

# **ALBANIA: THE FUTURE PATH TO SUSTAINABLE DEVELOPMENT**

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**Tirane, September 2003**

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## LIST OF ABBREVIATIONS

EU	European Union
FIAS	Foreign Investment Advisory Service
GCF	Gross Capital Formation
GDP	Gross Domestic Product
GNI	Gross National Income
IMF	International Monetary Fund
INSTAT	National Institute of Statistics, Albania
LPG	Liquid Petroleum Gas
NSSED	National Strategy for Social and Economic Development
ODA	Overseas Development Assistance
SEE	South East European
WTO	World Trade Organization

## **I. EXECUTIVE SUMMARY**

The approach we have taken to examining the prime requirements for sustainable development can be summarised as:

- Examining Albania's development since transition, to identify the key factors which have driven its performance since then;
- Examining 'best practice' in relation to developing a framework for sustainable development, according to both academic and practical considerations, on a world wide basis;
- We then examined where Albania stands in relation to these. This allowed us to identify key priorities for sustainable development;
- We have included a separate section on the respective roles of government and the private sector in a free market economy, since we feel that it is vital that necessary measures are taken to ensure that both sectors carry out their appropriate roles;
- Finally, we summarise our conclusions and recommendations, and give an illustration of what has been done in other small countries through implementing appropriate measures.

As noted above, considerable attention was given to an analysis of Albania's performance since the commencement of transition, analysing evidence in relation to the key factors behind sustainable development elsewhere, and Albania's situation in relation to these. Findings in relation to these are summarised in the main paper, but fuller accounts of our conclusions are given in Appendices 1,2, and 3, attached.

The paper commences with a brief analysis of Albania's growth since transition, and lists some of the factors that we consider to have been particularly important during this period. It notes that:

- Although growth rates in recent years have been quite high, the overall growth rate since transition is more modest. In fact much of the growth has been recovery from downturns (in other words, we are not in any position to conclude that Albania has any high 'natural' long-term growth trend);
- Key factors behind the growth have been the very high remittance inflow, and more recently the growth of tourism and export industries. These key factors, combined with an increased level of domestic flows through new investments and businesses, have generated the economic growth that has helped to finance growth in government expenditure;
- By comparison with other countries with similar standards of living, Albania's domestic economy is rather fragile, with low (and unsophisticated) export market development, a massive trade deficit, a high cost structure and high unemployment. The high (and persistent) level of unemployment is a major weakness in the economy.

The paper then notes some of the findings of recent studies that have examined factors behind sustained economic growth. It notes that:

- There is general agreement that sustained economic growth is due to sustained technological progress<sup>1</sup>.
- There is general agreement that the policy framework, or “getting the basics” right, is essential<sup>2</sup>;
- The importance of initial conditions prevailing is of interest, mainly from a theoretical point of view;
- In recent years the importance of institutions (which can be summarised as the presence of clear property rights, the rule of law, and a business friendly bureaucracy) have been recognised as being of overriding importance.

We then examine Albania’s situation, and future prospects, from different points of view<sup>3</sup>, namely:

- geography (including climate, location, and natural resources);
- integration (including participation, and impediments to participation in the world economy);
- policies, and
- institutions.

We concluded that, from the point of view of future sustainable economic development, Albania has strengths in relation to geography, it is ‘on course’ in relation to integration, and the policy framework generally (with one or two reservations<sup>4</sup>), but has problems in relation to the latter factor, namely, institutions<sup>5</sup>. This is troubling since all the indications are that the institutional framework (or ‘institutional quality’) is of paramount importance.

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<sup>1</sup> This issue is not, however, particularly relevant to Albania which is at an early stage in capital accumulation, and which has ample labour resources;

<sup>2</sup> “Getting the basics right” includes a macroeconomic aspect which encourages economic growth through ensuring stable and low inflation, promoting the integrity of the financial and banking system, providing for open markets, and striving for stable and realistic exchange rates. On the microeconomic side, it requires government to ensure property rights, law and order, and adequate provision of public goods. Government should avoid high tax rates, price controls, and other distortions of relative prices.

<sup>3</sup> A significant amount of academic literature has recently examined economic growth from these angles, which are currently considered as alternative determining factors in economic growth.

<sup>4</sup> These relate to the high social security and health insurance taxes levied at low rates of income, and the setting of the minimum wage by administrative decision rather than market forces.

<sup>5</sup> For the purpose of this paper, the term “institutions” refers broadly to the rule of law, including property rights, and a business friendly bureaucracy. Another definition, by Acemoglu, defines institutions as behavioural norms and rules of human interaction in a society, particularly those relating to enforcement of property rights; constraints on the actions of elites, politicians, and other powerful groups; and a degree of equal opportunity for broad segments of society.

The study goes through the list of items that make up a ‘government accountability index’<sup>6</sup>. These include voice and accountability, political stability and the absence of violence, government effectiveness, regulatory burden, rule of law, freedom from graft, and ‘business friendly bureaucracy – other’.

Drawing largely on the findings of the recent (March 2003) report of Foreign Investment Advisory Service (FIAS), the paper notes that Albania has problems in relation to the last four issues, which are related to two critical areas, namely property rights and a business friendly bureaucracy. It notes measures specified in the NSSED to deal with the issues, but considers that these areas, nevertheless, pose the critical areas to be addressed for sustained economic growth.

The paper then looks at the respective roles of government and the private sector. It notes that whereas, in a command economy, government owns or controls the factors of production and makes the business decisions, in a market economy individuals own the means of production (either directly, or through various forms of business organisation), while it is the private sector that must make the business decisions.

In the transition from a command economy to a market economy the role of the government and private sector needs to be redefined. First of all, as a precondition, it is critical that government realize that its role is now completely transformed. The challenge facing transition governments is to, first, understand their new role, and understand it properly, and second, put in place the institutions, the policies, and the attitudes under which a market economy will function effectively.

It concludes that “ ..understanding the new role of government and putting in place the institutions, policies, and attitudes to allow the market economy to function properly is (still) the outstanding challenge.”

The paper closes by looking at Albania’s strengths and weaknesses.

The strengths include:

- a good geographical location, a good climate, and natural resources;
- openness to trade;
- openness to foreign investment;
- low tax structure, with generally low marginal tax rates;
- active pursuit of privatisation;
- competitive cost structure, by comparison with EU member states;
- an entrepreneurial population, and
- a high inflow of funds from Albanians abroad for various purposes, including investment

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<sup>6</sup> These have been slightly modified to suit the overall method of analysis applied in this paper.

The weaknesses include:

- unclear property rights;
- a business environment and bureaucracy which is far from ‘business friendly’, while corruption is widespread;
- high social security taxes at low levels of income;
- a minimum wage which is set by administrative decision rather than market forces;
- a high cost structure, by international standards.

It notes that these are serious disadvantages, which will work to slow down future growth in Albania.

It further notes that “..unless the issues are tackled urgently and with conviction, we see a major danger that the “free market” approach will be transformed into “crony capitalism”, where those with the connections get the benefits, while others lose out. As so clearly brought out in so many studies, this is not an option for sustained development.”

It notes that Albania has been in a “transition” mode for over 10 years, and it is still very much in “transition mode”. It argues that a major effort is required to get all involved into a “free market” mindset, and away from the “central command” mindset. This includes transparency in the application of all regulatory measures, reduction of scope for decision taking on specific matters by either officials or politicians, and clear rights of appeal.

The overriding concern, we believe, must be to complete the reforms necessary for full transition. In addition to changes to the relevant laws and regulations, this will require a change in the attitudes and mindset of administrative officials from a “central command and control” mentality to a “facilitation” mentality.

From the perspective of “getting the basics right” measures which governments need to implement, we believe, to ensure high and sustained growth include:

- a high-level political commitment to private property reforms, with a clear and coherent strategy to accelerate their implementation;
- promoting a business friendly bureaucracy;
- review of the financing of social security and health insurance, with a view to reducing the very high costs incurred at low levels of income; and
- allowing the market to determine remuneration levels and conditions, including minimum wages.

*The first two measures are related to institutional quality, and are fundamental for broad based economic growth. The latter two measures are policy related, aimed at removing barriers to employment growth.*

The paper closes with an illustration of what can be done when market forces are allowed to operate freely in a business friendly environment, in small countries like Albania.

## **II. INTRODUCTION AND APPROACH**

The approach we have taken to examining the prime requirements for sustainable development can be very simply summarised as examining best practice, according to both academic and practical considerations, on a worldwide basis. We then examined where Albania stands in relation to these. This allowed us to identify key priorities for sustainable development.

The paper commences with a brief analysis of Albania's growth since transition, and lists some of the factors, which we consider to have been particularly important during this period.

It then notes some of the findings of recent studies that have examined factors behind sustained economic growth.

We then examine Albania's current situation, and future prospects, from different points of view<sup>7</sup>, namely:

- geography (including climate, location, and natural resources);
- integration (including participation, and impediments to participation in the world economy);
- policies, and
- institutions.

We concluded that, from the point of view of future sustainable economic development, Albania has strengths in relation to geography, it is 'on course' in relation to integration, and the policy framework generally, but has problems in relation to the latter factor, namely, institutions.

We note that the Government is attempting to cover a wide range of measures in a wide range of fields, as is documented in the NSSED. We appreciate that there is a wide range of pressing needs, and in these cases determining priorities can be difficult.

However, we feel that, in the circumstances, the overriding requirement is to establish a clear set of priorities at an overall level, based on the most critical issues at each stage. The priorities are not "set in stone" (in that they are not set for an indefinite

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<sup>7</sup> A significant amount of academic literature has recently examined economic growth from these angles, which are currently considered as alternative determining factors in economic growth ( e.g. Acemoglu, Daron, Simon Johnson and James A. Robinson, 2001, " The Colonial Origins of Comparative Development: An Empirical Investigation", American Economic Review, Vol 91 (December); Jeffrey D. Sachs "Institutions Matter, but Not for Everything", Finance & Development, June 2003, or Hali Edison "Testing the Links", also Finance & Development, June 2003)

period), they are not set out as the only priorities that matter, but are they set out as those which should be emphasised as giving the highest returns at this point in time<sup>8</sup>.

Over time, we would expect priorities to change as relevant measures are implemented, and as the economic framework changes.

### **III. BACKGROUND**

Appendix 1 examines Albania's economic performance since independence, and the factors behind realised growth. It then goes on to compare some key characteristics of the Albanian economy relative to both other lower-middle income economies of the world, and lower and middle income economies of Europe and Central Asia, in particular.

The main conclusions are:

- While real growth has averaged 6.6 per cent a year from 1993 onwards, from 1990 the real average rate of growth has been 2.1 per cent annually. Much of Albania's so-called "high growth" has been recovery rather than real growth;
- The main factors behind the growth have been:
  - the high inflow of expatriate remittances;
  - the growth in tourism income in recent years; and
  - growth of exports;

These key factors, combined with an increased level of domestic flows through new investments and businesses, have generated the economic growth that has helped to finance growth in government expenditure;

- By comparison with other countries which have similar standards of living, Albania has:
  - a very small export base, and consequently a huge trade deficit;
  - relatively unsophisticated export market development;
  - very high levels of overseas development assistance (ODA) on a per capita basis;
  - a high cost structure;
  - fairly high rates of taxation; and
  - very high rates of unemployment.

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<sup>8</sup> We would point out that implementing measures that give the highest rates of return, at any point in time, will also lead to the highest provision of revenues for implementing of other priorities.

The high dependence on expatriate remittances, the large trade deficit, high dependence on aid, and very high rates of unemployment, are indications of a relatively weak domestic economy. Economic growth in any year, and the flow-ons from economic growth, are dependant on outside factors. The high (and persistent) level of unemployment is a major weakness in the economy.

#### **IV. EMPIRICAL EVIDENCE ON ECONOMIC GROWTH**

There has been a long running debate over the nature of growth: whether it is just an accumulation of manpower and machinery, or is it the result of the latest technology? What are the roles of government, compared to investment and exports, and what is the importance of economic conditions prevailing at the very beginning of periods of extended growth? Finally, what is the relative importance of the institutional framework in economic growth? The answers to these questions are paramount to those countries wishing to embark on periods of extended growth, including Albania.

We now look at the conclusions drawn from examinations of empirical evidence in relation to the factors determining economic growth. We note that there are overlaps, in particular between classifications of certain factors as either ‘policy-related’ or ‘institution-related’, in the studies. This does not, however, detract from conclusions reached.

##### **IV a) Manpower, machinery and technology**

We turn first to the role of manpower, machinery and technology in economic growth.

Looked at from an accounting perspective, there are three elements that determine production of goods and services: labour, capital, and technology. Labour and capital, the factors of production, refer to the workforce and the capital goods (buildings, machines, vehicles) that the workforce uses in manufacturing some product or providing some service. Technology refers to all the methods employed by capital and labour to produce a good and depends on the development or acquisition of practical skills to get the job done more quickly and more efficiently.

It is now agreed that only by significant and sustained technological progress is it possible to achieve a sustainable rate of economic growth. This is because there are limits to how much labour participation rates can be increased, while increasing capital more than labour will eventually lead to diminishing returns to capital, leading to a fall in the growth rate even if capital continues to grow at a constant rate. Studies continually show the importance of technological progress (or innovation) as the overriding factor in advanced economies.

We would note that this issue is not particularly relevant to Albania at the present stage of its growth. Albania is at an early stage in capital accumulation, and it has ample labour resources, so the issue of whether growth is factor led (implying that once the increased supply of factors runs out, growth rates will fall) or productivity led is largely irrelevant.

#### IV b) Economic Policies

Turning now to the role of economic policies, where government's set “the economic policy framework for economic growth”, it should be noted that different studies come to different conclusions, depending on the viewpoint of the authors.

It is generally acknowledged that the major policy-related measures required for high growth are:

- high savings;
- prudent monetary and fiscal policies;
- low taxes;
- openness to trade; and
- a strong commitment to education.

However, there have been disputes over the relative role of government in the economy. The ‘neoclassical liberal’ school emphasises the primacy of free markets. According to this school, the role of government should be to “get the basics right”.

“Getting the basics right” means creating an environment which will encourage economic growth through:

- ensuring stable and low inflation;
- promoting the integrity of the financial and banking system
- providing for open markets; and
- striving for stable and realistic exchange rates;

in respect to the macroeconomic environment.

On the microeconomic side, it requires government to ensure property rights, law and order, and adequate provision of public goods. Government should avoid high tax rates, price controls, and other distortions of relative prices.

The ‘revisionist’ school embraces the view that government should get the basics right, but additionally asserts that since markets work imperfectly in poorer countries, selective interventionist policies should also be followed. This would allow the use of selective intervention in credit policies, tax policies, and other assistance to specific industries that are seen as having economic potential. The World Bank report on the

high growing economies of east and southeast Asia in 1993, for instance, conceded that measures such as directed credit and export subsidies had sometimes been helpful, but concluded that industrial policies to promote specific industries did not work<sup>9</sup>.

Problems associated with the East Asian financial crisis of 1997/98 tend to support the former (neoclassical liberal) approach, since many of the problems that emerged were associated with government interference in the economy. This refers, in particular, to the problems associated with ‘crony capitalism’, whereby selective interventions favoured specific producers on the basis of connections rather than efficiency.

In respect of Albania’s circumstances, the principle of “getting the basics right” are undoubtedly essential. In general would argue that while government might ‘facilitate’ industrial development (for instance through promotion of identified opportunities, provision of serviced industrial sites, general promotion of exports, or locally produced goods), it should not become directly involved in favouring particular interests or producers through such measures as direction of credit, or granting of specific assistance to single producers or types of producers.

#### IV c) Initial Conditions

Turning now to an examination of initial conditions for growth, we can note that a study tracing average growth of income per person in 41 countries during 1960-85 back to initial conditions in 1960 showed that countries that were poorer, but had good primary education systems, less inequality of income and land distribution, high life expectancy, and low fertility rates grew faster than others during the following period<sup>10</sup>. However, some caution is recommended in analysing the results, due to problems with data reliability and small number of observations, and since it is not clear what the practical implications of the findings are for policy purposes.

#### IV d) Institutional Framework

In recent years attention has shifted to more long-term analysis of factors underlying sustained growth over longer-term time frames. In particular, attention has concentrated on the particular roles of geography, integration in the world economy, and institutions in economic growth.

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<sup>9</sup> The World Bank, “The East Asian Miracle” 1993.

<sup>10</sup> Rodrik, Dani “King Kong Meets Godzilla: The World Bank and the East Asian Miracle”. Chapter 1 in “Miracle or Design? Lessons from the East Experience” ed. by Albert Fishlow and others (Washington: Overseas Development Council, 1994)

The key findings are given in a review of recent literature in Appendix 2. Key findings include:

1) The primacy of institutional quality<sup>11</sup>.

Findings here include:

- if Middle East countries strengthened the quality of their institutions to all-country average, there would be a 150% increase in per capita incomes.
- If Bolivia would raise its level of institutional quality to that of Korea, its per capita GDP would be close to \$18,000 rather than its current level of \$2,700<sup>12</sup>.

The World Development Report for 2003<sup>13</sup> illustrates the connection between institutional quality and national income in the following graph:

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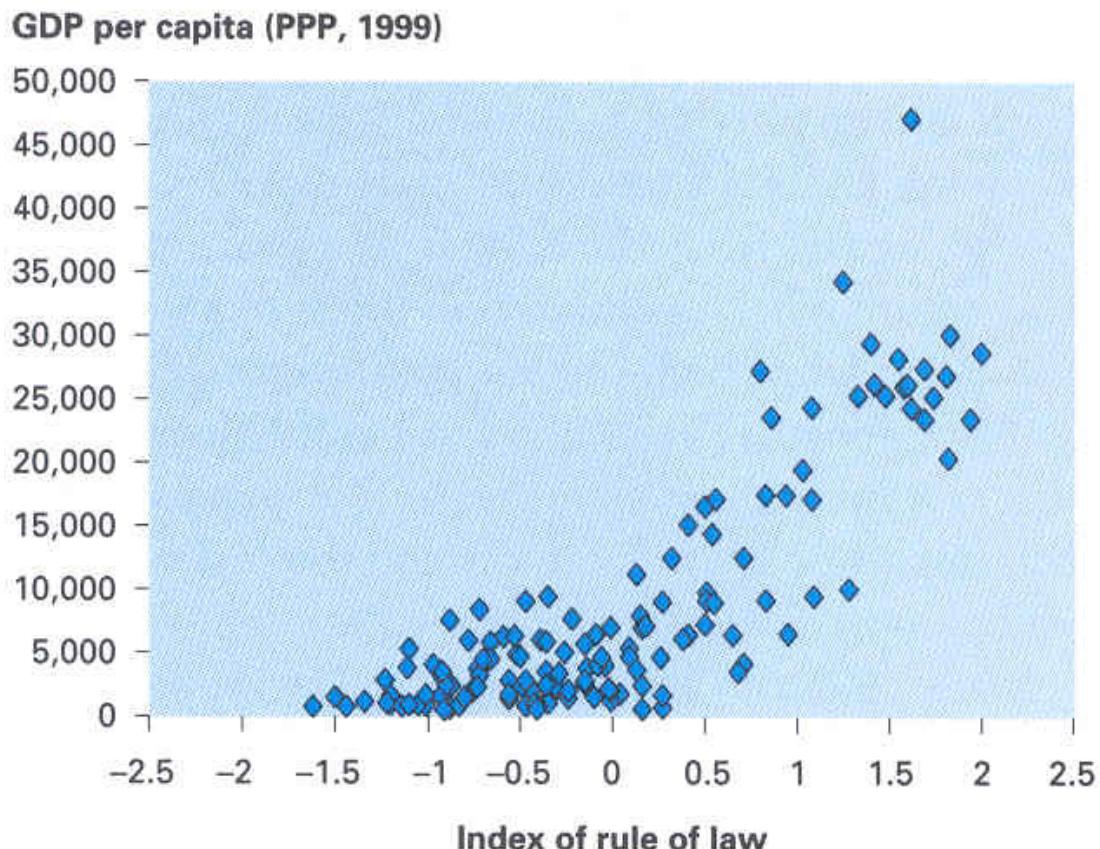
<sup>11</sup> For the purpose of this paper, institutions are broadly defined as behavioural norms and rules of human interaction in a society, particularly those relating to:

- (i) enforcement of property rights, so that a variety of individuals have incentives to invest and participate in economic life;
- (ii) constraints on the actions of elites, politicians, and other powerful groups, so that these people cannot expropriate the incomes and investments of others or create a highly uneven playing field;
- (iii) a degree of equal opportunity for broad segments of society, so that individuals can make investments, especially in human capital, and participate in productive economic activities (Acemoglu<sup>11</sup>).

<sup>12</sup> Rodrik, Dani. and Subramanian, Arvind. The Primacy of Institutions (and what this does and does not mean). Finance & Development June 2003, p. 32.

<sup>13</sup> World Development Report, 2003. World Bank, Washington, D.C. Figure 3.3.

## The relationship between institutional quality and national income



PPP = Purchasing power parity.

Note: As a measure of institutional quality, the rule of law includes considerations such as the security of property rights, or the confidence with which a group or individual can find tomorrow the fruits of what is planted or conserved today.

- 2) Institutions that are geared to protecting property rights, placing constraints on elites and politicians, and allowing the accumulation of human capital, the spread of entrepreneurship, and the creation of a mass market are of paramount importance.

Examples here relate to different colonisation strategies, in particular the comparative development of the US, Canada, Australia and New Zealand, where laws, institutions and policies provided the population with the ability to invest, accumulate human capital, and participate in commercial activity. This compared to countries where there were resources to be extracted (e.g. Africa, India, Caribbean, Latin America, Mexico etc.) where institutions neither protected the property rights of regular citizens nor constrained the power of elites. It notes that these “..institutions inhibited the

accumulation of human capital, the spread of entrepreneurship, and the creation of a mass market – factors viewed as important in economic development”.

Further examples relate to the importance of property rights, in particular, in allowing sustained economic growth. The World Development Report 2003<sup>14</sup> (World Bank) also states that “...if not properly protected, assets cannot thrive and contribute to growth or human well-being.” The report notes that among the six transition economies where property rights were least secure, income (GDP) fell in the decade of transition - by 40 percent or more.

In conclusion, economies with high inequality in the ownership of assets tend to generate institutions that placed restrictions on individuals’ opportunities for future economic advancement, and this ties these economies into low growth paths.

We now try to evaluate Albania’s position in relation to the most recent criteria identified, as well as its policy framework, to examine where it stands in relation to the requirements for long term sustained growth.

## **V. EVALUATION OF ALBANIA’S SITUATION**

Our summary of the situation is that Albania’s position appears very satisfactory from the viewpoints of geography and integration with the world economy. In respect of the policy framework, we believe that most elements of a sound policy framework are in place, but adjustment is required in some areas. It is in the field on institutional development, however, where we feel Albania needs to take bold steps to set an environment for sustainable long-term economic growth.

We note that there are necessarily some overlaps between the different characteristics we have specified (geography, integration, policies, and institutions), and note that this is unavoidable in the circumstances.

### **V a) Geography**

In respect of geography, we note that Albania has advantages in location and climate. Advantages include:

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<sup>14</sup> The report refers, in particular, to the following studies: Bohn, Henning, and Robert, T. Deacon. “Ownership, Risk, Investment, and the Use of Natural Resources.” *American Economic Review*, 2000, 90(3):526-49.

Hellman, Joel S., Geraint Jones, and Daniel Kaufman. “‘Seize the State, Seize the Day’: State Capture, Corruption, and Influence in Transition.” World Bank Policy Research Working Paper 2444, 2000. Washington, D.C.

Hoff, Karla, and Joseph Stiglitz. “After the Big Bang? Obstacles to the Emergence of the Rule of Law in Post-Communist Societies.” World Bank, 2002. Washington, D.C. Processed.

EBRD (European Bank for Reconstruction and Development). 2002. *Transition Report 2000*. London.

- Its proximity to the large EU market;
- A climate, coastline, and mountains that give it a huge tourist potential;
- A climate that is favourable for the production of ‘niche’ market fruit and vegetables; and
- Good natural resources, including chrome, copper, nickel, coal, marble, oil and liquid petroleum gas (LPG).

### **V b) Integration**

In respect of integration with the world economy, we would note that:

- Albania has been a member of the WTO since 2000 and is in the process of implementing its obligations under the WTO;
- It benefits from the ‘asymmetric regime’ with the European Union (combined with the asymmetric regime accorded to some countries in the region);
- It has, or is in the process of forming free trade agreements, with Macedonia (in force July 2002), Croatia (in force July 2003), as well as Bosnia and Herzegovina, Montenegro and Serbia, Romania, Bulgaria (agreements signed by relevant Ministers), Moldova, and Kosovo and Turkey;
- It has a generally liberal foreign investment regime, whereby local and foreign businesses are given equal treatment in most respects.

### **V c) Policy Framework**

Albania, we note, is generally ‘on track’ in relation to the policy environment. While it does not have high domestic savings, it is noted that high savings are generally associated with higher standards of living, in later rather than earlier periods of growth<sup>15</sup>. While deficits are still high, these have been reduced progressively. In the circumstances, it is probably fair to say that prudent monetary and fiscal policies are generally followed, with attention being focussed on controlling the domestically financed deficit. Marginal tax rates are generally low by international comparison (though there are, we believe, some problems relating to social security levies). As noted above, openness to trade is increasing, and there is a strong commitment to education.

In respect of the basics, a policy of pursuing low and stable inflation is being followed; measures have been, and are being put into place to promote the integrity of the financial and banking system<sup>16</sup>; and the exchange rate is market determined. We believe that there is room to reduce interest rates, and encourage greater development

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<sup>15</sup> Carroll, Christopher D., and David N. Weil “Saving and Growth: A reinterpretation”, Carnegie-Rochester Conference Series on Public Policy, Vol 40 (1994), pp 133-92.

<sup>16</sup> We would note that the banking and financial system needs far more development, but understand measures are underway to facilitate this.

of the use of the banking system by the private sector, and we understand measures are being put into place in this regard. We note that there are no direct price controls other than the minimum wage rate, and regulated prices for local monopoly suppliers. Privatisation has been actively pursued.

The low rates of employment growth in recent years, we believe, reflect weaknesses in the policy environment. High social security taxes<sup>17</sup>, which become operational at low rates of pay, combined with an administered minimum wage, do not encourage the growth of small and medium size enterprises. The relatively high economic growth of recent years should have encouraged employment growth, particularly in the non-farm private sector, where most of the economic growth has occurred. This does not appear to have happened to any significant degree. We would urge that these two policy fields be re-examined to make them more economic growth and employment growth orientated.

#### **V d) Institutional Framework**

Albania's position in relation to the institutional framework is examined more fully in Appendix 3. While it is noted that quality of institutions can be measured in different ways<sup>18</sup>, the analysis uses a broad based measure called the 'aggregate governance index', though it adjusts this to suit Albania's circumstances<sup>19</sup>.

The findings on the six measures are:

##### ***1. Voice and accountability***

This covers the extent to which citizens choose their government, have political rights, civil liberties, and an independent press. Albania has gone a long way in this field but we consider that there is room for improvement in specific areas.

##### ***2. Political stability and absence of violence***

The main issue in this area is the frequent changes of government and ministerial portfolio, which works to slow down the effectiveness of government initiatives.

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<sup>17</sup> For instance, the IMF Country Report No. 01/118, July 2001, states "...contribution rates in the urban (pension) scheme are high". The Report further states " considering other transition economies, only the contribution rates in Bulgaria (39 percent) and the Kyrgyz Republic (36 percent) are higher than the Albanian one."

<sup>18</sup> These include one measure which relates purely to *property rights*, and another to *constraints on the executive*, in addition to the aggregate governance index.

<sup>19</sup> This includes adding another measure, 'business friendly bureaucracy - other' measure to capture issues which do not fall neatly into one category or another. In addition, we have re-interpreted the fourth measure, regulatory burden, away from policy related measures since these, in our analysis, are considered policy related. Instead, we have focussed on problems in government regulations and the use of those regulations more generally.

### ***3. Government effectiveness***

This covers the quality of public service delivery, the competence and political independence of government employees.

The National Strategy for Social and Economic Development (NSSED) notes that improving the quality of public service delivery “.. is presently a problem area”, and lists a series of measures being implemented.

### ***4. Regulatory burden***

We consider this a particular problem area. The Foreign Investment Advisory Service (FIAS) recently commented:

“.. Ten years after the initial transition to a monetary economy, the present administrative system in Albania is still burdened with many outdated regulatory requirements. These are rooted in a mentality of state planning and control, and micro-management of the economy by the Government”<sup>20</sup>.

The NSSED acknowledges problems in government administration and refers to reform of the services and appeal procedures. The objective is to reduce the number of licenses, streamline similar units and functions and create a "one stop shop".

It is probably fair to comment that this area still requires much further attention, but it appears to be in the process of being recognised, with identification of initial measures to improve the situation.

### ***5. Rule of law***

This refers to the protection of persons and property, independent and effective judges, and contract enforcement. Contract enforcement, in turn, requires a strong and enforceable judicial system, relative absence of corruption, and transparent dispute resolving mechanisms.

This is an area, which needs particular attention. The NSSED recognises problems in relation to the problems of crime, and the judiciary, and notes measures being taken.

In our opinion, resolution of property rights is perhaps the greatest single challenge facing Albania at this point in time. The FIAS study continually draws attention to the need for a sound and viable land market for the following key requirements:

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<sup>20</sup> FIAS, “Albania Removing Administrative Barriers to Investment: A Critical Component of the National Development Strategy” March 2003.

- to allow further development, and to prevent strategic investors being deterred;
- to complete the requirements for transition to a full market economy;
- to encourage genuine investment;
- to prevent illegal construction and the negative effects on investors and the public associated with it.

The study notes “ ..Albania needs to encourage investment of strategic benefits to its long-term national economic development. Such investments require an adequate legal and institutional framework providing strong protection for property rights, clear guidance for land use and construction requirements, and equal and predictable treatment when dealing with regulatory agencies at the national and local levels.”

The case for establishing sound property rights as a precondition for sustained economic growth is soundly established in virtually all analyses of sustainable growth, as is the negative impact of not having such rights.

## ***6. Freedom from graft***

In other words public power is not abused for private gain or corruption.

Economic literature emphasizes that corruption has a high economic cost. A study of corruption in the former CIS countries, for instance, gave its effects as:

- worsening distortions in resource allocation;
- raising costs and reducing incentives to invest, and deterring foreign investors;
- affecting small and medium sized enterprises particularly adversely; and
- reducing domestic savings and investment and stimulating capital flight.

It concluded that corruption “is one of the most important forces inhibiting investment and growth and thereby lowering living standards in many of the transition economies reviewed”<sup>21</sup>.

The NSSED notes that “ ..The fight against corruption is a cross-cutting issue of all reforms ... The fight against corruption will continue to be a priority ..”.

The FIAS study notes that “..a recent study based on surveys conducted in seven countries in the South East European (SEE) region ... revealed that Albania was the worst among all countries in the region in terms of perceived corruption, and that its performance is getting worse with time”<sup>22</sup>. The report further notes that “..flaws in the

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<sup>21</sup> Refer Thomas Wolf and Emine Gurgen “Improving Governance and Fighting Corruption in the Baltic and CIS Countries, Economic Issues No 21, International Monetary Fund, July 2000.

<sup>22</sup> “Corruption Indexes”, Regional Corruption Monitoring, Centre for the Study of Democracy and the International Legal Development Institute, Rome, April 2002. Tables produced in the FIAS report are attached in Annex 1.

operation of the administrative regulatory system, such as the exercise of too much discretion and a lack of transparency and accountability, provides fertile opportunities for the practice of corruption”.

### ***7. Business friendly bureaucracy – other***

The four final issues relating to institutions, namely government effectiveness, regulatory burden, rule of law (certain components) and freedom from graft are sometimes treated jointly under the issue of ‘business friendly bureaucracy’. The FIAS study notes that there are four major problems in this area:

- there is a systematic lack of implementing regulations and operational guidelines. They note that new laws are not supported by necessary procedures, criteria and responsibilities, so permitting a high degree of administrative discretion by agencies and officials;
- there is a systematic lack of effective institutional structures, with no clear designation of responsibility or accountability, or inter-agency cooperation;
- legal and regulatory enforcement is chronically lacking, with dispute settling mechanisms not working effectively; and
- administration is further weakened by a lack of development of the appropriate mindset and skills of officials at all levels. The study notes that “..in general, regulatory officials seem not to trust businesses. Many appear to see themselves as policemen, not service providers..”

The study notes that “...while these features are not unusual among transition economies in the region, their severity is remarkable when benchmarked against comparable country results”.

It is noted that a special group has been established, under the Chairmanship of the Minister of the Economy, to work out and implement an action plan to remove the barriers identified in the FIAS report.

## **VI. THE ROLE OF GOVERNMENT AND THE PRIVATE SECTOR**

Albania is still in the process of transition to a market economy from the command economy. As the FIAS report stresses: “the economic transition is far from complete, with many laws and regulations introduced but not effectively implemented.”

Expressed in a more theoretical context, two criteria critically distinguish between the central command and the market economy systems. These are:

- who owns the factors of production – land, capital, and labour? and
- who makes the business decisions?

Under the command economy, not only did government effectively own or control the factors of production, but they also took the business decisions. As noted by Balcerowicz<sup>23</sup> “ ..the peculiarity of the communist party-state consisted in the attempt to have *total control over the individual’s activities* – in other words, in the radical curtailment of individual liberties.” From the economic perspective, two of these exceptionally extensive state controls are of importance:

- the banning of the private entrepreneurship, which, together with the initial nationalisations, resulted in a monopoly by the state sector;
- central planning on state-owned enterprises, which included output commands, rationing of inputs, foreign exchange, price controls and directed foreign trade.

Under a market economy, individuals (either directly, or through companies or other forms of business organisation) own and control the means of production, and businesses themselves make the business decisions. Government’s role is to set the framework within which businesses operate, in a clear and transparent manner, so that the market forces lead businesses to generate growth in a competitive environment.

This is a completely different role for government to that in which it operated previously. As Balcerowicz also states, “ ..the legal framework and the judicial system criminalized private economic activity and independent political activity, and were ill suited to the market economy, rule of law and free society.”

In the transition from a command economy to a market economy the role of the government and private sector needs to be redefined. First of all, as a precondition, it is critical that government realize that its role is now completely transformed. The challenge facing transition governments is to, first, understand their new role, and second, put in place the institutions, the policies, and the attitudes under which a market economy will function effectively.

It is in this area, we feel, that Albania has its biggest shortcomings, in setting a path to sustainable development. As the FIAS report states “ ..Ten years after the initial transition to a monetary economy, the present administrative system in Albania is still burdened with many outdated regulatory requirements. These are rooted in a mentality of state planning and control, and micro-management of the economy by the Government”.

Returning to the questions asked above, i.e.

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<sup>23</sup> Balcerowicz, Leszek, “Post-Communist Transition: Some Lessons”, The Institute of Economic Affairs, London, 2002.

- who owns the factors of production – land, capital, and labour? and
- who makes the business decisions?

We would stress that it is individuals that own the means of production (either directly, or through various forms of business organisation), while it is the private sector, which must make the business decisions. It must be very clearly understood that it is the role of the private sector to use the factors of production to create incomes in an efficient and competitive manner, within an appropriate institutional framework set by the state.

Government, for its part, needs to realize that it no longer needs to make the everyday microeconomic business decisions. That role is better left to the private sector, in other words, to the businesses that have to survive through taking the right decisions. Government's role is to create the proper institutional framework which will encourage economic growth.

Government should use the criteria that separate two types of economic systems as a basis to determine priorities that need to be tackled first and, at the same time, identify which measures will give the greatest returns in moving towards the Government's goal of achieving "private sector led growth and development".

Looked at from this point of view, understanding the new role of government and putting in place the institutions, policies, and attitudes to allow the market economy to function properly is (still) the outstanding challenge.

We are well aware that this cannot be implemented without a major effort to get everyone into "free market" mindset, and away from the "central command" mindset. At an administrative and regulatory level, it requires transparency in the application of all regulatory measures, reduction of scope for decision-taking on specific matters by either officials or politicians (including both committees of officials and politicians), and clear rights of appeal. We know that resolving these issues will be far from easy. We believe that special outside assistance may be essential to assist the Albanian Government in these areas, and we would urge donors to give these areas a very high priority.

We would stress that the evidence overwhelmingly shows high returns from completing the reforms associated with the transition process<sup>24</sup>.

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<sup>24</sup> For instance, refer Box 1 in the following section.

## **VII. CONCLUSIONS AND RECOMMENDATIONS**

The Albanian economy has many strengths. These include:

- a good geographical location, a good climate, and natural resources;
- openness to trade;
- openness to foreign investment;
- low tax structure, with generally low marginal tax rates;
- active pursuit of privatisation;
- competitive cost structure, by comparison with EU member states;
- and entrepreneurial population, and
- a high inflow of funds from Albanians abroad for various purposes, including investment.

These have allowed the economy to grow at over 6 per cent, in real terms, since 1993.

At the same time, it has a number of weaknesses that will work to slow future growth, the most critical of which are associated with an incomplete reform agenda. Specifically, the main weaknesses, we believe, include:

- unclear property rights;
- a business environment and bureaucracy which is far from ‘business friendly’, while corruption is widespread. This includes a continuing “central command” mindset in the bureaucracy.
- high social security taxes at low levels of income;
- a minimum wage which is set by administrative decision rather than market forces;
- a high cost structure, by international standards.

These are serious disadvantages. Unclear property rights will deter strategic investors from locating in Albania. The “business unfriendly bureaucracy” and in particular the “central command mindset” associated with it slows, frustrates, and deters businesses, and appears to nullify much of the advantages of Albania’s openness to trade and foreign investment. Corruption raises costs, worsens resource allocation, and skews distribution of income and wealth. High social security taxes (particularly combined with minimum wages set by administrative decisions rather than market conditions) will work against the development of small and medium sized businesses, as well as reducing employment growth. The high cost structure, by international and regional standards, effectively reduces Albania’s attractiveness to foreign investors.

These factors will work to slow down future growth in Albania.

Unless the issues are tackled urgently and with conviction, we see a major danger that the “free market” approach will be transformed into “crony capitalism”, where those with the connections get the benefits, while others lose out<sup>25</sup>. As so clearly brought out in so many studies, this is not an option for sustained development.

We further believe the problems are more urgent than is generally realised. Albania’s long-term growth trend, since 1990, has been 2.3 per cent per annum. Much of the so-called “high” growth has really been recovery from previous decline. Once the “catch-up” phase is excluded, Albania’s long-term growth trend is much less favourable. The dangers of reverting to such a trend should not be dismissed out of hand.

We believe that Government needs to allocate clear priorities to its development strategy, based on identifying those reforms that will give the greatest return at specific points in time. At this point in time, we would emphasise that understanding the new role of government and putting in place the institutions, policies, and attitudes to allow the market economy to function properly remains the outstanding challenge.

The overriding concern, we believe, must be to complete the reforms necessary for full transition (refer Box 1 below). In addition to changes to the relevant laws and regulations, this will require a change in the attitudes and mindset of administrative officials from a “central command and control” mentality to a “facilitation” mentality.

#### *Box 1. Reforms and Growth*

*“.. The experience accumulated in the past decade, whether viewed informally or with the help of data, charts and regressions, provides support for the view that the most successful transition economies are those that have both stabilised and undertaken comprehensive reforms, and that more and faster reform is better than less and slower reform”. (Fischer, Stanley and Ratna Sahay, 2000, “Transition Economies after Ten Years” IMF Working Paper No. 30, Washington, D.C.)*

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<sup>25</sup> Balcerowicz notes that “.. Non-radical programmes, which typically feature less liberalisation and correspondingly more state intervention, also give rise to new economic inequalities, with the winners being those can successfully lobby government. In practice, this means members of the old communist elite, who are more experienced, better organised and better connected than others. The inequalities generated by their lobbying are less justified by economic performance than those that stem from the radical reform programmes and rankle with the ‘losers’ even more. Finally, by channelling entrepreneurship and managerial energies into rent-seeking and corruption rather than into the search for greater efficiency, non-radical programmes that avoid liberalisation destroy the prospects for economic development. Anyone willing to take the longer view should then realise that the discontent and drawbacks associated with non-radical reform outweigh the problems brought by sustained and radical efforts towards comprehensive liberalisation, stabilisation and institutional building”. Balcerowicz, Leszek, “Post-Communist Transition: Some Lessons”, The Institute of Economic Affairs, London, 2002.

From the perspective of “getting the basics right” measures which governments need to implement, we believe, to ensure high and sustained growth include:

- a high-level political commitment to private property reforms, with a clear and coherent strategy to accelerate their implementation;
- promoting a business friendly bureaucracy;
- review of the financing of social security and health insurance, with a view to reducing the very high costs incurred at low levels of income; and
- allowing the market to determine remuneration levels and conditions, including minimum wages.

The first two measures are related to institutional quality, and are fundamental for broad based economic growth. The latter two measures are policy related, aimed at removing barriers to employment growth.

The merits of having a thoroughly sound and business friendly environment, in an economy like Albania, cannot be overstated (refer Box 2 below). The potential advantages of completing the transition are great. The costs of delaying action, or giving low priority to fundamental measures, are potentially very high. We would urge that the measures needed to complete the transition from a control, to a free enterprise economy, need to be implemented in a prioritised manner with the greatest possible urgency.

*Box 2. Foreign Investment and Growth*

*“So what did the Irish get right, and can others repeat the trick? One reason that the Irish have managed such rapid growth in income per head is that there are not very many of them. In a country with a population of just over 3 million, high levels of foreign investment can have a dramatic effect. In the past decade in particular, foreign investment in Ireland has surged. In this respect, Ireland’s story resembles that of Singapore or Hong Kong, which have also managed to use a business friendly environment to attract high levels of foreign investment, particularly in technology. Like Ireland, they have small populations that were made rapidly richer by a surge of foreign investment.” (*The Wealth Effect*, The Economist, May 19<sup>th</sup> 2001)*

## VII.

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**Annex 1**  
 (Extract from FIAS Report of March 2003)

<b>TABLE II-2: CORRUPTION INDEX OF SEE COUNTRIES</b>		
<b>Country</b>	<b>Year 2002</b>	<b>Year 2001</b>
Albania	68.4	60.8
Rumania	59.9	59.9
Bosnia and Herzegovina	48.3	47.6
Croatia	41.1	41.7
Serbia	37.3	37.2
Montenegro	35.9	30.8
Bulgaria	35.1	37.5
Macedonia	31.2	35.1

Source: "Corruption Indexes," Regional Corruption Monitoring, Centre for the Study of Democracy and the International Legal Development Institute, Rome, April 2002

<b>TABLE II-3: CORRUPTION PRESSURE INDICATOR*</b>								
	Customs officer		Municipal official		Judge		Tax official	
<b>Country</b>	<b>2001</b>	<b>2002</b>	<b>2001</b>	<b>2002</b>	<b>2001</b>	<b>2002</b>	<b>2001</b>	<b>2002</b>
Albania	55.60	54.88	52.50	50.67	53.10	44.31	56.80	50.43
Bosnia and Herzegovina	15.90	16.20	19.10	22.91	8.30	9.15	8.80	12.19
Bulgaria	15.80	18.55	10.30	9.96	9.10	7.80	8.30	5.29
Macedonia	21.80	25.32	11.90	19.67	13.70	15.53	8.90	24.08
Rumania	20.50	29.60	26.90	19.70	16.60	13.70	10.60	7.98
Croatia	10.50	7.36	11.30	8.27	5.80	5.97	6.60	3.45
Serbia	42.80	52.60	27.20	25.12	19.30	26.24	22.00	23.49
Montenegro	21.60	29.67	19.30	20.79	7.00	7.65	13.30	17.24

Source: "Corruption Indexes," Regional Corruption Monitoring, Centre for the Study of Democracy and the International Legal Development Institute, Rome, April 2002

## **Appendix 1.**

### **ECONOMIC BACKGROUND**

Albania's economy is estimated to have grown at a real average rate of 2.1 per cent per annum since 1990. Looked at from this point of view growth cannot be considered impressive, but when viewed from the aspect of setbacks that the economy suffered during this time, and subsequent recovery from them, the overall picture is more encouraging.

In looking at Albania's development since transition, we propose to:

- first consider economic developments during the period;
- examine some factors which we believe have been the underlying forces behind progress, and
- consider some key features of the Albanian economy in the light of international comparisons, since this provides a framework against which to measure Albania's economic characteristics.

*a) Economic Developments during the period*

Since the beginning of the transition in 1991, the Albanian economy has gone through four distinct phases. The early years of transition (1991-92) were dominated by a contraction of real GDP as a result of social and economic disruption, and high inflation, driven by pressure for higher wages, food shortages, and currency devaluation. By the end of 1992, output in real terms had fallen to two thirds of its 1989 level and inflation had risen to over 220 per cent. The trade deficit had risen to over two-thirds of GDP and the fiscal deficit amounted to almost 14 per cent of GDP.

The period 1993-96 was characterised by a significant economic recovery. GDP grew by over 10 per cent annually in real terms, inflation was brought down substantially, and both the trade and fiscal deficit improved. Cautious monetary and fiscal policies resulted in easing of pressure on prices, while the privatisation of agriculture, and of retail and wholesale and retail trade as well as small and medium size enterprises resulted in strong growth in the agricultural, transport, construction and service sectors. Although economic growth remained buoyant during 1996, with the slippage of stabilisation policies the economy began to show some early signs of a collapse. Revenue collection decreased significantly and the fiscal deficit began to widen.

In early 1997, large pyramid investment schemes, which had been building up since 1993, collapsed, bringing the country to a state of anarchy. The resulting turmoil brought economic activity almost to a standstill. As a result, real GDP contracted by over 10 per cent, inflation increased from 13 to 42 per cent, the current account deficit

quadrupled<sup>26</sup>, the value of the currency depreciated by 42 per cent against the US dollar.

The new Government that came to power implemented a post-crisis recovery programme supported by the donor community. The recovery programme also intensified the implementation of structural measures. A new banking law was passed which strengthened the independence and controlling powers of the Bank of Albania. A privatisation strategy was developed that allowed the privatisation of medium and large enterprises as well as the sale of strategic enterprises to investors. Steps were taken to support the institutional and governance reforms needed to build a more responsive, accountable, and transparent state.

Since 1998 growth has recommenced. In spite of some signs of a slowdown during 2002, annual real economic growth averaged 7 per cent a year during the period from 1998 to 2002<sup>27</sup>. Revenue growth has been buoyant, with overall revenues increasing at 13.8 per cent a year, and the budget deficit, while still large, having fallen from previous levels. The average CPI increase has been kept to 3.5 per cent, in spite of a supply-induced increase in 2002.

*b) Factors associated with Albania's growth since transition*

It can be noted that the history of Albania's growth since transition has been one of GDP contraction, often associated with economic and social disruption, and subsequent recovery. But the factors underlying the growth trend, we believe, include:

- the high inflow of transfers from emigrants, supplemented by incomes earned by residents working overseas temporarily;
- a relatively high inflow of official transfers, particularly at critical periods;
- the growth in tourism income in recent years;
- growth of exports;
- growth in government expenditures;
- foreign investment, and
- an increasing level of domestic income flows through new investments and businesses.

A summary of the growth, and levels, of these factors relative to GDP during 1993 to 2003 is given in Table 1 below.

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<sup>26</sup> This was mainly as a result of a decrease in the private remittance inflow, from (US dollars) 476 million to 236 million. Official transfers also fell by two-thirds to 29 million. The trade balance actually decreased as a result of imports falling by more than exports, in dollar values.

<sup>27</sup> GDP per capita is estimated to have surpassed its 1989 level in 1999.

**Table 1: Features of Albania's Economic Growth, 1993-2002**

	Average Annual Growth Rate (%)	Percentage of GDP (average)
Growth at Constant Prices	6.6	
Nominal Growth Rate	20.6	
Consumer Price Index at end year	12.3	
Commodity Exports	16.9	7.3
Service Exports	29.7	8.2
Income Credits	13.6	3.1
Private Transfers	13.9	13.3
Public Transfers	-16.5	3.2
Foreign Direct Investment	11.7	3.0
Total Government Expenditure	16.3	31.5

Sources: Bank of Albania, INSTAT, and Ministry of Finance.

The high inflow of transfers from emigrants (supplemented by incomes earned by residents working overseas temporarily<sup>28</sup>) has, we believe, played a crucial role in raising domestic consumption and investment. The flow-on effects from these inflows have further raised taxation revenues and financed government expenditure. Over the period 1993 to 2002 these flows averaged over 14 per cent of GDP, and grew at an average rate of 14 per cent per annum.

Official transfers, by contrast, have averaged just over 3 per cent of GDP during this period, though their value has fallen from the high levels of the early transition years, and now averages less than 1 per cent. Their value tends to increase after economic and social crises<sup>29</sup>, and have contributed directly to stabilisation efforts.

The overall level of transfers, plus incomes brought into the country by residents working abroad temporarily, we would note, have contributed immensely to increasing levels of economic growth, in addition to balancing the net outflow from trade<sup>30</sup>. At the same time, we would note that such high inflows have undoubtedly resulted in appreciation of the currency, and therefore reduced international competitiveness.

Similar comments can be made regarding the development of tourist inflows in recent years. Service imports, which are dominated by tourism, averaged 8.2 per cent of

<sup>28</sup> Inflows from residents working overseas temporarily are referred to as 'compensation of employees' in the balance of payments statistics, and are recorded as an income flow.

<sup>29</sup> In 1992, according to the Balance of Payments statistics, such inflows reached 55 per cent of GDP, and in 1993 were equivalent to 23 per cent of GDP. It has since fallen progressively, except from an increase from 1.3 per cent in 1997 and 2.9 per cent in 1998 to 4.6 per cent in 1999.

<sup>30</sup> Over the period 1993 – 2003 these averaged about 18 per cent of GDP. In fact, much of the net outflow from trade can be directly related to the influence of the inward transfers in stimulating economic activity and imports.

GDP over the period 1993-2002, and grew by almost 30 per cent per annum. While tourism outflows reduce the net contribution of tourism (most of which is ethnic Albanians resident overseas returning for holidays) to generation of economic activity and government revenue should not be ignored.

Although exports, which averaged 7.3 per cent of GDP over 1993-2002, are small by international standards, and by comparison with the level of imports, they have still played a significant role in generating GDP growth over the period. Exports increased at an average rate of 16.9 per cent annually between 1993 and 2002.

Government expenditure has averaged 31.5 per cent of GDP since 1993, and it has grown at an average rate of nearly 24 per cent. While much of this expenditure is not directly recorded in GDP (such as interest, and social security and health transfers), most expenditure other than overseas debt payments is important in stimulating economic activity. As such, the level of government expenditure must be included as one of the key determinants of economic activity. At the same time, the dangers of ‘crowding out’ of private sector activity, particularly through running large budget deficits, must be borne in mind given the critical role of the private sector in economic growth<sup>31</sup>.

In contrast to the importance of current flows, in relation to remittances and tourism, the major benefit of foreign investment is the economic activity flowing from the investment<sup>32</sup>. Government has maintained an ‘open door’ approach to foreign investment, and this has resulted in foreign investment inflows, mainly in the trade sector, but with investment also occurring in the industry, services, construction and transport sectors<sup>33</sup>. Foreign investment in the manufacturing sector, in particular, has been instrumental in generating exports of manufactured goods. We note that direct investment inflows, which were growing significantly between 1992 and 1996, fell dramatically for the next three years, before starting to rise again in 2000. A significant portion of the direct investment inflow has been associated with privatisation.

The final key source of growth noted, namely “..an increasing level of domestic income flows through new investments and businesses”, refers to the increasing numbers of new enterprises in new fields, often established by returning emigrants. These contribute to increasing domestic circulation of currency (or, in macroeconomic terms, raising the ‘multiplier’ effects of exogenous expenditures).

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<sup>31</sup> In Albania, it is noted, bank lending to the private sector is minimal.

<sup>32</sup> The critical role of foreign investment in growth is brought out in the following comment taken from the Economist’s Economic Focus: “..The point about foreign direct investment is that it is far more than mere ‘capital’: it is a uniquely potent bundle of capital, contacts, and managerial and technical knowledge. It is the cutting edge of globalisation..” (from The Cutting Edge, Economics Focus, The Economist, January 24<sup>th</sup> 2001)

<sup>33</sup> Actual percentages are trade sector (67 per cent), industry (17 per cent), services (6 per cent), construction (5 per cent), transport (4.7 per cent) and agriculture (1.3 per cent). Source: An Investors Guide to Albania, Ministry of Economy, March 2003.

The high growth rate of nominal GDP (almost 21 per cent per annum) relative to most exogenous variables noted above, during 1993 to 2002, is largely attributable to this factor.

*c) Key features of the Albanian economy in the light of international comparisons*

Some key features of Albania's economy, by comparison with other lower middle-income countries, and lower and middle-income countries in Europe and Central Asia, are given in Table 2 below. The purpose of this comparison is to give some perspective on where Albania stands by international standards.

Table 2: Some International Comparisons

Feature	Albania	Lower Middle-Income Economies	Europe and Central Asia Low & Middle Income
Gross National Income (GNI)/ capita 2001 (US dollars - market exchange rates)	1,230	1,240	1,960
Gross National Income / capita 2001 (US dollars - purchasing power parity)	3,880	5,020	6,990
Relative Price Ratio to US, 2001 (%)	0.32	0.25	0.28
Per Capita GDP Growth, 2000-01	5.5	3.3	2.4
Foreign Direct Investment / GDP, 2000 (%) Investment (GCF) / GDP, 2001 (%)	3.5 19	2.3 27	2.9 21
Exports / GDP, 2001 (%)	6.8	25.8	35.0
Imports / GDP, 2001 (%)	29.4	24.2	35.1
Trade Bal / GDP, 2001 (%)	-22.6	1.6	-0.2
Current Account / GDP, 2001 (%)	-6.0	3.4	4.9
High Technology Exports (% of Manuf Exports, 2000)	1	13	10
Overseas Development Assistance/Capita (US dollars, 2000)	93	7	23
Current Revenues / GDP, 2000 (%)	19.3	16.6	27.6
Total Expenditures / GDP, 2000 (%)	29.8	20.7	30.5
Budget Bal (inc grants) / GDP, 2000 (%)	-8.5	-3.8	-1.3
External Debt, 2000 (% of GNI)	13	33.3	53.7
Domestic Credit by Banking Sector, 2001 (% of GDP)	46.5	91.3	37.8
Unemployment as per cent of labour force		4.3	11.1

Source: World Development Report, 2003, and 2003 World Development Indicators, The World Bank, 2003

Key features which emerge from the table include:

- Albania's gross national income per capita is similar to the world average for low and middle-income economies, but less than two-thirds of the European and Central Asian Low and Middle Income Economies (these include all of the former European Socialist Regimes plus the Asian former members of the USSR, plus Turkey and the Isle of Man).
- After adjustment for the cost of living (based on surveys conducted by International Comparison Programme, a joint programme of the World Bank and the regional economic commissions of the United Nations), Albania's standard of living is less than 80 per cent of world lower middle income country average, and slightly above half of the European and Central Asian Low and Middle Income Economies.
- The cost of living is 28 per cent more in Albania than in the world lower middle-income countries, and 13 per cent more than in the European and Central Asian Low and Middle Income Economies.
- GDP growth in 2001 and 2002 was significantly higher than in both the world lower middle-income countries, and the European and Central Asian Low and Middle Income Economies.
- Foreign direct investment inflows, and investment in capital goods, are broadly similar in Albania and the other categories of country.
- While the ratio of imports to GDP is broadly similar in Albania to the other countries, the ratio of exports to GDP is much lower in Albania (less than one-third the level of exports to GDP of world lower middle income countries, and one fifth of the level of the European and Central Asian low and middle income economies).
- Albania consequently has a huge trade deficit, of almost 23 per cent of GDP, compared to negligible trade deficits in the other groups of economies.
- However, after taking into account other current flows (in Albania's case mainly remittances) Albania's current account deficit is much smaller than its trade deficit, at about 6 per cent of GDP. The other groups of countries have positive current account balances.
- High technology exports are a much smaller proportion of Albania's manufactured goods exports, implying a much lower level in the development of the export market.
- Overseas development assistance for Albania (which we noted above has fallen considerably in recent years), at US \$93 per capita, is still far above levels for both other groups.
- Albania's revenue, expenditure and deficit (after deducting grant assistance) are considerably higher than for world lower middle-income countries. European and Central Asian low and middle-income economies have significantly higher revenues, and lower deficits, while expenditure levels in relation to GDP are similar.

- Albania's levels of overseas debt are very considerably lower than for both other groups of countries, while domestic credit by the banking sector is considerably lower than for world lower middle income countries, but above that for European and Central Asian low and middle income economies.
- While unemployment data for Albania is not given, it can be noted that both groups of countries have unemployment rates, which are well below the recorded unemployment rate for Albania for the same period of 16.9 per cent<sup>34</sup>.

In conclusion, we would observe Albania shows all the classic features of a 'high remittance' economy, including:

- growth being based on domestic demand rather than exports, so there is a massive negative trade balance;
- a high cost structure by international standards, for a country with lower middle income level; and
- a low level of employment, which is concentrated in government and official entities, with relatively little private sector non-farm employment.

In Albania, to a much greater extent than most other European transition economies, the transition process exacerbated difficulties in an economy that was already beleaguered in many respects, resulting in a massive increase in the unemployment rate.

The huge outward migration that followed has resulted in migrants obtaining skills and incomes that they would not have obtained at home, while the remittances have helped to alleviate poverty, and generate economic growth. Returning migrants establish businesses which help develop the economy.

At the same time, the particularly high level of remittances in Albania has also contributed to raising the exchange rate, and consequently reducing competitiveness. It has led to a 'dual economy' in many respects, with standards of living and costs varying immensely for difference segments of the population. A high dependence on remittances for longer-term growth should be of some concern, since remittances tend to be 'generation related'<sup>35</sup>.

The slow growth of employment, in the face of relatively high GDP growth in recent years, should be, we believe, a major concern. The non-agricultural private sector is estimated to account for about 55 per cent of total GDP<sup>36</sup>, yet it only accounts for

<sup>34</sup> The Bank's notes to the table state that "...no data are given in the table for economies for which unemployment data are not consistently available or are deemed unreliable". The recorded unemployment rate used for Albania is generally considered an underestimate of unemployment since it excludes discouraged persons and those who do not register.

<sup>35</sup> Findings in remittance economies in the South Pacific, for example, are that second generation remits about one-third of the original migrants, and it virtually ceases after that.

<sup>36</sup> This is based on year 2000 figures for agriculture (28 pr cent of GDP), public administration (7 per cent of GDP), and an allowance of 10 per cent for non-budget public sector institutions in other sectors.

some 29 per cent of total employment<sup>37</sup>, and just 7.9 per cent of the workforce. Yet this is the sector which, according to official statistics, is growing most rapidly and therefore should be experiencing increased employment.

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<sup>37</sup> This is based on contributors to the Social Security Institute in 2001. Non-farm private sector employment includes 72,089 employees and 26507 self employed, compared to 342,318 non-rural contributors.

## **Appendix 2.**

### **Empirical Evidence on Economic Growth relating to the Institutional Framework**

In recent years attention has shifted to long-term analysis of factors underlying sustained growth over longer-term time frames. In particular, attention has concentrated on the particular roles of geography, integration in the world economy, and institutions in economic growth.

The key findings are:

- 1) The primacy of institutional quality.

Some examples from one particular study (Edison, Hali) suggest<sup>38</sup>:

- a) there would be a 150% increase in per capita incomes in Middle East countries if their institutions are strengthened to the all-country average institutional quality: the income gains are much larger if institutional quality rises to the level of advanced economies;
- b) annual growth in per capita GDP in the Middle East countries would increase by 1 percentage point if countries there had institutions as good as the average quality for the entire sample: the increase would be 3.2 percentage points if these countries raised their institutional quality to the level of advanced economies;
- c) if institutions in the Middle East countries were as good as those in the average country in the sample, countries in that region would experience a 12% reduction in economic volatility (i.e. instability): if there institutions were brought to the level of the advanced economies, economic volatility would be reduced by more than 50%.

In another study, it is noted that: “..the quality of institutions is the only positive and significant determinant of income levels.” According to their estimates an increase in the quality of institutions can produce large increases in income per capita. For example, the difference between the quality of institutions in Bolivia and Korea is equivalent to one standard deviation (in statistical terms) or a 6.4 fold difference. Therefore, if Bolivia would raise its level of institutional quality to that of Korea, its per capita GDP would be close to \$18,000 rather than its current level of \$2,700”.

Further, the World Development Report for 2003<sup>39</sup> states that “...a large body of theoretical and empirical studies concludes that there are strong causal effects from good institutions, measured by such variables as rule of law, to higher incomes per

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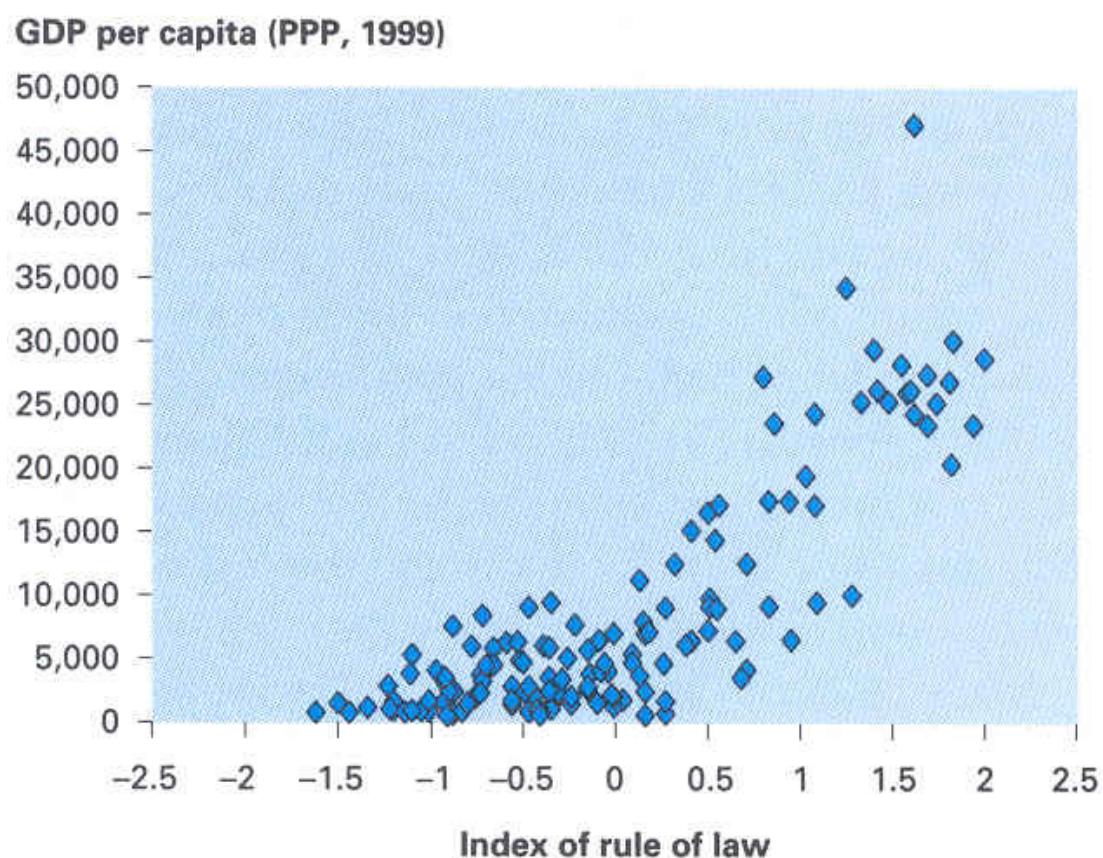
<sup>38</sup> Edison, Hali. Testing the Links. How strong are the links between institutional quality and economic performance? Finance & Development June 2003, p35-37.

<sup>39</sup> World Development Report, 2003. World Bank, Washington, D.C.

capita (refer graph below). According to one study<sup>40</sup>, better voice and accountability would raise national income per capita by a factor of 2.5.

The World Development Report, 2003, plots the relationship between institutional quality, based on rule of law index, and national income as shown in the chart below.

## The relationship between institutional quality and national income



PPP = Purchasing power parity.

Note: As a measure of institutional quality, the rule of law includes considerations such as the security of property rights, or the confidence with which a group or individual can find tomorrow the fruits of what is planted or conserved today.

- 2) Institutions that are geared at protecting property rights, placing constraints on elites and politicians, and allowing the accumulation of human capital, the spread of entrepreneurship, and the creation of a mass market are of paramount importance.

<sup>40</sup> Kaufman, Daniel, Aart Kraay, and Pablo Zoido-Lobaton. "Governance Matters." World Bank Policy Research Working Paper 2196, 1999. Washington, D.C.

a) Acemoglu<sup>41</sup> looked at the two types of colonization strategies (and their associated institutions) followed by the Europeans and their effect on economic prosperity. In countries where there were resources to be extracted (e.g. Africa, India, Caribbean, Latin America, Mexico, etc.), Europeans pursued the strategy of setting up extractive institutions. These institutions neither protected the property rights of regular citizens nor constrained the power of elites (Europeans themselves and their allies). On the other hand, Europeans created a number of colonies where they replicated – and often improved – the European form of institutions protecting private property and placing significant constraints on elites and politicians. Primary examples include Australia, Canada, New Zealand, and the United States.

It is this difference in institutions that explains the reversal of fortune in economic prosperity between the two types of colonies. The second group of the former European colonies, that are relatively rich today were poor before the Europeans arrived. However, the type of institutions set up in these colonies were much more conducive to investment and economic growth, producing as a consequence this reversal of fortune.

A second example comes from the World Bank publication “World Development Report 2003” that compares per capita incomes of several Latin American countries with those in Canada and the United States. In the 16th and 17th centuries, the GDP per capita of several Latin American countries like Argentina, Barbados, Cuba, etc. was similar (or higher, by more than 50%) than the US GDP per capita<sup>42</sup>. However, once industrialization began in North America in the 19th century, the United States and Canadian economies diverged sharply from the rest of the hemisphere. One key to early industrialization was the ability of the broad population to invest, accumulate human capital, and participate in commercial activity. The United States and Canada provided the laws, institutions, and government policies to make such investment and participation available.

On the other hand, conditions in the Latin American countries, made possible a high inequality in income, wealth, and human capital, which in effect influenced the development of institutions. The emerging institutions blocked effective access to opportunities for economic and social advancement for a broad cross-section of the population. These institutions “ ..inhibited the accumulation of human capital, the spread of entrepreneurship, and the creation of a mass market – factors viewed as important in industrial development”.

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<sup>41</sup> Acemoglu, Daron. Root Causes. A historical approach to assessing the role of institutions in economics development. Finance & Development June 2003, p. 28-29.

<sup>42</sup> World Development Report 2003, World Bank, p. 34.

b) The World Development Report 2003 (World Bank) also states that "...If not properly protected, assets cannot thrive and contribute to growth or human well-being." Further the Report states: "...with insecure property rights, incomes and well-being collapse....A staggering 75 percent of firms in the Kyrgyz Republic, Moldova, the Russian Federation, and Ukraine were not confident that the legal system would uphold my contract and property rights in business disputes. Among the six economies where property rights were least secure, income (GDP) fell in the decade of transition-by 40 percent or more. Many countries with contractions in GDP also had large increases in death rates."

The Report also states that ".Without commitments to law and property, well-managed exploitation is unlikely. Insecure property rights also hurt natural and environmental assets: fish populations are threatened, and trees are cut prematurely. Because people are not sure that they will be able to harvest tomorrow, they take what they can today - initiating a race for property rights... "For a cross-section of countries, the insecurity of property rights reduces investment in human-made capital and increases deforestation. Forests would benefit from reforms that strengthen the commitment to law and property. There are good reasons to believe that benefits will extend to other natural and environmental assets as well."

Another study<sup>43</sup> suggests that per capita incomes would grow at least 2 percent per year in all countries if they would only protect property rights (public and private) and pursue more competitive market policies.

Additional studies<sup>44</sup> provide evidence that natural assets decline when protective institutions are weak. Poor institutions contribute to a poor investment climate and to the depletion of natural resources. Moreover "...countries with high rates of depletion of natural resources also tend to be countries with low stocks of physical capital"<sup>45</sup>.

In conclusion, economies with high inequality in the ownership of assets tend to generate institutions that placed restrictions on individuals' opportunities for future economic advancement, and this ties these economies into low growth paths.

We now try to evaluate Albania's position in relation to the most recent criteria identified, as well as its policy framework, to examine where it stands in relation to the requirements for long term sustained growth.

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<sup>43</sup> Sachs, Jeffrey D., and Andrew M. Warner. "Economic Convergence and Economic Policies." National Bureau of Economic Research Working Paper 5039, 1995. Cambridge, Mass.

<sup>44</sup> Acemoglu, Daron, Simon Johnson and James A. Robinson, 2001, "Reversal of Fortune: Geography and Institutions in the Making of the Modern World Income Distribution", National Bureau of Economic Research Working Paper 8460. Cambridge, Mass.

<sup>45</sup> Source: World Development Report, 2003, Box 3.3.

## **Appendix 3.**

### **Evaluation of Albania's Situation relating to the Institutional Framework**

Institutional quality can be measured using different indices. One of these relates purely to *property rights*, another to *constraints on the executive*, relating to institutional and other limits placed on political leaders (on the grounds that the more constraints there are, the more sustainable are the policies implemented). Another measure, the *aggregate governance index*, is the average of six measures of institutions, including (1) voice and accountability (2) political stability and the absence of violence (3) government effectiveness (4) regulatory burden (5) rule of law, and (6) freedom from graft.

In assessing quality and effectiveness of the institutional development we have examined the measures included in the aggregate government index, and finally included a 'business friendly bureaucracy - other' measure to capture issues which do not fall neatly into one category or another<sup>46</sup>.

Going through these, in turn:

#### **1. Voice and accountability**

This covers the extent to which citizens choose their government, have political rights, civil liberties, and an independent press. Albania has gone a long way in this field but we consider that there is room for improvement in specific areas.

#### **2. Political stability and absence of violence**

The main issue in this area is the frequent changes of government and ministerial portfolio, which works to slow down the effectiveness of government initiatives.

#### **3. Government effectiveness**

This covers the quality of public service delivery, the competence and political independence of government employees.

The National Strategy for Social and Economic Development (NSSED) notes that improving the quality of public service delivery "... is presently a problem area". Measures that are underway to improve public service delivery, competence and political independence, include:

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<sup>46</sup> In addition, we have re-interpreted the fourth measure, regulatory burden, away from policy related measures such as government restrictions on goods markets, international trade and banking systems since these, in our analysis, are considered policy related. Instead, we have focussed on problems in government regulations and the use of those regulations more generally.

- implementation of the civil service status among public servants;
- more transparent recruitment procedures;
- definition of the role of the general secretary as the link between the political and administrative level in ministries and other institutions;
- improved job specification, evaluation, and training procedures;
- the ability to appeal to the Civil Service Commission.

We would note that improvement in the quality of public service delivery is necessarily tied to the following issue relating to the role of government.

#### ***4. Regulatory burden***

Commenting on government regulation the Foreign Investment Advisory Service (FIAS), a joint service of the International Finance Corporation and the World Bank, commented:

“...Ten years after the initial transition to a monetary economy, the present administrative system in Albania is still burdened with many outdated regulatory requirements. These are rooted in a mentality of state planning and control, and micro-management of the economy by the Government”<sup>47</sup>.

The NSSED refers to a study on the “the Public Service in the Central Administration” carried out by the Anti-corruption Unit. It notes that “..the purpose of this study was to promote the simplification, normalization, unification of all of the procedures and technical criteria with regards to the delivery of all public services offered by central administrative institutions as well as the reform of the services and appeal procedures. The objective is to reduce the number of license, streamline similar units and functions and create a "one stop shop".

It is probably fair to comment that this area still requires much further attention, but it appears to be in the process of being recognised, with identification of initial measures to improve the situation.

#### ***5. Rule of law***

This refers to the protection of persons and property, independent and effective judges, and contract enforcement.

This is an area which needs particular attention.

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<sup>47</sup> FIAS, “Albania Removing Administrative Barriers to Investment: A Critical Component of the National Development Strategy” March 2003.

In respect of the independence and effectiveness of the judiciary, the NSSED notes that “..While the independence of the judiciary has increased, its efficiency and fairness remain problematic”. It identifies a series of steps to increase the independence and effectiveness of the judiciary, including “...continued reforms ... aimed at strengthening the institutions of judicial autonomy, building capacity, increasing transparency and enhancing access to justice by vulnerable social groups”.

In respect of law and order generally, the NSSED comments that “...The reduction of serious crime, increased crime detection and public order in general are being strengthened through reforms to prosecuting institutions. This includes some initial success in the fight against illegal trafficking and organized crime. The strengthening of public order and the fight against the international organized crime and money laundering in particular needs more international support.”

Contract enforcement requires a strong and enforceable judicial system, relative absence of corruption, and transparent dispute resolving mechanisms.

Resolution of property rights is perhaps the greatest single challenge facing Albania at this point in time.

*The FIAS study continually notes the problems with property rights, as follows:*

- *In relation to the need for a sound and viable land market for future development*

The report states:

“ ...However, there is a wider concern in relation to broader issues of land, property, and construction rights, characterised by numerous land tenure disputes, illegal occupancy, and chaotic construction activity. Many pointed out that the weak legal and regulatory framework further weakened by corruption, has encouraged rampant development based on short term and speculative motivations at the cost of long term and strategic investments. If allowed to continue, such developments will undermine the Government’s efforts to develop a sound and viable land market based on private ownership, consistent with the public interest, and supporting future development.”

They go on to recommend that “..the Government act quickly to review and implement the World Bank recommendations. Further delay can only exacerbate the problems and deter strategic investors..”

- *In respect of the requirements for transition to a full market economy:*

“...weak, and often conflicting, property rights, have seriously hampered these private transactions. They are the result of errors and inconsistencies arising from the multiple privatisation and restitution programs, as well as from chaotic construction

activity. While a problem across the country, it has been particularly acutely felt in the urban areas where the commercial demand for land is high...

“ ..many decisions made by the Restitution Commission created overlapping claims over the same land and housing properties, and forced current and historical owners to enter into difficult processes in pursuit of sale, lease or co-ownership agreements.”

- *In relation to the adverse impact on genuine investment:*

“For a prolonged period, municipal authorities granted construction permits haphazardly without always following title search requirements. Frequently, at the time of construction, the investor was not fully aware of any tenure controversy concerning the development site. Subsequent restitution of the site, following completion of construction, legally required the investor to enter negotiation with the ex-owner(s) of the site for a lease or sale deal, something he had not had reason to expect...

“ ..on the other hand, there were also speculators who took advantage of the weak system and deliberately obtained construction rights without tenure-rights, knowing that, once the development was completed, eviction was going to be difficult.”

- *Referring to the impact of illegal construction:*

“..Finally, some property disputes were caused by illegal construction, that is, construction undertaken with neither property nor construction rights. Although the law does not accord illegal developers the same status as those who build with construction permits, eviction is practically difficult and costly. In some cases, it becomes impossible as the developer has already sold the development to a third party and disappeared with the large profits from the transaction.”

- *Referring to the negative effect on investors and the public:*

“...First Registration has been achieved in most rural areas. In urban areas, however, the process has stagnated due to the complexity of tenure controversies, noted above. It is also hindered by the lack of information about land and properties that remain in state-ownership and are believed to be significant in urban areas...<sup>48</sup>

“ ..Ultimately, all are caught up in and suffer the negative consequences of this vicious circle, which impedes strategic investors whose need for land with secured property rights is essential...

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<sup>48</sup> State-owned land and properties can be in the hands of the national and municipal governments, as well as state owned enterprises. Although statistics of state owned land and properties are extremely deficient, some study estimated that they made up about 50% of the total urban land and close to 40% of urban commercial land by the end of 1998. See “City Made By People,” p. 53, Vol. 2, 2000, Centre for Habitat Development, Tirana.

“ ..Investors are increasingly concerned about rampant and effectively uncontrolled construction activity. It leads not only to vexatious and costly property right disputes, but also creates physical disorder in the built environment...”

“ ..The lack of law enforcement and proliferation of corruption enabled speculative developers to build and sell properties opportunistically and very profitably, leaving innocent buyers and the general public to cope with the adverse consequences.”

- *The Report goes on to recommend specific measures, in particular the need for a clear and unambiguous commitment by Government:*

“ ..Most importantly, the Government must demonstrate a high-level political commitment to these reforms and develop a coherent strategy to accelerate their implementation. Many past efforts failed due to a fragmented approach with non-existent or weak linkages between the various programs and responsible institutions.”

- *The necessity for such an approach:*

“Albania needs to encourage investment of strategic benefits to its long-term national economic development. Such investments require an adequate legal and institutional framework providing strong protection for property rights, clear guidance for land use and construction requirements, and equal and predictable treatment when dealing with regulatory agencies at the national and local levels.”

The case for establishing sound property rights as a precondition for sustained economic growth is soundly established in virtually all analyses of sustainable growth, as is the negative impact of not having such rights<sup>49</sup>.

The NSSED recognises the need for the further strengthening of the rule of law and resolution of property rights, noting that it is expected to have a positive effect on the economy. Measures to be put into place in regard to property rights include:

- completion of the inventory and registration of state assets by 2006;
- improving their administration and increasing the transparency of their disposition and sale.

In relation to urban land, measures include:

- appropriate settlement of the rights of private property, joint ownership in dwellings, public ownership; and

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<sup>49</sup> Some analyses of institutional quality focus exclusively on property rights. Refer Edison, Hali. “Testing the Links. How strong are the links between institutional quality and economic performance?” Finance & Development June 2003, p35-37

- the adoption of the instruments for their implementation and protection, including appropriate forms of compensation;

Measures to be implemented in relation to the rural land market include the development of the land market and consolidation of ownership.

## ***6. Freedom from graft***

In other words public power is not abused for private gain or corruption.

Economic literature emphasizes that corruption has a high economic cost. It emphasises the links between governance and corruption, and emphasises that poor governance creates opportunities and incentives for corruption, can lead to a skewed distribution of income and wealth, and negatively affects growth and living standards. A study of corruption in the former CIS countries, for instance, gave its effects as:

- worsening distortions in resource allocation;
- raising costs and reducing incentives to invest, and deterring foreign investors;
- affecting small and medium sized enterprises particularly adversely; and
- reducing domestic savings and investment and stimulating capital flight.

It concluded that corruption “is one of the most important forces inhibiting investment and growth and thereby lowering living standards in many of the transition economies reviewed”<sup>50</sup>.

The NSSED notes that “..The fight against corruption is a cross-cutting issue of all reforms. It has been waged both towards narrowing the spaces for corruption through increased transparency as well as through the adoption of anti-corruption incentives which have mainly medium-term and long-term impacts. Measures have also been taken towards enhancing control and prosecuting corruption cases. As a result, the index of perceived corruption has fallen. The fight against corruption will continue to be a priority and it will be fought according to these two aforementioned approaches”.

The FIAS study notes that “..a recent study based on surveys conducted in seven countries in the South East European (SEE) region by the Centre for the Study of Democracy and the International Legal Development Institute,<sup>51</sup> revealed that Albania was the worst among all countries in the region in terms of perceived corruption, and that its performance is getting worse with time”. Tables produced in the FIAS report are attached in Annex 1.

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<sup>50</sup> Refer Thomas Wolf and Emine Gurgen “Improving Governance and Fighting Corruption in the Baltic and CIS Countries, Economic Issues No 21, International Monetary Fund, July 2000.

<sup>51</sup> “Regional Corruption Monitoring,” the Centre for the Study of Democracy and the International Legal Development Institute, Rome, under its South East European Region Legal Development Initiative (SELDI), 2002.

The report notes that “..flaws in the operation of the administrative regulatory system, such as the exercise of too much discretion and a lack of transparency and accountability, provides fertile opportunities for the practice of corruption. Governments that are serious about combating corruption must endeavor to simplify investment regulatory procedures and eliminate the exercise of unnecessary administrative discretion”. It notes measures that are already underway led by a Special Committee in the Prime Ministers Office, and urges the addition of a further specific term of reference addressed at the removal of administrative barriers to investment in order to remove opportunities for corruption and improve transparency.

### ***7. Business friendly bureaucracy – other***

The four final issues relating to institutions, namely government effectiveness, regulatory burden, rule of law (certain components) and freedom from graft are sometimes treated jointly under the issue of ‘business friendly bureaucracy’. The FIAS study notes that there are four major problems in this area:

- there is a systematic lack of implementing regulations and operational guidelines. They note that new laws are not supported by necessary procedures, criteria and responsibilities, so permitting a high degree of administrative discretion by agencies and officials;
- there is a systematic lack of effective institutional structures, with no clear designation of responsibility or accountability, or inter-agency cooperation;
- legal and regulatory enforcement is chronically lacking, with dispute settling mechanisms not working effectively; and
- administration is further weakened by a lack of development of the appropriate mindset and skills of officials at all levels. The study notes that “..in general, regulatory officials seem not to trust businesses. Many appear to see themselves as policemen, not service providers..”

The study notes that “...while these features are not unusual among transition economies in the region, their severity is remarkable when benchmarked against comparable country results”. Problems that the study noted related mainly to taxation and customs matters.

A special group has been established, under the Chairmanship of the Minister of the Economy, to work out and implement an action plan to remove the barriers identified in the FIAS report.