than in most other countries and beneficiaries of minimum pensions received higher transfers from the government than pensioners that have contributed over a long period of time, reducing incentives to contribute

[24] Albania has a total of 429 budget institutions, including local institutions and special funds, which together have created 1548 spending units for the purpose of budget execution through the Treasury system. The five pilot institutions that are already connected include the General Directorate of Roads, the National Assembly, the National Agency of Natural Resources, the National Licensing Center and the Intelligence Service.

[25] The Treasury now requires information on date of the contract, the date of the supply of goods and services, the date of the presentation of the invoice, the date of accounting and the date of payment.

to the pension system. As discussed above, the energy sector is in crisis, posing significant fiscal risks in the absence of reforms.

PBG prior action #5: *The MOF has established a 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*.

38. **Albania's fiscal consolidation strategy rests to a significant degree on improving revenues through changes in tax policies and improvements in tax administration**. Tax evasion is significant in Albania. Albania's large tax gaps can only be closed if tax administration is strengthened and existing policies enforced. The revenue impact of recent tax policy changes, such as the CIT rate increase from 10 percent to 15 percent, will depend on compliance. To improve compliance, the General Directorate of Taxes (GDT) is implementing a New Tax Compliance Strategy which is based on the OECD/EU Compliance Risk Management Strategy. In the past, GDT's compliance strategy rested on applying the same approach of verifying and enforcing tax payments to all individuals. This was not efficient. Its new strategy focuses its efforts on increasing compliance of high-risk tax payers. These are identified using objective criteria. Low risk taxpayers are expected to be managed through education and corrective approaches. This approach is expected to improve revenue collection and tax payer services. It also provides a stronger focus for evidence-based evaluation. The VAT rules of the Compliance Risk Management Strategy have been programmed into the risk module of the GDT's new IT system and the system is expected to become live in February 2015. Going forward, the GDT also plans to implement a new-sub-routine model to support a risk-based approach to VAT refunds, which should have a favorable impact on reducing arrears.

- **Expected results**: The productivity of VAT increased by 10 percent between 2013 and 2015.

PBG prior action #6*: Parliament has enacted a new pension law.*

39. **The Albanian Parliament approved a new pension law in July 2014.** 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. The law replaces the former minimum pension with a social pension for residents who are older than 70 years of age, not eligible for other pensions and do not have any incomes in excess of the amount of the social pension. The law increases the minimum contributory wage, raises the contribution requirement to receive a pension from 35 years to 40 years by 2025 and gradually increases the rural contribution rates to urban levels by 2017. It also gradually increases the retirement age to 67 years by 2056 for both men and women from 65 years currently for men and 60 years for women. Finally, it indexes pensions to a reference consumption basket.[26] *Ad hoc* pension increases were one of the key drivers of increases in the fiscal deficit in the past. It is estimated that the reform would lower the projected average pension deficit from about 2.2 percent of GDP in 2015 to below 1.1 percent after 2019. In addition to the pension deficit, the government also finances i) part of the contributions for rural contributors; ii) special compensations for pensioners for bread, electricity, dependents, etc; iii) supplementary pensions for civil servants and members of parliament; and iv) special pensions given to distinguished people and veterans. The new pension law will eliminate the rural contribution subsidy over a four year period and will treat the special compensations as

[26] The reference consumption basket is the Consumer Price Index.

part of the new social pension. The Government is also preparing a new law to address the supplementary pensions for civil servants and members of parliament.

40. **Expected results:** These measures are expected to contain government financing to the pension system below 3.45 percent of GDP in 2015.[27]

***PBG prior action #7**: The collection rate of energy bills increased by at least 10 percent in 2014 relative to 2013 in accordance with the Energy Sector Arrears Clearance and Prevention Strategy.*

41. **Improving the collection rates of energy bills is essential for improving the financial situation in the energy sector**. Albania's energy sector suffers from persistently high distribution losses (about 43 percent in 2013), low collection rates from households, businesses and public institutions and regulated tariffs that do not reflect the true energy costs. Collection rates averaged 78.3 percent between 2009 and 2013. To improve collection rates, the Government established an inter-ministerial task force in January 2014 which disconnected illegal connections, including businesses. In October 2014, the Government launched a campaign to enforce criminal penalties for electricity theft. The criminal code has been revised to make power theft and damages to the electricity infrastructure punishable by imprisonment. As a result of these efforts, the collection rate of energy bills increased from 78.2 percent in 2013 to an average of 88.2 percent between January and November 2014.

***PBG prior action #8**: The Ministry of Finance has cleared at least 60 percent of arrears from the central government, public water utility and public schools to the energy sector as of end December 31, 2014 in accordance with the Energy Sector Arrears Clearance and Prevention Strategy.*

42. **Settling and preventing arrears of Albania's energy sector, which encompasses private as well as public enterprises, is important for resolving the energy crisis.** In the past, bill collection from public institutions was weak. Supported under the first DPF of this series, the Ministry of Finance netted off Lek 5 billion of government arrears on utility bills and tax refunds which were used to reduce arrears of the former private distribution company CEZ Sh. to the publicly owned generation company KESH which in turn reduce its arrears to the government in the equal amount. As of end December 2014, the total amount of arrears from the central government, public water utilities and public schools to the energy sector amounted to Lek 12 billion, of which Lek 8 billion were cleared in February 2015. Clearing these arrears is an important step towards improving the balance sheets of these energy sector companies.

***PBG 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.*

43. **Aligning the tariff structure with energy costs is an important step to reduce contingent liabilities emanating from the energy sector.** The revised power law will restructure the institutional relationship between the three public power companies responsible for generation

[27] Pension expenditures are financed partly by employer and employee contributions and partly by general government revenues. This result refers to the portion that is financed by general government revenues and does not include earmarked contributions. It includes the cost of subsidies to pensioners, the supplementary scheme for government employees and the government costs of administering the pension system.

(KESh),[28] transmission (OST) and distribution (OSHEE), will set a schedule for limiting regulated tariffs to low voltage consumers, such as households and small enterprises and move the responsibility for wholesale purchases from independent producers from KESh to OSHEE, in line with the EU's 2009 Electricity Directive.[29] The law will also clarify the responsibilities and establish full independence of the energy sector regulatory authority (ERE). Requiring large consumers to buy electricity on the market, ending KESH's role as supplier of last resort and moving towards a consistent supply of energy to tariff customers will not only restore the financial viability of the sector and reduce the fiscal risks on the budget but also support growth through a reliable supply of power. The implementation of the law will begin in the first quarter 2015. The power law will be complemented with regulatory changes to the tariff structure.

44. **Expected result**: Government guarantees for non-weather related energy imports are 30 percent lower in 2015 than in 2013.[30]

ANALYTICAL UNDERPINNINGS

45. **The design of this operation is underpinned by considerable analytical and TA activities carried out over the past 3 years**. In particular, the Public Finance Review (PFR), a pension policy note and associated technical assistance (TA), energy sector TA, PFM TA as well as regional activities (e.g. Western Balkans programmatic poverty and gender assessments) have informed this operation.

- ***Public finance review:*** The 2013 Public Finance Review has provided the basis for this operation. The review identified opportunities for improving Albania's fiscal sustainability through tax, pension and energy sector reforms and by strengthening PFM.
- ***Pension policy note and TA:*** The pension policy note of 2013 explored challenges and different directions for pension reform in Albania. One of the options proposed in the note formed the basis for Albania's new pension law. The WB pension team also provided TA for drafting the pension strategy and the law.
- ***Power sector TA:*** Three policy sector notes[31] reviewed the sector's reform progress and needed adjustments, the financial situation of the energy sector and key steps for achieving cost recovery. The notes covered netting off of energy sector arrears, key components of the new regulatory statement and the required amendments for the Power Law and the Renewable Law. The World Bank's Energy Sector Recovery Project complements the PFPBG prior actions.

[28] Albania already removed high voltage consumers (industrial consumers) in late 2011 from tariff regulation, requiring them to buy electricity at non-regulated prices.
[29] The WPS/KESH buys currently the electricity produced by KESH at a regulated price as well as the electricity produced by independent power producers (IPPs) at a price agreed in Power Purchase Agreements (PPAs), to the extent needed to serve tariff customers. KESH may sell any electricity on the market that is not taken by WPS/KESH. The WPS/KESh is also the supplier of last resort: it has to buy any additional electricity needed to meet the demand of final tariff customers. WPS is obliged to purchase power from IPPs first because of the PPA obligations after purchasing power generated by KESh, and then import electricity as needed to serve tariff customers.
[30] This is equivalent to the value of non-weather related energy imports.
[31] The policy notes are the 2012 "Assessment of the Albanian Power Market Reform", the May, 2013 "Optimization of the Hydroelectric System in the Drin Cascade" and the 2013 policy note on "Albania's Power Sector: Financial Review and Recovery Plan".

- ***Western Balkans programmatic poverty and gender monitoring:*** The regional work on poverty monitors trends in poverty, inequality and exclusion; provides statistical and capacity building in poverty measurement; and addresses poverty and distributional issues. The regional gender work aims to reduce the gender gap in economic opportunities through enhancing knowledge of gender differences.

Table 5: PBG Prior Actions and Analytical Underpinnings

Prior Actions	Analytical Underpinnings
Pillar A: Strengthening public financial management to address arrears	
Prior action #1: The Ministry of Finance has reduced central government arrears (excluding those to the energy sector) accumulated prior to end-December 2013 by at least Lek 14 billion, following the criteria specified in the Arrears Clearance and Prevention Strategy.	PFR; PFM TA
Prior action #2: Parliament has established mandatory expenditure ceilings for each budget user for the years 2015, 2016 and 2017.	PFR; PFM TA
Prior action #3: The Ministry of Economic Development, Tourism, Trade and Entrepreneurship has issued instructions to all line ministries to submit to the Ministry of Economic Development, Tourism, Trade and Entrepreneurship monthly execution reports of all ongoing projects larger than EUR 5 million and has published the annual execution report 2014.	PFR; PFM TA
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 data base to record all multi-year contractual commitments for 2015, 2016 and 2017.	PFR; PFM TA
Pillar B: Tax, pension and energy sector reforms to improve fiscal sustainability	
Prior action #5: The MOF has established a 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.	
Prior action #6: Parliament has enacted a new pension law.	PFR; Pension policy note
Prior action #7: The collection rate of energy bills increased by at least 10 percent in 2014 relative to 2013 in accordance with the Energy Sector Arrears Clearance and Prevention	Power sector TA
Prior action #8: The Minister 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.	Power sector TA
Prior action #9: The Council of Ministers has approved and submitted to Parliament a revised Power Law: (i) limiting regulated tariffs to Low Voltage customers only; (ii) replacing 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.	Power sector TA

B. LINK TO CPF AND OTHER BANK OPERATIONS

46. **The PFPBG is aligned with the Country Partnership Strategy (CPS) FY11-14 for Albania, endorsed by the Board in January 2011**. It addresses the first of the three strategic objectives of the CPS, namely "supporting a recovery in economic growth by improving competitiveness through fiscal consolidation, better public sector management, an improved business climate, deeper access to credit and reduction of infrastructure bottlenecks." The Albania Systematic Country Diagnostic (SCD) considers macro-fiscal sustainability and financial sector stability to be the highest priority, having a fundamental impact on the country's ability to move to an accelerated and sustainable growth model. A new Country Partnership Framework (CPF) is currently being finalized and is expected to be presented to the World Bank Group (WBG) Board

in April 2015. This operation is fully aligned with the first focus area of the forthcoming CPF on restoring macroeconomic balances, and the associated objective of restoring fiscal sustainability and maintaining financial sector stability to sustain growth.

47. **Parallel to the first Public Finance DPL, the World Bank Board approved a stand-alone Financial Sector DPL which supported the strengthening of the financial sector regulatory and supervisory regime as well as address key vulnerabilities in the bank and non-bank sector**. Building on the Financial Sector Assessment Program (FSAP) of 2013, the operation supported: (i) strengthening the regulation and supervision of the banking sector and the financial safety net; (ii) the resolution of NPLs; and (iii) strengthening the non-bank financial sector.

48. **The World Bank is also undertaking a Power Sector Recovery Program.** It consists of an Investment Project Financing (IPF) and a TA package. It focuses on addressing structural issues in the energy sector and enhancing Government's capacity to transition to an updated energy market model**.** Targeted investments include the financing of metering; a public awareness program to improve the "willingness to pay" by retail consumers; and a medium-term operations and maintenance contract to improve operational efficiency of the distribution company.

C. CONSULTATION AND COLLABORATION WITH DEVELOPMENT PARTNERS

49. **The authorities have consulted with a wide range of stakeholders on measures supported by this programmatic series.** The results of the PFR which provided the analytical underpinning for most prior actions were presented and debated by the New Economic Council with business and financial sector representatives and presented to the public during a media event in June 2014. The consultations on the pension reform were officially launched during a public event in April 2014 and the authorities engaged with a wide range of social partners, civil society and affected groups during the various stages of the preparation of the pension law. The media was invited to all key meetings of the technical working group. The Government has also launched a broad based communication strategy around the need for the energy sector reform. The European Commission and the IMF are supporting both reforms.

50. **The Bank has collaborated closely with the European Commission (EC) and the IMF on this program.** The staffs of all three institutions have collaborated closely on macroeconomic, fiscal and structural reforms. The policy measures supported by this DPF series have been discussed in detail with both the EC and the IMF to ensure that they reinforce and complement their support to Albania. The World Bank Group, the IMF and the EC have also been closely coordinating PFM technical assistance.

V. OTHER DESIGN AND APPRAISAL ISSUES

A. POVERTY AND SOCIAL IMPACT

51. **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.[32]

52. **Arrears clearance and improvements in PFM, supported under Pillar A, are expected to have a positive poverty and social impact.** Although data limitations prevent a quantitative analysis of the impact on the 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.

53. **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.

54. **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

[32] 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.

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.

55. **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.[33] 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.

56. **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.

57. **The DPF series is expected to have an overall positive gender impact**. The impact of reforms supported under Pillar A are unlikely to differ by gender. The reform of the pension system,

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[33] 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.

supported under Pillar B, 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 expected to have a positive impact on reducing gender inequality by reducing poverty among elderly women. Based on currently available information, the energy sector reforms and the increase in the CIT rate, supported under Pillar B, are unlikely to have a gender-specific impact.

B. ENVIRONMENTAL ASPECTS

58. **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, as mentioned in section V.A. on Poverty and Social Impact.

C. PUBLIC FINANCIAL MANAGEMENT, DISBURSEMENT AND AUDITING ASPECTS

59. **Albania has participated in a number of detailed reviews of its PFM.** These include two PEFA assessments (2006 and 2011), a Public Expenditure Review (2006), a Public Finance Review (2013), annual EU-SIGMA reviews, and other analysis by the World Bank, the IMF, the EC, and other organizations. The various reviews have plotted the progress Albania has made in improving its PFM. The last PEFA assessment for Albania from 2011 concluded that Albania has an adequately functioning fiscal and budget management system, in the sense that the system has enabled the government to finance and execute a budget that delivers public services to the general population. Albania scores relatively well on comprehensiveness and classification of the budget, basic treasury operations (including budget, and payroll controls), financial reporting/transparency and public access to government budget and financial information. Lagging areas, as identified in the 2011 PEFA assessment include: (i) multi-year perspective in fiscal planning and policy formulation; (ii) internal audit; (iii) implementation of the integrated planning system (FMIS); and (iv) scope and nature of the external audit function.

60. **The Medium Term Budget Plan (MTBP) and the Annual Budget Law are the two main documents presented for Parliamentary review and approval.** These documents are part of Albania's IPS which tries to ensure that the core policy and financial processes of government function in an integrated manner. Still, the process of allocating expenditure commitments is

fragmented which renders it difficult to ensure that each set of decision makers take all relevant considerations into account. Each has a specific perspective derived from its mandate and mode of operations but operates separately from the other decision making and management agencies. This can lead to such disconnects as approval of more activities and expenditures than the funds available can accommodate, altering the balance between new construction and service delivery or operations, or diverting funds from other priorities without full awareness of the consequences. Though there are processes to screen and approve proposals for investment projects, these functions are not yet fully integrated into the overall budget process and the linkages remain somewhat weak.

73. **Albania has made important progress in developing the national treasury system, yet challenges remain.** A Treasury Single Account (TSA) has been introduced and all central Government revenues and expenditures are recorded in it, though the recording of expenditure transactions is dependent on the timely submission of accurate information from primary budget institutions. Records and information are produced, maintained and are widely disseminated. The State Treasury is also a direct participant in the automated inter-banking system of the Bank of Albania. Reconciliations between the central bank and the Treasury are performed on a daily basis. The Treasury prepares monthly and quarterly budget execution reports for all levels of government, with generally accurate data, broken down by economic and functional classifications and the reports are available one week after the end of the period. The Ministry of Finance monitors the execution of local government budgets on a daily basis as these accounts are managed by regional treasury offices. Monthly and annual budget execution reports are available to the public – these reports can be found on the Ministry of Finance website. All contracts are required to be registered with the treasury within 3 days of signing. In an attempt to strengthen cash management and planning, the treasury system can register multi-year contracts, however the outer year commitments are not currently disaggregated thereby distorting the actual level of commitments and obligations and impacting effective medium-term budget and financial planning. Revenue receipts (tax and customs collections) are collected outside the TSA and are reported to the treasury on a net basis (taxes levied less refunds).

74. **The IMF undertook a safeguards assessment of the BoA in June 2014.** It concluded that the BoA has strengthened its safeguards framework in a number of areas (including in its external and internal audit and financial reporting functions) since the last assessment in 2006. However, its governance structure was found to lack effective oversight of audit, financial reporting, and control matters, and the assessment recommended, *inter alia*, the establishment of an audit committee. In August 2014, the BoA Governor was removed by the Albanian Parliament after a BoA employee confessed to the theft of Lek 700 million (or 0.05 percent of GDP) of bank notes withdrawn from circulation. Since then, the BoA has thoroughly investigated the incidence in collaboration with the prosecutor’s office and state police, and taken steps to strengthen the physical security of its premises. A new Governor assumed office in February 2015. Of note, the Bank of Albania has received unqualified (or clean) audit opinions from two external auditors (Grant Thornton Albania and KPMG Albania) for the past four years (2010-2013).

75. **While the fiduciary risk for this development policy operation is assessed as substantial, no additional mitigation measures are required.** Although the fiduciary risk is primarily driven by the current PFM environment in Albania, the clean audit opinions of the Bank of Albania and the combination of the prior actions of this DPF series and the medium-term PFM reform program negate the need for additional measures to be introduced to safeguard the loan

proceeds. Consequently, the borrower's PFM system, taken together with the borrower's commitment to an acceptable PFM reform program, is adequate to support the operation.

76. **Upon notification by the World Bank of the PBG effectiveness, the Borrow may request withdrawal from the Private Lenders within a defined drawdown period.** The front-end fees and the annualized guarantee fee are expected to be paid out of the proceeds of the IBRD Guarantee Loan. The front-end fees and the annualized guarantee fee will be paid from the Loan proceeds.[34] As the borrower, the Government of Albania has the obligation to ensure timely repayment to the lenders. Details of the callability of the Guarantee will be defined at a later stage once the instrument is more precisely defined. Following payment by the Bank under its guarantee, the Bank would have sole discretion to decide whether to demand immediate repayment from the Government of Albania or to extend terms for repayment over time, and in the latter case, would have sole discretion as to the terms to be extended. The administration and accounting of the loan from the private lender will be the responsibility of the Ministry of Finance. **No additional fiduciary arrangements are required.**

D. MONITORING, EVALUATION AND ACCOUNTABILITY

77. **Monitoring and Evaluation:** The Bank continues to work closely with the offices of the Prime Minister, the Ministry of Finance, the Ministry of Youth and Social Welfare, the Ministry of Economic Development, Tourism, Trade and Entrepreneurship and the Ministry of Energy and Industry 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 and tracked according to the indicators and outcome measures shown in the monitoring and results framework of the policy matrix (Annex 1). Several of the results indicators will be tracked by the Ministry of Finance on a monthly basis.

78. **Grievance Redress.** Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

[34] Consistent with the current Bank policy, there is a front-end fee of 25 basis points on the face value of the guarantee exposure and a guarantee fee of 50 basis points per annum (equivalent to the contractual spread for loans) on the present value of the Bank's exposure from the transaction. The guarantee fee will also be collected upfront, on a present value basis.

VI. SUMMARY OF RISKS AND MITIGATION

79. **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.

Table 6: Risk Ratings

Risk Categories	**Rating[1/]**
Political and governance	S
Macroeconomic	S
Sector strategies and policies	S
Technical design of project or program	M
Institutional capacity for implementation and sustainability	S
Fiduciary	S
Environment and social	L
Stakeholders	M
Overall	**S**

1/ Ratings are substantial (S), moderate (M) and low (L).

80. **Political and governance risks are substantial.** 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. Public discontent with reforms could also impede the government's ability to implement and sustain the needed structural reforms, in particular, with respect to the power sector. The Government has launched an extensive public outreach and communication strategy to garner public support for its reform efforts. The Government's strong electoral mandate from the parliamentary elections in 2013 and the frontloading of reforms are further mitigating factors against this risk. The Government remains strongly committed to strengthening PFM. There seems a broad public consensus about the need to clear arrears and put public debt on a downward trajectory. Yet, political pressures for inserting *ad hoc* fiscal spending items in the budget persist and may increase in the run-up to the municipal elections in summer 2015. Parliamentary elections will only be held in 2017 which minimizes political and stakeholder risks. The operation receives direct support from the top leadership, including the Prime Minister, the Ministry of Finance, the Minister of Economic Development, Tourism, Trade and Entrepreneurship, the Minister of Social Welfare and Youth and the Minister of Energy and Industry.

81. **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. Contrary to the past, the

government's fiscal and macroeconomic projections for 2015 are realistic, increasing the likelihood that fiscal targets are met. Medium-term fiscal planning has been significantly strengthened.

82. **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. Clearance of arrears to the energy sector, improvements in the collection rate, the implementation of the Power Law, reduction of distribution losses and improvements in the management of energy sector companies – actions which are supported under this operation and the World Bank's Power Sector Recovery Program - will help to get the sector out of crisis mode and reduce fiscal risks. Fiscal risks could also arise from Albania's compensation scheme for expropriation.

83. **There are also substantial risks associated with sector policies, institutional capacity and fiduciary aspects.** Risks are related to the implementation of power sector related reforms, which require a strong reform commitment and could suffer from substantial staff turnaround, lack of management capacity, a tight financial situation and weather related shocks. These risks are mitigated through actions supported under the World Bank's Power Sector Recovery Program and a close cooperation with the Ministry of Energy and Industry, which has established an inter-Ministerial task force to ensure proper implementation of the power sector recovery and reform program and a close coordination with International Financial Institutions. The Government has also taken several steps to enforce payment discipline among budgetary and on-budgetary institutions and the clearance of energy sector arrears, supported under this operation, will help to improve the balance sheet of the energy sector companies. There are also risks related to Albania's institutional capacity of implementing reforms as it lacks an effective merit principle in civil service recruitment and human resources management and service delivery are not well linked. A new civil service law was adopted in May 2013. Implementation has started in 2014. The Government restructured some public institutions and started to introduce more transparent recruitment procedures for public servants. This operations also receives high-level government support which mitigates risks associated with lack of institutional capacity. Fiduciary risks, as mentioned in section V.c., are primarily driven by PFM related weaknesses and mitigate through some of the reforms supported under this operation.

84. **As highlighted in the PSIA section, the poverty and social impact of the policy measures supported under this DPF series are expected to be neutral or positive**. At the same time, there do not seem to be risks for the environment, forests, water resources, habitats or other natural resources. Finally, the clean audit opinions of the Bank of Albania and the combination of the prior actions of this PFPBG and the medium-term PFM reform program mitigate fiduciary risk.

Annex 1. Policy and Results Matrix

DPL1 Prior Actions	PBG Prior actions	Results
Pillar A: Strengthening public financial management to address arrears		
Prior action #1: The Council of Ministers has adopted a central government arrears clearance and prevention strategy.	Prior action #1: The Ministry of Finance has reduced central government arrears (excluding those to the energy sector) accumulated prior to end-December 2013 by at least Lek 14 billion, following the criteria specified in the Arrears Clearance and Prevention Strategy.	More than 70 percent of central government arrears as of end-December 2013 cleared by end-December 2015. **Baseline:** Central government arrears as of end December 2013 amount to Lek 70.7 billion.
Prior action #2: The Ministry of Finance has verified all outstanding obligations and liabilities of the central government from September through end of December 2013 and has issued a call for tender for an independent, external party to complete an audit of liabilities and claims that have not yet been validated due to disputed or incomplete documentation.		
Prior action #3: The Ministry of Finance has issued a budget circular, notifying line ministries that all financial commitments must be met within the expenditure ceilings for the current and two subsequent years.	Prior action #2: Parliament has established mandatory expenditure ceilings for each budget user for the years 2015, 2016 and 2017.	No new central government arrears accumulated in 2015. **Baseline**: Central government arrears accumulated in 2013 amount to Lek 10.8 billion.
Prior action #4: The Ministry of Finance has issued a budget circular, requiring all ministries to establish a prioritized list of all expenditure projects larger than EUR 5 million and has received the lists from all ministries.	Prior action #3: The Ministry of Economic Development, Tourism, Trade and Entrepreneurship has issued instructions to all line ministries to submit to the Ministry of Economic Development, Tourism, Trade and Entrepreneurship monthly execution reports on all ongoing projects larger than EUR 5 million and has published the annual execution report 2014.	
Prior action #5: The Council of Ministers has issued a regulation, requiring the budget units to get a confirmation on availability of funds from the MOF before initiating procurement for investment projects.	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 data base to record all multi-year contractual commitments for 2015, 2016 and 2017.	

Pillar B: Tax, pension and energy sector reforms to improve fiscal sustainability		
DPL1 Prior Actions	**PBG Prior actions**	Results
Prior action #6: Parliament has approved budget for 2014 which increases the CIT rate from 10 to 15 percent.	Prior action #5: The MOF has established a 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.	Revenues from CIT increased by 0.5 percent of GDP from 2013 to 2015. **Baseline:** Revenues from CIT as a share of GDP in 2013 of 1.1 percent of GDP. The productivity of VAT increased by 10 percent between 2013 and 2015. **Baseline:** The productivity of VAT is 53 percent in 2013.
Prior action #7: An Inter-Ministerial Pension Reform Working-Group has been established and has finalized a policy paper on the strategic direction for the pension reform.	Prior action #6: Parliament has enacted a new pension law.	Government financing of the pension system remains below 3.45 percent of GDP in 2015.
Prior action #8: The Council of Ministers has adopted a time-bound settlement and prevention strategy of public sector arrears in the energy sector.	Prior action #7: The collection rate of energy bills increased by at least 10 percent in 2014 relative to 2013 in accordance with the Energy Sector Arrears Clearance and Prevention Strategy.	Government guarantees for non-weather related energy imports are 30 percent lower in 2015 than in 2013. **Baseline:** Government guarantees for non-weather related power imports in 2013 at Lek 12 billion.
Prior action #9: The Minister of Finance has netted off part of public sector energy arrears as per the Memorandum of Understanding approved by the Council of Ministers.	Prior action #8: The Minister 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.	
Prior action #10: ERE has issued a resolution to implement a flat rate for all non-metered household customers and has started its implementation.	Prior action #9: The Council of Ministers has approved and submitted to Parliament a revised Power Law: (i) limiting regulated tariffs to Low Voltage customers only; (ii) replacing 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.	

Annex 2. Letter of Development Policy

Letter of Development Policy

Dr. Jim Yong Kim
President
The World Bank
1818HStreet, N.W. Washington D.C., 20433

20 February, 2015

REF: Letter of Development Policy
Albania: Public Finance Development Policy Loan

Dear Dr. Kim:

The Government of the Republic of Albania (Albania) appreciates the long-standing partnership and cooperation with the World Bank (Bank) on a range of development issues and remain cognizant of the crucial development financing and implementation support that the Bank has provided to Albania's reform program and transition over the last two decades. In particular, we express our gratitude for two Development Policy Loans as well as the energy sector loan which were successfully concluded within a very short time last year. We remain strongly committed to enhance further this excellent partnership.

Context: Successful finalization of embarked reforms in an adverse economic environment

The global financial crisis in 2008 and the subsequent Eurozone crisis have considerably slowed the growth and poverty reduction momentum of our country. Although Albania managed to avoid recession, the real economic growth has since slowed to less than 3 percent, and further less than 1.5 percent in the last couple of years, as exports, remittances, and foreign direct investment inflows have suffered, in particular due to Albania's proximity and close ties to the Greek and Italian economies.

The economy is beginning to recover, however external environment remains adverse and risks to growth are present. Real GDP is expected to have grown by 2.1 percent in 2014, mostly in the second half of the year. External imbalances are expected to have widened in 2014 mainly because higher demand for electricity imports due to weak rainfall in the first quarter, and higher intermediate imports while exports of goods increased thanks to higher agriculture and textile exports. Inflation continues to be modest constrained by weak price pressures from foreign trading partners, the negative output gap, and modest wage growth.

Economic recovery is expected to continue in 2015 and medium term, though low inflation will likely persist. Although the external environment remains weak, a continued recovery in private demand, boosted by further progress on arrears clearance and a modest pick-up in lending, is expected to help support growth. Survey results predict a steady improvement in economic confidence, as well as improving lending conditions, that should support stronger private

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investment. The implementation of large private projects in the energy sector (i.e. TAP and Devoll Hydropower) are going to finance higher imports of capital goods in the medium term and as a result the external account deficit is likely to remain high for the next couple of years. Over the medium term, the external current account deficit will decline because of improvements in export capacity, import substitution, and lower import needs of big FDI projects.

Public debt has surged upwards since the crisis. Albania's public debt has increased from about 55 percent of GDP in 2008 to about 71 percent in 2014, due principally to lower economic growth, lower revenue collection, rising fiscal pressures related in particular to energy shortages as well as the accumulated stock of government's arrears to the private sectors at about 5.2 percent of GDP. The high public debt level has also led to elevated interest expenditures, presenting a major vulnerability to the budget and crowding out other more productive spending. In 2014 we paid a substantial part of accumulated arrears at about 2.4 percent of GDP, audited by the external auditor, and we expect in 2015 to pay most of the remaining amount of arrears. Such policy should considerably improve financial position of the private sector and stimulate private investment for the medium term ahead.

A large portion of debt depends on short term financing that is subject to considerable rollover risks. Thanks to the support from IFIs with favorable lending in 2014, in particular with the support from World Bank, we managed to have a better management of debt during 2014. Therefore, we have considerably increased the average maturity of the public debt as well as reduce its servicing costs during 2014. The Standard & Poor's raised its outlook from negative to positive, recognizing our efforts to embark on a credible path of fiscal consolidation which will eventually reduce public debt at sustainable levels. In this regard, the continued support from IFIs is crucial for us in order to successfully carry on with our consolidation and PFM reforms program which was established in agreement with the IMF and the EU.

Our financial sector has remained largely resilient throughout the global financial crises but considerable risks remain. Albania's portfolio of non-performing loans (NPLs) has increased sharply since the crisis, and as a result, credit growth has slowed. Due to several measures taken by the Bank of Albania (BoA) and the Government since the onset of the NPL problem, and in this matter having valuable expertise assistance from the World Bank, we have managed to stabilize the potentially further increasing level of the NPL. We believe that the agile progress in the payment of arrears has contributed positively and significantly to avoid a further deterioration. Some positive developments have already taken place with regard to crediting of the economy.

After a negative growth for more than one year, financial activity resumed in the third quarter of 2014. Credit growth turned positive in September 2014, nevertheless it still remains at a historical low. We believe that our ability to shift more the financing of our budget deficit toward foreign borrowing and leave more financing space in the domestic market will be important to boost credit in the economy which is key for economic growth and consequently for the successful implementation of the full-fledged program of embarked reforms. In this regard, we believe that the utilization of Policy Based Guarantee (PBG) from the World Bank will be a very important support for this year.

Government's Program

Our main economic objectives over the medium term are to restore robust and sustainable growth that would improve the living standards of our citizens; reduce the macroeconomic risks associated with the rising public debt; and mitigate the financial sector risks so credit can flow *again.* The government's draft National Strategy for Development and Integration (NSDI) 2014-2020 will be finalized by April 2015. The strategy focuses on achieving the following goals: (i) growth through fiscal stability and increased competitiveness; (ii) sustainable growth through efficient use of resources; and (iii) investing in people. Improving good governance and the rule of law forms the foundation.

The National Strategy for Development and Integration 2014-2020 (NSDI), will be the basis for the design of medium-term budget programming and the orientation of donor funding, especially from the World Bank, the IMF, and the European Union's (EU) Instrument for Pre-accession Assistance (IPA). The NSDI provides the strategic framework for all sector and cross-sector strategies and is the backbone of the Integrated Planning System (IPS) which is a set of operating principles to ensure that government policy planning, budgeting and monitoring processes function in a coherent, efficient, and integrated manner. The IPS ensures that all strategies and systems are consistent and reflect the same goals, activities, desired results and timeframes. Budget plans are checked during the annual budget process to ensure that they reflect the stated intentions.

Progress on public finances reforms

We are committed to lowering public debt over the medium-term. We have made concrete progress toward putting public finances on a sustainable path and we remain fully committed to fiscal consolidation, as planned, to lower debt-related vulnerabilities that hamper growth and cause macroeconomic instability. The process of fiscal consolidation that we embarked stating with 2014 budget is completely on track. In line with the initial objectives, from 2015 we are going to bring down public debt as a share of GDP for the first time since 2010, despite the significant energy-related spending this year. This will be the first time since 2010 to reduce the public debt. By 2018, we aim to bring public debt down to around 60 percent of GDP (including guarantees and local government debt). We will work closely with our international partners, including the World Bank and the IMF to strengthen medium-term fiscal framework and public financial management. We will of course adjust our future fiscal consolidation efforts in line with the strength of the economy—with less fiscal adjustment in the event of weaker than anticipated economic growth, and vice versa.

To achieve the fiscal deficit objective of 3.9 percent of GDP in 2015, down from 5,1 percent in 2014, we have adopted a package of fiscal adjustment measures. On the revenue side, the main measures include: (i) increase in the excise tax on cigarette from 90 lek to 110 lek ; (ii) increase in the circulation tax (national tax) on gasoline and diesel by 10 lek per liter; (iii) increase in the withholding tax for interest, rent, dividends, and capital gains from 10 percent to 15 percent, in line with the tax on (other) personal income; (iv) removal of VAT deferral scheme for machinery and equipment; (v) introduction of a 3 percent tax on insurance premiums (national tax), except for life and travel insurance. On the spending side, the main measures include: (i) reform of the disability system; (ii) modification of the royalty sharing arrangements (national tax) with local governments, which results in a reduction of unconditional transfers to local governments.

The total savings as a result of these measures amount to around 21 billion lek. Of this amount 2.3 billion lek is a result of the measures adopted under the 2014 budget law. At the same time, fiscal space is created from the downward revision of interest spending projections over the medium term as compared to the previous fiscal framework, reflecting more accurately the interest spending needs over the medium term. In addition, local government debt will stay at the 2014 level during 2015-17 to support the fiscal effort. All these measures have been incorporated in the 2015 budget approved by Parliament in December 2014 and are now effective since January 1, 2015.

Stable financial sector

We are committed to maintaining a stable financial system, and improving the supervisory framework. The BoA (and the Government to what it relates) are proceeding with implementing the recommendations of the 2013 FSAP. The FSAP mission found that the BoA has ensured a high level of compliance with the Basel Core Principles for Effective Banking Supervision. Several of the specific recommendations have been implemented under the World Bank's Financial Sectror Development Policy Loan (FS-DPL). The BoA is further reinforcing supervision and at the same time adoption of more stringent capital adequacy requirements is ongoing. We plan to undertake additional measures to facilitate problem loan restructuring. These include cooperation with FinSAC/World Bank to facilitate loan restructuring through developing recovery and resolution plans for large problem borrowers. We remain committed to implementing the amendments to the Albania Financial Supervisory Authority's (AFSA) law to ensure AFSA's independence. At the same time we are continuing efforts to strengthen the regulatory framework for investment funds.

Robust and sustainable growth

Even as we undertake fiscal adjustment to reduce public debt, we remain committed to taking a proactive role in reforming the business climate to support robust and sustainable growth. We are implementing several budgetary policies to support growth and offset tightening effects of fiscal consolidation. Public investment in the short and medium term is preserved at least at 5 percent of GDP, which is important to fuel aggregate demand in the short run and shift potential growth in the medium and longer term. The full payment of the accumulated government arrears to the private sector, which started in 2014, will continue steadily in 2015 and in 2016, which is critical for restoring the health of the private sector. At the same time, stimulating measures are adopted for some critical employment-generating sectors of the economy. In particular, the government has exempted from custom duties some agricultural inputs and increased subsidies to the textile sector. In addition, employment in public administration (e.g., police, teachers) will increase to meet pressing needs.

We are committed to creating a business friendly environment. The Government has established the National Economic Council, as an advisory body for the Government, which includes representatives from the business community, key ministries, and multilateral partners. It is now finalizing steps to create an investment council, funded by the EBRD, which will address business community concerns. The inter-ministerial working group created to implement "Doing Business" reforms – based on the World Bank's Doing Business Report – and supported by the IFC, worked on a range of reforms, including paying taxes, starting a business, access to electricity, and registering property. As a result of these efforts, Albania has recorded the biggest improvement (from 108^{th} to 60^{th} place) among all countries in its Doing Business rank. Reforms will continue next year focusing on resolving insolvency, starting a business, paying taxes, registering property, enforcing contracts, and trading across borders. The high level government working group is already working on a range of measures to facilitate and improve performance in these indicators.

Additional progress will be made in simplifying business registration procedures. The National Registration Center (NRC) is currently testing the online business registration procedures; these could become operational at the beginning of 2015. We are also assessing the feasibility of creating a single service window for businesses by merging the NRC and the National Licensing Center (NLC) into a single entity.

We remain cautious about the uncertainties ahead especially with regard to the shaky economic situation of the Eurozone which is the main destination for Albanian exports and the main source of remittances. If some of these risks materialize in the form of lower than planned revenues we stand ready to make the adjustments necessary to ensure that fiscal consolidation is preserved.

EU Accession

Albania's long-term goal is to join the European Union. As outlined in the European Commission's 2013 Progress Report for Albania, we have adopted key judicial, public administration and parliamentary reform measures that would allow us to make progress toward EU accession. In that matter, Albania recorded a huge success in June 2014, when the European Council officially decided to grant Albania the status of candidate country to the European Union.

We have also made strides in the fight against corruption and organized crime, with financial assistance from the EU through IPA. During 2007-13, the EU allocated approximately Euro 594 million for Albania, which financed reforms and investments in governance, justice and home affairs, transport, environment, employment and social inclusion, as well as agriculture and rural development. We intend to further strengthen the independence and efficiency of the justice system, the fight against corruption and organized crime, and reforms in public administration. The EU is also providing technical assistance to improve public financial management in Albania.

Reforms Supported by the Public Finance Development Policy Loan

The proposed Public Finance PBG (PF – PBG) from the World Bank supports our efforts to: (i) strengthening public financial management to address arrears; and (ii) improve fiscal sustainability through tax, pension and energy sector reforms.

(i) Public financial management / Arrears clearance

Our goal is to clear the remaining unpaid arrears and ensure that the financial controls which have been put in place are going to effectively work in order to avoid the recurrence of new arrears in the future. In line with the comprehensive and transparent Arrears Prevention and Clearance Strategy (APCS) which we adopted at the beginning of 2014, we managed to pay almost half of the total arrears during 2014. The process so far was assessed and evaluated as broadly correct by the external auditor's report. The auditors' preliminary covered about 55 percent of the non-tax claims as of mid-November 2014 (in value). The preliminary report did not find major and systematic problems with the clearance process but in certain cases identified problems related to contracting and procurement at the time the projects were signed. There were challenges in following the first-in first-out principle in payments partly because of difficulties in verifying older claims. We are reviewing the auditors' recommendations and will prepare an action plan for the Arrears Committee to address these deficiencies by March 2015 (the action plan, once adopted, will be posted on the MoF website).

Besides clearance of existing arrears, we have made concrete progress in terms of putting in place the necessary processes to monitor future commitments and avoid arrears accumulation. In that regard:

- we have finalized preparations in the treasury system (AGFIS) for the disaggregation of multi-year commitments by individual outer year allocations, and registration of multi-year commitment limits controlled with the respective allocations. As a result, we have introduced multi-year commitment limits in the 2015 budget submitted to Parliament. However, as envisaged under the recently adopted PFM strategy supported by donors, the change in the Procurement law, the financial management and control law, and the Organic Budget Law have been extended until end 2015 to ensure a more thorough review process.
- We are in the process of purchasing the IT hardware for the new treasury system and plan to have the system in place by the second part of the year,
- In March we will complete the corporate strategy for medium to long term capacity building at General Directorate of Taxes,
- We have approved the pension reform strategy ahead of schedule, and the new law has become effective on January 1, 2015.

More specifically Albania is implementing the following key measures with the support of the PF-DPL:

- The new IT system at GDT went live on the 1st of January. The GDT is also preparing a new corporate strategy for medium and long term capacity building and the establishment of a Risk Management Unit (RMU) in GDT. Extensive training is ongoing, including through the Fiscal Academy. The strategy will be drafted by the MoF staff in cooperation with the Fiscal Academy and GDT. The Risk Management Unit is currently active at GDT but will be reviewed in light of the structural changes expected before the end of March 2015.

- A key priority in 2015 is the reform of the tax refund scheme. The responsibility for tax refund payments, which has been transferred from the GDT and GDC to Treasury since early 2014, will be refined further to ensure that refunds are paid accurately and on time. The new VAT law which passed in July 2014 and became effective on January 1, 2015 eliminates the requirement for compulsory audit of VAT refunds, and establishes risk criteria as the basis for undertaking an audit—risk-based auditing is expected to begin by June 2015. Risk Module for VAT refunds will be operational after establishing the new Refund Unit and adapting the refund risk criteria and the required procedures. Restructuring of GDT administration will lead to the creation of a dedicated Refund Unit to coordinate refund efforts on a country basis, and to dedicated functions at regional offices to undertake operational functions related to VAT refunds. Legal changes will also be needed to ensure that the Refund Unit/Directorate has the final authority to decide on refunds.

- *Closer coordination between GDT and GDC would enhance tax administration efforts.* To leverage each other's potential and thus improve tax compliance, the GDC and GDT will strengthen cooperation. They will take measures to improve compatibility of their IT systems to enable access to each other's databases. They will also establish joint controls and audits of excisable taxpayers by the end of June.

- *We are reinforcing public financial management to prevent accumulation of new arrears.* We plan to extend AGFIS to 15 budget institutions accounting for 60 percent of the budget, and one local government by the end of 2015. Most of the new functional configurations will become operational by the end of 2015.

- *Arrears payments will continue to advance in tandem with progress in auditing and verification of paid arrears.* The High State Audit will continue to participate in regular meetings of the Arrears Clearance Committee. In addition, the audit by the external auditor of nontax claims paid will continue. We expect to have 75 percent of non-tax claims paid through end of January 2015 to be audited by April 2015. Similarly, the verification of arrears payments on tax refunds is expected to be completed by April.

- *We commit to introducing a valuation-based property tax by end 2016.* A working group has been established and different options are being reviewed. The reform will be undertaken in consultation with TA from the IMF. As a first step, we plan to introduce a fiscal cadaster to assess tax for each property by the end of 2015.

- The changes to the regulatory framework for investment funds on asset valuation and liquidity requirements, initially expected by the end of September 2014, have not been completed due to the need for additional technical assistance from the IMF and World Bank. We expect these changes to be completed by June 2015 *(ii) Reforms in pensions and energy*

Pensions

Pension reform, approved by Parliament in July 2014, has become effective in 2015. Key features include equalizing the minimum contributory wage with the official minimum wage, increasing the contributory period and retirement age, while removing the benefit ceiling. The new law also indexes pension benefits to inflation. Persons above the age of 70 who do not qualify for pension, would receive a social pension (means tested).

We are intensifying efforts to reform the current system of disability benefits. Spending on disability benefits has risen sharply in recent years, in part because of weak controls and fraud. We are working with the World Bank on a medium term project to reform disability benefits.

More specifically Albania is implementing the following key measures with the support of the PF-DPL:

- The draft law on the supplementary pension scheme for high government officials, which increases the retirement age and the contribution rate has been prepared and will be approved by the Parliament in the first quarter of 2015.
- We will reform the disability benefits which envisage the revision of assessment criteria by introducing a new bio-psycho-social model, the establishment of a new multidisciplinary commission for the determination of disability, and the use of a management information system (MIS) to cross check accuracy of applicants' eligibility. This reform will begin in 2015 but will take time to complete and yield savings.
- Therefore for 2015 we have issued and published a decree that reduces the additional disability benefits for those pursuing higher education degrees, and the support provided to families which have more than one person with disability (currently 50-100 percent of the disability benefit).

Energy

We recognize that energy sector spending (in the form of public guarantees) poses a heavy fiscal burden. Public guarantees to the sector have increased to 3.2 percent of GDP, with a large share accruing over the past three years, contributing to an increase in public debt. The financial gap in the electricity sector is projected at US$150 million in 2014, reflecting the still low, yet increasing, level of collection, large network losses even though considerable improvements reducing losses from 45% on 2013 to 37.6% on 2014, and tariffs that were set below cost recovery. Because of these chronic structural problems and costs associated with electricity sector reform, guarantees to the sector will continue to exert significant budget pressure over the medium term. We commit to implementing an ambitious set of structural reforms in the sector that will remove the need for government guarantees by 2020. Although the energy sector's financial gap is expected to decline over time as a result of reforms, the government will be obliged to assume the fiscal burden in the meantime. We therefore aim to limit new energy guarantees (excluding rollover) to 13.1 billion lek in 2015, 8.8 billion in 2016, 5.8 billion lek in

2017, 4.8 billion lek in 2018, 1.3 billion lek in 2019, and zero in 2020. If government guarantees exceed the annual programmed amount, we commit to taking additional budgetary measures to offset the impact on the fiscal balance, including guarantees. In addition to addressing the fiscal risks in the energy sector, we are moving forward with an integrated approach to addressing problems in the sector.

More specifically Albania is implementing the following key measures with the support of the PF-PBG:

Institutional changes:

- We have prepared a draft power sector law and have submitted it to Parliament for further processing. The Government commits to carrying out all reasonable efforts to ensure that this draft law is passed. The draft power law will restructure the institutional relationship between the three public power companies responsible for generation, transmission and distribution (KESH, OST, and OSHEE) and move toward further market liberalization, in line with the EU's 2009 Electricity Directive. Specifically, the responsibility for wholesale purchases from independent producers will shift from KESH to OSHEE together with the WPS. The draft law also sets in place a schedule for moving all medium voltage customers out of the regulated tariff structure by end 2018, beginning with 35Kv customers by end-2015 (on completion, the share of de-regulated consumption would increase from 10.1 percent to 29 percent assuming the same structure of consumption of energy resulted on 2014). The draft law also clarifies the responsibilities and full independence of the Energy Sector Regulatory authority (ERE). The draft law was submitted to Parliament in December 2014, and implementation is expected to begin within the first quarter of 2015. The shift of 35KV customers out of the regulated tariff structure is as well a Structural Benchmark for December 2015 under the program with the IMF.

Tariff adjustments:

The three public power companies submitted applications to ERE for tariff adjustments which were approved by ERE and became effective in January 2015, as follows.

- Restructuring of the retail tariff for households by eliminating the subsidized lower block. As a result, the current tariff for 2012–2014 of 7.7 lek/kWh for consumption of up to 300 kWh and 13.5 lek/kWh for consumption above that threshold was replaced with a single tariff of 9.5 lek/kWh;
- increase in tariffs for commercial users by15 percent in average; and
- Adjustment in the purchase price for electricity from independent power producers to reflect current import prices, based on a benchmark price from the Budapest power exchange HUPX.

We certify that these changes are consistent with the estimated funding gap included in the fiscal framework. We will also undertake a review of our current tariff methodology, with a view to moving toward more frequent and automatic adjustments based on market pricing, in cooperation with the World Bank.

Improvements in electricity collections and legal enforcement:

- In October 2014, we launched a campaign to enforce criminal penalties for electricity theft and disconnect service for nonpayment of bills. The criminal code has been revised to make electricity theft and damages to electricity system infrastructure punishable by imprisonment rather than just an administrative offence. As a result, we were able to reduce electricity distribution losses in October 2014 to 35 percent, compared with 45 percent in October 2013. For 2014 as a whole, the distribution losses have averaged to 37.6 percent; we are committed to further reducing distribution losses by about 5 percentage points per year, to 15 percent by 2019. The level of distribution losses will be monitored as an Indicative Target under our program with the IMF.
- We are also committed to improving our collection rate on amounts billed resulting with 90 percent on 2014 to 94 percent in 2019. Our efforts in this area will be supported by a World Bank project that will finance targeted investments in priority areas to accelerate cash collection and reduce losses, including metering, grid infrastructure and upgrades to the commercial billing and collection system.
- The Government is also committed to ensuring that budgetary, non-budgetary and local government institutions make timely payment of electricity bills. These efforts will be supported by a restructuring of the state electricity companies with a view to improving efficiency. In this regard, the distribution company will have a performance management contract. We are currently in consultation with an expert who submitted a report in December. We expect a contract to be signed in mid-2015.

Shkëlqim Cani

Minister of Finance

Annex 3. IMF Press Release

Statement at the Conclusion of an IMF Review Mission to Albania
Press Release No. 14/539
November 25, 2014

An International Monetary Fund (IMF) mission led by Nadeem Ilahi visited Tirana during the period November 17 – 25, 2014 to conduct discussions on the second and third reviews of the arrangement under the Extended Fund Facility (EFF). At the end of the visit, Mr. Ilahi made the following statement:

“Albania’s economic program is on track. The IMF team reached staff level agreement with the authorities on the policies needed to complete the second and third reviews of the EFF.

“Economic growth is projected at around 2 percent this year, boosted by strong growth in exports and petroleum production, clearance of domestic government arrears, and a modest recovery in domestic demand. Output still remains below potential, however, and inflation is expected to remain low.

“Fiscal performance during the second and third quarters of 2014 was broadly in line with program targets. The authorities remain committed to achieving the fiscal deficit target for 2015 as well as limiting expenditure within the programmed envelope. Despite significant energy-related spending, the 2015 budget is expected to achieve a reduction in public debt as a share of GDP for the first time since 2010.

“Inflation expectations appear well-anchored and monetary policy should continue to be supportive of economic recovery, consistent with the Bank of Albania’s mandate of maintaining price stability. Credit growth is recovering but remains low, affected by high non-performing loans and weaknesses in contract enforcement.

“Electricity reforms are urgently needed to end the sector’s fiscal burden. The authorities have begun to take important first steps in implementing their electricity sector reform plan, developed in consultation with the World Bank. This includes curbs on electricity theft, proposals to restructure tariffs by end-2014, and institutional reform of the government-owned enterprises involved in the sector. Staff welcomes the plan to compensate the poor through targeted cash compensation.

“The IMF staff mission supports the authorities’ policy and structural reform efforts and views them as providing a credible basis for restoring economic growth and maintaining macroeconomic and financial stability.

“The Executive Board of the IMF is expected to discuss the second and third reviews under the EFF in late January 2015. Approval of the reviews would enable the disbursement of SDR 47.1 million (about euro 53 million). Albania’s 36-month EFF arrangement was approved on February 28, 2014 (see Press Release 14/81).”

Annex 4: Indicative Terms and Conditions of the Potential IBRD Policy Based Guarantee

This term sheet contains a summary of indicative terms and conditions of a potential IBRD Policy-Based Guarantee (the IBRD Guarantee) for a private-sector loan to the Republic of Albania.

This term sheet does not constitute an offer from IBRD to provide an IBRD Guarantee. The provision of the Guarantee is subject, inter alia, *to satisfactory appraisal by IBRD of the related Program, review and acceptance of the underlying financing structure and transaction documentation, and the approval of Management and the Board of Directors of IBRD in their sole discretion.*

IBRD Guarantee and Guaranteed Loan:

Guarantor:	International Bank for Reconstruction and Development (IBRD).
Borrower:	Republic of Albania.
Guarantee Beneficiaries:	Commercial bank lender(s) to be identified (the Lender).
Purpose:	The proposed Policy Based Guarantee (PFPBG) is the second development policy operation in a series of two programmatic operations designed to improve fiscal sustainability and support macro fiscal stability. The operation aims to strengthen public financial management (PFM) by addressing arrears and through tax, pensions and energy sector reform.
Guarantee Term:	[10][35] years.
Guaranteed Event:	Failure by the Borrower to repay the [principal amount] or [principal and interest amounts] of the IBRD Guaranteed Loan at [stated maturity[36]].
Guarantee Support:	The IBRD Guarantee would cover any outstanding scheduled payment of [principal] or [principal and interest] (up to EUR 200,000,000), which the Lender would have otherwise received from the Borrower under the IBRD Guaranteed Loan Agreement, but for the occurrence of a Guaranteed Event, during the period of [ ] through [ ] (**IBRD Callable Period**). [For the avoidance of doubt, the Lender shall not make any demand under the IBRD Guarantee until after the commencement of the IBRD Callable Period and then only in respect of scheduled amounts that fell due and payable during (and not prior to) the IBRD Callable Period].
IBRD Guaranteed Loan Principal Amount:	Principal amount of [EUR 250,000,000][37].

[35] To be ultimately determined based on underlying loan maturity.
[36] Structure to be determined following market soundings.
[37] To be confirmed.

IBRD Guaranteed Loan Interest Rate:	A fixed interest rate equivalent to [5][10][38] year EUR swap rate plus a margin of [ ]bp][39].
Maturity:	[5] [10][40] years.
Currency:	Euro.
Governing Law:	English Law
Negative Pledge:	The terms of the IBRD Guaranteed Loan and the IBRD Guarantee will restrict the ability of the Borrower and IBRD, as the case may be, to create certain liens on their property or assets without equally and ratably securing the IBRD Guaranteed Loan or the IBRD Guarantee, respectively.
Status of the IBRD Guarantee:	The obligations of IBRD under the IBRD Guarantee will constitute direct, unsecured obligations of IBRD ranking *pari passu*, without any preference among themselves, with all its other obligations that are unsecured and unsubordinated.
Status of the IBRD Guaranteed Loan:	The IBRD Guaranteed Loan will constitute direct, general, unconditional, unsecured and unsubordinated external indebtedness of the Borrower ranking *pari passu* with all other unsecured and unsubordinated external indebtedness of the Borrower.

IBRD Guarantee Provisions:

IBRD Policy-Based Guarantee:	IBRD will guarantee to the Lender the payment by the Borrower of up to EUR 200,000,000 of [the principal] or [the principal and interest] of the IBRD Guaranteed Loan at scheduled maturity and will agree to pay on demand from the Lender as provided in the IBRD Guaranteed Loan Agreement, the amount of such [principal] or [principal and interest] which is due and payable by the Borrower, provided that the maximum aggregate amount of [principal] or [principal and interest] for which IBRD shall have liability shall not in any circumstances exceed the amount of the IBRD Guarantee as described above (*see Guarantee Support).*

[38]10 year or weighted average of 5 year and 10 year EUR swap rates
[39] To be confirmed.
[40] To be confirmed.

Demand Notice for Payment under the IBRD Guarantee:	The Lender will notify IBRD no later than thirty (30) business days after the scheduled maturity date of any amount of [principal] or [principal and interest] that has fallen due and payable and remains unpaid after the scheduled maturity date. Such notice shall also constitute a demand on IBRD for payment. IBRD shall have 30 days from and inclusive of its receipt of such demand notice to make payment in respect thereof. The obligations of IBRD under the IBRD Guarantee constitute a guarantee of payment and not of collection. Any demand notice must be received by IBRD within thirty (30) business days of the date any amount of [principal] or [principal and interest] referenced in such demand notice becomes due and payable under the IBRD Guaranteed Loan Agreement.
Reduction of Demand:	If after the Lender has made a demand on IBRD for payment under the IBRD Guarantee but before IBRD has made payment of the amount so demanded, the Borrower pays the Lender (or the Lender recovers otherwise than from IBRD) any sum which is applied to the satisfaction of the whole or any part of the such [principal[or [principal and interest] amount, the Lender shall promptly notify IBRD of such fact and IBRD's liability under the IBRD Guarantee in respect of such demand shall be reduced by an amount equal to the portion of [principal] or [principal and interest] so paid by the Borrower (or so recovered by the Lender) and so applied.
No Discharge:	Neither the obligations of IBRD under the IBRD Guarantee nor the rights, powers and remedies conferred upon the Lender with respect to IBRD by the IBRD Guarantee or by applicable law or regulation shall be discharged, impaired or otherwise affected by: (i) any insolvency, moratorium or reorganization of debts of or relating to the Borrower; (ii) any of the obligations of the Borrower under the IBRD Guaranteed Loan Agreement being or becoming illegal, invalid, unenforceable, void, voidable or ineffective in any respect; (iii) any time or other indulgence being granted to the Borrower in respect of its obligations under the IBRD Guaranteed Loan Agreement or (iv) any other act, event or omission (other than the failure of the Lender to make a demand under the IBRD Guarantee) which might otherwise operate to discharge, impair or otherwise affect any of the obligations of IBRD under the IBRD Guarantee or any of the rights, powers or remedies conferred on the Lender by the IBRD Guaranteed Loan Agreement or be applicable law or regulation.

No Amendment without IBRD Consent:	The IBRD Guarantee shall terminate and any written demand from the Lender pursuant to the IBRD Guarantee shall be void if any amendment is made to the IBRD Guaranteed Loan Agreement, or any waiver or consent is given in writing with respect thereto, without IBRD's prior written consent.
IBRD Obligations Binding:	IBRD's obligations under the IBRD Guarantee shall be binding upon IBRD and inure to the benefit of the Lender and shall be enforceable only by the Lender, provided that the obligations of IBRD under the IBRD Guarantee shall not be treated as a separate obligation of IBRD independent from the [principal] or [principal and interest] amount guaranteed, and the benefit of such obligations may only be transferred by a Lender in accordance with the provisions below, as more fully described in the IBRD Guaranteed Loan Agreement.
Assignment:	Except as IBRD may otherwise agree, any assignment of the IBRD Guaranteed Loan may be made only to an assignee established as a bank or financial institution duly licensed to carry out banking or financial business in its country of domicile. Such assignee may be a partly or wholly government-owned institution, but cannot be an export credit agency, multilateral institution or state entity. Such assignee must not have been declared ineligible to be awarded an IBRD- or IDA-financed contract in accordance with World Bank Sanctions Procedures and must not be an entity included on the consolidated list of individuals and entities maintained by the United Nations Security Council Committee established pursuant to United Nations Security Council Resolution 1267. The assigning Lender shall provide advance notice of potential assignments to IBRD as provided in the IBRD Guaranteed Loan Agreement.
Subrogation:	Upon payment by IBRD of amounts under the IBRD Guarantee, IBRD shall, to the extent it has not been reimbursed by the Borrower under the Indemnity Agreement (as discussed below), be immediately entitled to recover from the Borrower the amount so paid by IBRD in respect of [principal] [principal and interest] and for this purpose IBRD shall be immediately subrogated to the rights of the Lender to the extent of the amount in respect of [principal][principal and interest] so received by such Lender, regardless of whether such Lender has been fully prepaid or repaid by the Borrower, and the Lender shall forthwith assign or transfer to IBRD, without representation, warranty or recourse, all of such Lender's claims, interests, rights and security which it then has against Republic of Albania under the IBRD Guaranteed

	Loan Agreement in respect of [principal][principal and interest] so received.
Withholding of Payment:	If at any time between the effective date of the IBRD Guaranteed Loan Agreement and the maturity date of the IBRD Guaranteed Loan (i) there is substantial evidence that the Lender has, in connection with the IBRD Guaranteed Loan, engaged in fraudulent, corrupt, coercive or collusive practices or (ii) the Lender has been declared ineligible to be awarded a contract financed by the International Bank for Reconstruction and Development or the International Development Association in accordance with the World Bank Sanctions Procedures, then IBRD shall be entitled to withhold payment of all amounts otherwise payable under the IBRD Guarantee by IBRD on account of such Lender.
Role of IBRD:	The Lender will acknowledge and agree that IBRD will be acting under the IBRD Guaranteed Loan Agreement solely in its capacity as guarantor of the [principal][principal and interest] of the IBRD Guaranteed Loan as provided therein and in no other capacity. IBRD shall incur no liability under the IBRD Guaranteed Loan Agreement nor have any other duties or responsibilities, except to the extent expressly specified in the IBRD Guaranteed Loan Agreement or in any document delivered by IBRD under or pursuant to that agreement.
Cross-Default Restriction:	IBRD may require a cross-default-related provision in the IBRD Guaranteed Loan Agreement, including a restriction on the ability of the Lender to accelerate the IBRD Guaranteed Loan upon a default by the Borrower under any World Bank loans such that the IBRD Guaranteed Loan may only be accelerated in the event of a material default on World Bank loans.

IBRD Guarantee-Related Fees:

IBRD Guarantee Fees:	IBRD charges a guarantee fee of 0.5% per annum [for up to 8 year avg life][41] on the present value of IBRD's exposure under the IBRD Guarantee, payable up front in advance by the Borrower. If Guarantee Fee not paid upfront in advance, IBRD may terminate the IBRD Guarantee if the IBRD Guarantee Fee is not paid by either of the Borrower or the Lender on or before

[41] For a guarantee with a avg life of 8-10 years, a maturity premium of 10bp would be applied, rendering a guarantee fee of 0.60% applied to the NPV of IBRD's exposure

	the fourteenth (14th) business day following the date of a notice provided by IBRD to the Lender.
IBRD Front-end Fees:	IBRD charges a one-time front-end fee of 0.25% of its maximum exposure (in this case, an amount of up to EUR 200,000,000) for Policy-Based Guarantees. This fee is payable by the Borrower.
Stand-by Fees:	TBD.

Conditions Precedent to the IBRD Guarantee:

Conditions Precedent:	Usual and customary conditions for financing of this type, including: a) Satisfaction of relevant programmatic conditions, in form and substance acceptable to the IBRD; b) Delivery of relevant legal opinions, in form and substance acceptable to the IBRD; c) Payment in full of the Front-end Fee and the Guarantee Fee; and d) Execution and delivery of (i) an IBRD Guaranteed Loan Agreement among the Lender, the Borrower and IBRD and (ii) an Indemnity Agreement between IBRD and the Borrower.

IBRD Documentation:

IBRD Guaranteed Loan Agreement:	The terms and conditions of the IBRD Guarantee would be contained in the IBRD Guaranteed Loan Agreement among IBRD, the Borrower and the Lender. IBRD will represent and warrant to the Lender that (in addition to standard representations about due authorization, capacity and enforceability) its obligations pursuant to the IBRD Guaranteed Loan Agreement rank *pari passu* with all other unsecured and unsubordinated obligations of IBRD. The Lender will represent and warrant that it has not engaged in and are not engaging in fraudulent, corrupt, coercive or collusive practices, and will covenant, *inter alia*, to apply all amounts received by them under the IBRD Guaranteed Loan Agreement towards payment of the

	[principal][principal and interest] amounts covered by the IBRD Guarantee which were the subject of the demand notice.
Indemnity Agreement:	The Borrower would enter into a separate Indemnity Agreement with IBRD. Under the Indemnity Agreement, the Borrower would undertake to indemnify IBRD on demand, or as IBRD may otherwise determine, for any payment made by IBRD under the terms of the Guarantee. The Indemnity Agreement will follow the legal regime, and include dispute settlement provisions, which are customary in agreements between member countries and IBRD. Any obligation by the Borrower to reimburse IBRD for payments made under the IBRD Guarantee will rank *pari passu* with all other external indebtedness of the Borrower, including external indebtedness of the Borrower to IBRD. The Indemnity Agreement will also contain provisions on the deposit and use of proceeds of the IBRD Guaranteed Loan. The Borrower shall agree to deposit the proceeds of the IBRD Guaranteed Loan in an account acceptable to IBRD, with appropriate tracking of amounts deposited therein in the Borrower's budget management system. The Borrower will make withdrawals from such account for use in support of its development policy program, and will agree not to use such withdrawals to finance any excluded expenditures, which shall include, *inter alia*, goods included in groups or subgroups of the United Nations Standard International Trade Classification, Revision 3, military goods, environmentally hazardous goods, certain payments prohibited by a decision of the United Nations Security Council taken under Chapter VII of the Charter of the United Nations, or expenditures with respect to which IBRD determines that corrupt, fraudulent, collusive or coercive practices were engaged in by representatives of the Borrower. If any such withdrawals are used for excluded expenditures, the Borrower shall deposit an equivalent amount in the account or prepay the Lender an equivalent amount. In the event that the Borrower fails to make any payment to or to indemnify IBRD under the Indemnity Agreement or otherwise defaults on its obligations under the Indemnity Agreement, IBRD shall be entitled, in addition to any other rights and remedies it may have, to suspend or cancel in whole or in part the Borrower's right to make withdrawals under any loan or guarantee between IBRD and the Borrower or under any development credit agreement or financing agreement between IBRD and the Borrower, or to declare the outstanding principal and interest of any such credit or loan due and payable immediately.

Annex 5: Rationale for a Policy Based Guarantee

1. **The proposed PBG supports the government's medium-term debt management strategy.** Albania's debt management objectives are to meet the funding needs of the central government, minimize borrowing costs within an acceptable level of risk and support the development and efficiency of the domestic debt market. This PBG is expected to: (a) reduce Albania's borrowing costs; b) alleviate government funding pressures and risks; and c) free up commercial bank resources for credit to the private and the energy sector.

2. **The PBG would enable the Government to secure the needed financing at a reasonable cost, while minimizing transaction risk in a climate of volatility.** The proposed PBG would allow Albania to borrow at improved terms, including longer tenor (7-10 years) and lower rates (3-4 percent). The PBG rates would be significantly below the rates available to Albania for an external bond or syndicated loan in today's currently supportive but uncertain market environment in the absence of an IBRD guarantee. The perceived transaction risk will be reduced by engaging lending banks directly. Pricing can be guaranteed ex ante through a loan operation that requires potential lenders to make committed offers of financing. The cost-structure of a public bond, on the other hand, would be difficult to lock in at an earlier stage and would be vulnerable to market volatility at the time of closing. The PBG is also expected to lead to financing diversification for Albania, by initiating interest among large foreign banks and financial institutions that may currently have little exposure to the country.

3. **Reducing transaction risk and further diversifying the investor base is particularly important given the uncertainty of the external environment and as the demand for longer-term domestic government securities has declined in recent months.** Funding costs in external markets have reached a record low in the last year, but spreads for countries with Albania's risk rating have increased appreciably in recent weeks. At the same time, demand for longer term domestic government securities has declined in recent months as the largest holder of government securities has started to reduce its risk-weighted assets in Albania.[42] Forty-four percent of Albania's debt is held by three commercial institutions, making Albania vulnerable to changes in their investment strategies. Albania's secondary securities market is undeveloped. The PBG would enable the government to meet its funding needs without increasing its share of short-term domestic debt. Albania's short term debt already constitutes 30 percent of total government debt in 2014, contributing significantly to roll-over risk and interest rate risk.

4. **Moreover, Albania's financing needs in 2015 are high.** Central government gross financing needs in 2015 amount to 31.0 percent of GDP. Besides covering the budget deficit of 4.8 percent to GDP, Albania must repay 21.7 percent of GDP in domestic debt, the 2010 Eurobond and 1.7 percent of GDP on foreign financing project loans.

[42] A similar deleveraging occurred in 2013, but the shortfall was absorbed by other banks and a newly created investment fund. Other market participants are, however, unlikely to increase their demand for government securities this time around.

Table 7: General Government Financing Needs and Sources
(Percent of GDP)

	2010	2011	2012	2013	Est. 2014	Proj. 2015	2016	2017	2018	2019
	Percent of GDP unless otherwise indicated									
Gross financing needs	**28.0**	**24.8**	**26.7**	**29.0**	**34.7**	**30.9**	**27.9**	**22.5**	**20.3**	**18.8**
Primary deficit (- is surplus)	-0.3	0.4	0.3	2.0	2.8	1.5	-0.6	-2.6	-2.5	-3.0
Interest payments	3.4	3.2	3.1	3.2	2.8	3.3	3.2	3.1	3.0	2.9
Debt amortization	24.9	21.3	23.2	23.9	29.0	26.1	25.3	22.0	19.9	18.9
Domestic	22.2	20.7	22.4	23.0	27.7	21.6	23.7	20.4	18.3	17.5
Short term debt	19.2	17.8	18.1	18.3	22.8	17.3	19.0	18.5	17.3	16.5
Medium & long term debt	3.1	2.9	4.4	4.6	4.9	4.3	4.6	1.8	1.1	1.0
External	2.7	0.6	0.8	0.9	1.3	4.5	1.6	1.6	1.5	1.4
Private creditors	2.2	0.0	0.0	0.0	0.0	2.8	0.0	0.0	0.0	0.0
Official creditors	0.5	0.6	0.8	0.9	1.3	1.7	1.6	1.6	1.5	1.4
Gross Financing Sources	**28.0**	**24.8**	**26.7**	**29.0**	**34.7**	**31.4**	**27.9**	**22.5**	**20.3**	**18.8**
Privatization receipts	0.0	0.0	0.1	1.2	0.0	0.1	0.0	0.0	0.0	0.0
Use of Government deposits	0.0	0.0	-0.1	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Domestic market access	23.1	22.9	24.3	26.5	31.3	22.9	24.5	20.4	18.8	17.4
Short term debt (t-bills)	18.7	18.6	18.7	23.8	18.3	18.6	19.9	18.6	17.8	16.4
Medium and Long term bonds	4.5	4.3	5.6	2.7	13.0	4.3	4.6	1.8	1.1	1.0
External financing	4.8	1.9	2.4	1.6	3.3	8.4	3.4	2.1	1.5	1.4
Private creditors	3.3	0.0	0.0	0.0	0.0	5.3	0.0	0.2	0.0	0.0
of which: Energy Guarantees	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.2	0.0	0.0
of which: PBG	0.0	0.0	0.0	0.0	0.0	2.3	0.0	0.0	0.0	0.0
of which: Eurobond	3.3	0.0	0.0	0.0	0.0	2.8	0.0	0.0	0.0	0.0
Official creditors	1.5	1.9	2.4	1.6	3.3	3.1	3.4	1.9	1.5	1.4
of which: IMF	0.0	0.0	0.0	0.0	0.5	1.4	0.9	0.3	0.0	0.0
of which: IBRD	0.0	0.0	0.0	0.0	1.6	0.0	0.7	0.0	0.0	0.0
Memorandum Item										
Total PPG Debt	57.7	59.4	62.0	70.0	71.0	70.7	68.1	64.4	60.9	57.1

Source: Albanian Ministry of Finance; World Bank staff estimates and projections.

5. **The PBG may also help to free up credit to the private sector.** Credit growth has been low due to a high level of NPLs and lack of bankable projects. In addition, high domestic government financing needs have provided a good investment opportunity for the financial sector at a time of higher risk aversion. Reduced domestic issuance could catalyze lending for alternative private sector investments.

6. **The PBG would help leverage the Bank's capital.** The proposed PBG would leverage better the World Bank's capital by helping Albania to increase the total volume of funding raised. In order to maximize debt capacity, the PBG will guarantee a partial amount of debt service, between 60-70 percent of principal and interest. This will allow Albania to raise a sizable commercial loan of at least EUR250 million, out of which about EUR200 million would be guaranteed by IBRD. The loan would carry a higher interest rate compared to a full principal guarantee, but the terms achieved will be substantially better than under a non-guaranteed instrument.

7. **The recent experiences of middle-income borrowers who have used PBGs to support market access have been favorable**. For example, in 2012 FYR Macedonia undertook a PBG-supported EUR130 million commercial loan, which extended the maturity of government debt? by 50 percent and produced a savings of at least 300bp p.a. More recently, the same Government

availed itself of another PBG in 2013 to raise at least EUR 250 million, achieving longer maturities and similar levels of savings, through an even more leveraged structure. The experience of neighboring Montenegro and the earlier experience of Serbia is also encouraging.[43] Neither country had real market access and both utilized PBGs to raise funding under very attractive terms, significantly better than those expected on a standalone basis at that time. Moreover, the latter PBG-backed transactions paved the way for subsequent standalone funding transactions by all three borrowers. Montenegro and FYR Macedonia have each issued an unenhanced Eurobond under very favorable terms since using the PBG, and Serbia has raised over $5 billion in the bond market.

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[43] In July 2012, Montenegro borrowed with the support of a PBG, EUR100 million during a period of heightened volatility and greatly impaired market access at an otherwise unavailable maturity and with an estimated savings of up to 400bp p.a. Serbia raised EUR292 million and achieved a doubling of its tenor and an improvement in borrowing costs of at least 400bp through a PBG-supported transaction that closed in February 2011.

Annex 6: Debt Sustainability Analysis

1. **This DSA projects the public debt trajectory through 2019 under a baseline scenario with "most likely" assumptions and examines the robustness of the baseline to changes in the underlying assumptions.** The key assumptions underpinning the baseline scenario are related arrears clearance, economic growth, key fiscal variables, energy sector related contingent liabilities, and financing parameters:

   - **The clearance of arrears amounting to 5.2 percent of GDP in 2014, 2015 and 2016.** The clearance schedule assumes three annual payments of Lek 35 billion, Lek 20 billion and Lek 16 billion in 2014, 2015 and 2016, respectively. Arrears are reflected in the 2013 public debt stock.

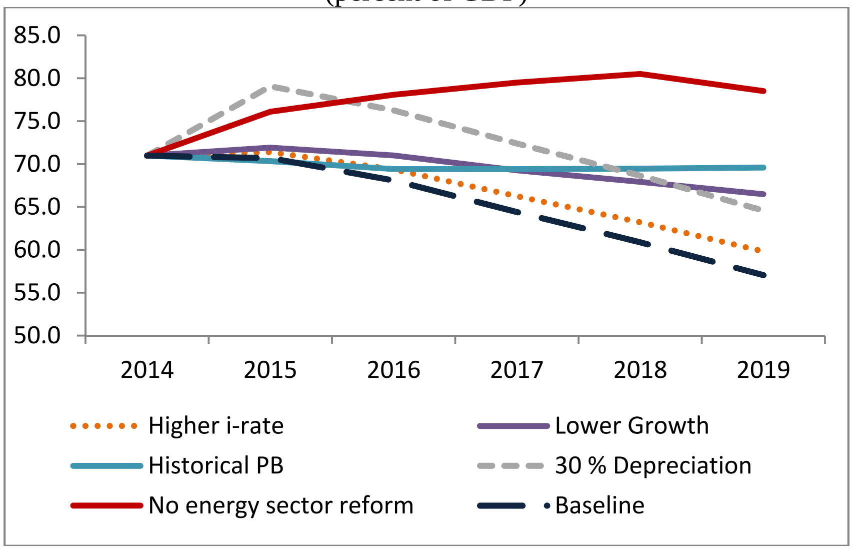
   - **A gradual pick-up in economic growth.** Growth is expected to recover to 3 percent in 2015 and remain at 3.5 percent until 2019. This is below Albania's ten-year average of 4.6 percent and close to its five-year average of 3.7 percent. Gradual recovery in the external environment, increased FDI and higher domestic demand are expected to sustain economic growth.

   - **Fiscal consolidation.** Public revenues are projected to remain at a historically high 28.2 percent of GDP from 2016 onward as a result of new tax policy and administration measures. The primary balance is projected to turn into a surplus from 2016 onward.

2. **Under the baseline scenario, public debt is projected to peak at 71 percent of GDP in 2014 and then gradually decrease to 57.1 percent of GDP by 2019.** Net external government borrowing is estimated to amount to 2 percent of GDP in 2014, peak at 3.9 percent of GDP in 2015 and decline gradually thereafter. Net domestic government borrowing requirements are expected to reach 3.7 percent of GDP in 2014 and then decrease to 0.9 and 0.8 percent of GDP in 2015 and 2016, respectively.

3. **The public debt trajectory is vulnerable to changes in policies, growth, financing terms and the exchange rate.** Failure to implement the planned fiscal consolidation and keeping the primary deficit at the ten-year historical average would push up public debt to 69.6 percent of GDP by 2019. Even if the fiscal effort remains on track, a negative shock that permanently reduces GDP growth by 1.2 percentage points (half a standard deviation from its 10-year average) throughout the projection period would keep public debt well above 60 percent by 2019. An increase in interest rates by 200 basis points is projected to lead to a public-debt-to-GDP ratio of 63 percent in 2019. If the Albanian Lek were to depreciate by 30 percent in 2015, public debt would rise to 79.1 percent of GDP and then fall to 64.6 percent of GDP by 2019.

Figure 1: Albania's Public Debt-to-GDP Trajectory
(percent of GDP)



Source: WB Staff projections.

4. **Contingent liabilities emanating from the energy sector are a source of fiscal risks.** About 98 percent of Albania's energy is generated from hydropower. Recurrent energy shortages due to fluctuations in rainfall, persistently high distribution losses (about 43 percent in 2013) and regulated tariffs below energy costs, have resulted in sustained fiscal support from the government, in the form of guarantees for power imports and liquidity injections, to the energy generation company KESh.[44] Government liabilities could also arise if OSHEE's unfunded deficit would be reduced though government subsidies rather than tariff adjustments. In the absence of any energy sectors reforms, liabilities from the energy sector could undo the gains from fiscal consolidation over the medium term.

[44]As of mid-2014, the commercial overdraft of KESh was US$340 million (about 2.5 percent of GDP).