

INSTITUTIONAL REFORM IN ALBANIA

Gjergj Konda

IFC

Dear Colleagues,

I am very honored to appear before this audience today. It is a great pleasure to meet with many of you who have witnessed the extraordinary efforts of Albania towards the transition process, unquestionably a watershed in the history of the country.

The sense of growing normalcy is in many ways the main achievement of Albanian economic policy during the past 10 years,

and especially during the past three years. Something irreversible has been accomplished, to the extent that this can be said. Having the chance to be associated with this transition for almost 5 years, during 1991-95, I would like to focus more on earlier institutional reforms, some of the lessons learned, and current challenges Albania is facing at present.

INTRODUCTION

Ten years have passed since Albania became a member of the World Bank and the International Monetary Fund. It has been the period of greatest transformation in the country's history, evolving the entire spectrum of political, economic, and social life. Going back in time, we are amazed by what Albania has been able to achieve in these ten years.

It took enormous efforts by many governments, politicians, economists, and an entire army of intellectuals to move the country towards freedom, democracy, and market economy. It was the steadfast support, professionalism, passion, and love of many teams with specialists from the IMF, the WB, the EBRD and other international and bilateral institutions, among the best in the world, that helped Albania make its dream come true.

We are now together with a question in mind: what have we learned and where shall we be going. With 75 percent of GDP produced in the private sector, Albania is a market economy. However, the transformation of the society is far from complete. True, the market will help more efficient allocation of resources. Still, a sustainable development depends on the entire transformation of the society where institutions do matter a lot.

EARLY TRANSITION PROCESS – A NEO-CLASSICAL APPROACH

Certainly, the institutions have been a centerpiece of the reform throughout the transition process. As a multidimensional process, the institutional³³ reform is a very difficult topic with neither simple

³³ When I talk about institutions and institutional reform, I have in mind the set of rules that shape the behavior of organizations and individuals in a society. They can be formal (constitutions, laws, regulations, contracts, internal procedures of specific organizations) or informal (values and norms). Organizations are sets of actors who collectively pursue common objectives. In this context the term "institutions" and "organizations", which are often used as synonyms in Albania, is

recipes nor one single model to be followed. Albania entered the transition to market economy with a completely new political leadership, committed to radical economic and institutional reforms. With no history of autonomous rule and 45 years of dictatorship, Albania didn't have its own model of market institutions. In 1951, the communist government abrogated constitutional provisions on the civil liberties and administration of justice. Human rights and judicial independence was close to nonexistent, and courts became instruments of the state. The centralized economy had a set of institutions virtually not applicable to the new system where Albania was inspiring to embark on.

Emerging in modern times from fifty years of the most isolationist totalitarian regime was a decisive factor why the new political leadership supported a neo-classical or neo-liberal economic perspective on development. This approach, which dramatically shrinks the role of the state and liberalizes the participation of private sector, played an important role in terms of future institutional reforms in Albania. Other countries had adopted the view that market failure is endemic in development and assigned a larger role to the state.

An intermediate position is commonly taken by proponents of the so-called "New Institutional Economics" which view the state and the institutions that comprise it as endogenous to the development process. They view the design and functioning of public sector institutions and private sector organizations that interact with these institutions, as critical determinants of the country's development prospects. Albania has been gradually shifting towards that approach in the course of the transition process.

SHOCK THERAPY AND INSTITUTIONAL REFORM

As many other former communist countries, in the early 1990s Albania was facing two major challenges: dealing with the legacy of the past and investing for the future. Transition started as a complex process of constructive distraction, of creation and adoption of new institutions. As previously mentioned, the approach of new political leadership was neoclassical one assuming that markets are "perfect". The shock therapy approach,

not the same concept. Reforming institutions, under this broad definition, means reforming rules.

in terms of liberalization, privatization, and stabilization was designed and implemented. It included liberalization of the economy, macroeconomic stabilization, as well as creation of the institutions needed for a competitive market economy. In mid 1992, the authorities took decisive steps to establish fiscal and monetary control, and introduced comprehensive price, trade, and exchange rate reforms.

The exchange rate stabilization implementing a floating market-determined exchange rate, and bringing inflation under control rapidly (while price liberalization was generally followed by persistently high inflation in most other transition economies), were two impressive episodes. Albania moved quickly towards macroeconomic stabilization and structural reforms. This is now history.

Macroeconomic stability has been a success story. Without underestimating the complexity of the economic changes, Albania's progress early in the transition process has been particularly obvious in the areas where necessary development of formal institutions and behavior of informal institutions, be they in the government or in the private sector, was less demanding. Institutional design was often oriented towards political feasibility. Therefore, while institutional reform was more rapid in areas where the political cost of adapting to the new rules was lower, such as price and trade liberalization and small-scale privatization, it was much slower in the areas of asset redistribution, competition policy, and financial sector and legal reform.

From this perspective, the shock therapy approach didn't succeed and, as a matter of fact, couldn't apply to the area of the institutional reform. One good reason might be the complexity of the institutional reform as a change of the fundamental "rules of the game", involving the political, social and economic institutions that shape the behavior of citizens. The friction between formal institutions (new laws and regulations) and the legacy of informal institutions (conventions and moral values) was also a limiting factor. Early reforms eliminating of price distortions, opening markets to competition, deregulation, unifying exchange regimes, and small-scale privatization, represent an organic and important stage of market institution building process. However, these reforms are of a different nature compared to the development of market-enhancing institutions. While the former mostly capture measures that can be introduced within a short time frame, the later by their very nature take much longer to develop.

Therefore, the path to transition is much longer than we thought. It is a lengthy process of institutional changes including the entire set of economic, legal and social incentive structures governing the human economic behavior. During this process Albania has been facing many obstacles that were mostly of historical origin. The lack of democratic institutions and private business, and the legacy of informal institutions have been among the most important factors that shaped the institutional reform in Albania. However, the country didn't have to create its institutions from scratch. International agreements and internationally recognized standards such as WTO procedures or international banking standards were good models to be followed.

While with on one hand Albania aggressively adopted codes and hundreds of new laws and regulations, on the other hand, it was generally ineffective in implementing them. Some reasons can be summarized as follows:

- Authorities tried to quickly change the legislative framework to meet the requirements of the new economic system. The laws have to be clearly written and, thus, are not subject to conflict interpretation. Given the capacity of the administration at that time, creating a new, qualitative legal framework in a short time span was an extremely difficult task.
- The legal system has to be coherent, with laws and codes not conflicting each other. Every time a new law is enacted, all existing laws should be checked to ascertain that they are consistent with the new law. Since this was practically impossible, legal inconsistencies arose creating confusion for the institutions in charge of implementation.
- Because of inconsistencies, the authorities had to frequently change the laws and regulations, which increased the difficulty of coordinating them in a consistent way.
- The enforcement cost of the new rules was substantially high because they were not matched by the set of exiting self-enforcement informal rules.
- Regulations were weak and were left to bureaucrats for interpretation. This became one of the major causes of arising corruption.

Under a weak legal system, a well functioning court system would be indispensable to enforce legislation. Unfortunately, the judiciary system has been very weak as well. As a result, the system has not been effective in protecting individuals and property, enforcing contracts, and punishing individuals who break the law. Public confidence in the judiciary institutions has been decreased. System inefficiencies have provided an incentive to tax evasion, corruption, and other crimes.

INSTITUTIONAL REFORM – A TOP PRIORITY FOR THE COUNTRY

Market led-growth supported by good governance and consolidated free market institutions is a precondition for sustainable growth. Good macro policy alone is not enough; good institutions are critical for macroeconomic stability as well as for sustainable economic growth. This lesson of experience has been re-emphasized in 1997, when Albania experienced the pyramid schemes crisis. This tragic event explains how the delays and inconsistencies in institutional reform could destabilize the economy and jeopardy earlier achievements. Institutional reform remains a major medium-term challenge for the country. It might affect the economic growth through three channels:

- (a) the quality and efficiency of financial and public services, education, and judicial system. Institutional reform in these areas would enhance the private sector competitiveness, which in turn contributes to long-term economic growth.
- (b) pressure from exogenous factors promoting globalization, such as technological, economic, and demographic trends, and trade and financial liberalization. Building up good institutions is a precondition shall Albania aspire to be part of the European integration process.
- (c) increased financing for investment, foreign and domestic. Consolidation and strengthening of institutions, policies, and behaviors that underpin a well-functioning market economy would improve the investment climate. Albania's comparative advantage of geographical position combined with the rule of law, political stability and efficient institutions, is all the country needs to develop rapidly and to catch up with other more advanced transition economies.

The institutional reform is an ongoing process with medium term challenges falling into four areas: fighting corruption, improving business environment, increasing efficiency of the judiciary system,

and creating conditions for fair competition. Albania has been facing the risk of moving from a black market economy to an unofficial economy. The “c” word – **corruption**, is becoming major impediment to development. The use of public office for personal gains retains a strong impact on institutional performance. There is a strong evidence on the correlation between the level of corruption and the quality of services offered by institutions such as customs service, tax offices, health services, courts, electricity and water supply etc. Institutions have to protect the property and contract rights against violation by third parties as well as by the state. The challenge ahead is how to stop a handful of individuals from monopolizing the economic growth benefits, how to replace the “grabbing hand” by the “invisible hand”. This is easier said than done. Experience of many other countries show that it is easier to fight hyperinflation than to prevent hypercorruption. The stakes are too high and the magnitude of the task requires greater collaboration among all institutions in Albania.

Weak institutional and governance capacities undermine the **business environment**. Private entrepreneurs, domestic and foreigner, report having problems with enterprise, land and tax registration, dealing with the customs administration and the courts, and with unfair competition. Albanian society is increasingly demanding for missing institutional infrastructure through the political process. The industrial and financial enterprises, and primarily the SME sector, are now realizing that their interests are exposed to high risks by the lack of sound institutions. Financial intermediaries rely heavily on the legal system of private property rights. They need legal powers to effectively monitor firms, especially when firms run into trouble, and need a legal basis to enforce their claims. Clear rules and procedures are also necessary for secured lending, collateral recovery, and bankruptcy.

Although Albania has made progress approving a complex **regulatory framework** necessary for the formation and functioning of private enterprises, effective and fair enforcement of law remains a major weakness. Adequate company laws and commercial codes exist, but their effectiveness is undermined by gaps in implementation and the imposition of lengthy and confusing procedures. Just to give an example: although bankruptcy legislation has been in effect for nearly seven years, there has not been a single bankruptcy case. Market economy can operate only if institutions provide certain rules of the game that are widely known and coherent, predictable and credible, equal for all and evenly enforced. Inconsistent implementation and

interpretation of laws and regulations has given rise to discrimination between different types of investors. The private sector is demanding more reliable, independent, and **efficient judiciary** and requesting the state assists in modernizing the courts and increasing the salaries of judges. Hence, the role of the court system in protecting private property rights and enforcing contracts that facilitate their transfer to higher value uses has a high priority. A well-functioning court system is a necessary condition to enforce all laws. Formal enforcement mechanisms for long-term contracts are important determinant of growth. Countries with stable governments, predictable methods of changing laws, secure property rights, and a strong judiciary saw higher investment and growth compared to countries lacking these institutions.

Progress in establishing effective legislation for protection of **competition** has been slow and remains another policy priority. The middle class of businessmen is asking for antimonopoly policies and fair competition. One might say that the problem here is the market failure and Albania needs a stronger/bigger government. Speculations about the existence of a too strong or too weak state do not lead to any conclusion or might even lead to wrong conclusions. The state and market complement and not substitute each other. This is not a zero sum game in which markets expand at the expense of the state or vice versa. Albania doesn't need a bigger government. Albania needs more effective institutions. Albania has gone a long way towards capacity building and administrative reforms. However, the **governance and public sector efficiency** in delivering services remains a weakness. Civil service reforms are yet at an early stage, and the civil society is still to be adequately engaged. There is room for increasing the quality of the public sector by: (i) building up state structures that provide strong support to the open competitive market economy; (ii) fighting corruption through reduced regulation, greater transparency and use of markets, and better enforcement of the rule of law; (iii) protecting property rights; and (iv) promoting motivated and capable staff by using appropriate compensation policies and building "esprit de corps".

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