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Letter of Development Policy

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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

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 starting 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 Sector 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<sup>th</sup> to 60<sup>th</sup> 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 1<sup>st</sup> 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.

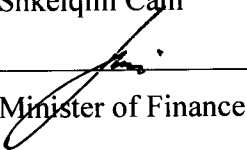
- Restructuring of the retail tariff for households by eliminating the subsidized lower block. As a result, the current tariff for 2012–2014 of 7.7 lek/kWh for consumption of up to 300 kWh and 13.5 lek/kWh for consumption above that threshold was replaced with a single tariff of 9.5 lek/kWh;
- increase in tariffs for commercial users by 15 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