Public Disclosure Authorized

Public Disclosure Authorized

PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

March 27, 2014
Report No.: AB7559

Operation Name	First Albania Public Finance DPL
Region	EUROPE AND CENTRAL ASIA
Country	Albania
Sector	General Public Administration (100 percent)
Operation ID	P147226
Lending Instrument	Development Policy Lending
Borrower(s)	GOVERNMENT OF ALBANIA
Implementing Agency	Ministry of Finance
Date PID Prepared	March 31, 2014
Estimated Date of Appraisal	April 4, 2014
Estimated Date of Board Approval	May 29, 2014
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of this operation.

I. Country and Sector Background

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

2. **The global financial crisis and the subsequent Eurozone crisis led to a significant slow-down in Albania's growth.** In the years preceding the global crisis, 2005-08, the economy grew at an average annual rate of 6.2 percent enabling an increase in household expenditures of the bottom 40 percent by 2.6 percent per year. The global financial crisis in 2008 and the subsequent Eurozone crisis slammed the brakes on Albania's growth. Albania was able to avoid a recession but GDP growth slowed to less than 3 percent on average between 2009 and 2012 as exports, remittances and inflows suffered, in particular from Albania's close ties to the Greek and Italian economies.

3. **As growth slowed down, public debt surged and arrears accumulated.** Albania's public debt has surged from 54.7 percent in 2008 to 62.9 percent in 2012 and to 70.7 percent in 2013. The government has accumulated general government arrears of around 5.3 percent of GDP. Arrears and high public debt are now weighing heavily on Albania's growth prospects and threatening the significant progress that has until recently been made in reducing poverty. The accumulation of arrears is undermining public confidence in government's fiscal policy and its ability to meet its future payment obligations. It is also contributing to the buildup of non-performing loans in the banking system. These problems limit the ability of productive firms to raise financing from the banking sector, depressing domestic demand. Arrears in the energy

sector have also been a recurring source of budgetary pressure and the poor financial performance of the sector threatens competitiveness and economic performance. The clearance of arrears, and the prevention of new arrears, is thus an essential step towards restoring confidence in public fiscal management and in unlocking the flows of finance to the private sector needed to support growth. Reducing Albania's public debt will be important to ensure macro-fiscal stability. Any fiscal consolidation would need to be based on a prudent mix of increasing revenues as well as containing and improving efficiency of expenditures.

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

II. Operation Objectives

5. **The development objective of this operation, which is the first in a series of two development policy loans, is to improve Albania's fiscal sustainability by strengthening public financial management to address arrears and through tax, pensions and energy sector reform to support macro-fiscal stability**. The series focuses on addressing weaknesses in public finance management that have resulted in the accumulation of general government arrears and a surge in public debt. Clearance of arrears and prevention of future arrears will help boost private investment and reduce the high levels of non-performing loans that are currently stifling credit to the private sector. Strengthening budget preparation and execution will in turn increase transparency and credibility of public finances, limit the accumulation of new arrears and improve the efficiency and effectiveness of public spending. In parallel, raising revenues, reforming pensions and reducing fiscal risks emanating from the energy sector are important for putting Albania's public debt on a sustainable long-term trajectory and safe-guarding macro-fiscal stability. Without reforms, Albania's pension system is fiscally and socially unsustainable while the energy sector, left unreformed, will pose a large threat to the budget and absorb increasing fiscal resources.

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

Prior action #1: The Council of Ministers has adopted a central government arrears clearance and prevention strategy. The strategy provides a roadmap for the payment and settlement of arrears of the central government and arrears prevention measures for all general government units.

Prior action #2: The Ministry of Finance has verified all outstanding obligations and liabilities of the central government from September 2013 through end of December 2013 and has issued a call for tender for an independent, external party to complete audit liabilities and claims that have not yet been validated due to disputed or incomplete documentation. This complements the review of arrears accumulated through August 31, 2013 by an independent, external auditor.

Prior action #3: The Ministry of Finance has issued a budget circular, notifying line ministries that all financial commitments must be met within the expenditure ceilings for the current and two subsequent years. This prior action is intended to strengthen the preparation and execution of medium-term budget plans to help prevent new arrears.

Prior action #4: The Ministry of Finance has issued a budget circular, requiring all ministries to establish a prioritized list of all expenditure projects larger than EUR 5 million and has received the lists from all ministries. This prior action is intended to rein in over-commitments on capital investment, which was a major source of budgetary pressure in previous years.

Prior action #5: The Council of Ministers has issued a regulation, requiring budget units to get confirmation of availability of funds from the MOF before initiating procurement for investment projects. Requiring budget users to obtain authorization from the Treasury before commencing procurement of a project will strengthen commitment controls.

The above public financial management actions supported under this series are expected to reduce the stock arrears. More specifically, they are expected to i) reduce central government arrears as of end December 2013 by 70 percent by end of December 2015; and ii) prevent the accumulation of new central government arrears in 2014 and 2015.

Prior action #6: Parliament has approved the 2014 budget which increases the CIT rate from 10 to 15 percent. Albania has cut its CIT rate from 20 percent to 10 percent in 2009 to make Albania a favored destination for foreign investment and reduce informality and corruption. Recent surveys, however, have shown that informality has not been significantly reduced and FDI seems to depend more on the general business environment as most Eastern European countries have CIT rates of 19 to 21 percent. Increasing the CIT rate is likely to generate additional revenues of 0.5 percent of GDP between 2013 and 2014 without harming Albania's competitiveness.

Prior action #7: An Inter-Ministerial Pension Reform Working-Group has been established and has finalized a policy paper on the strategic direction for the pension reform. This action supports Albania's pension reform which is needed since the current pension system is neither fiscally nor socially sustainable.

Prior action #8: The Council of Ministers has adopted a time-bound settlement and prevention strategy of public sector arrears in the energy sector. Settling and preventing arrears of Albania's energy sector is important for improving the financial situation of the energy sector and for attracting much needed investments. The expected result of the implementation of the energy sector arrears clearance and prevention strategy is that no new central government arrears to the energy sector will occur in 2015.

Prior action #9: The Minister of Finance has netted off part of public energy sector arrears as per the Memorandum of Understanding approved by the Council of Ministers. This action supports a partial settlement of public arrears in the energy sector.

Prior action #10: ERE has issued a resolution to implement a flat rate for all non-metered customers and has started its implementation. The introduction of the flat revenue increases the energy bill for non-metered customers. This is a first stop-gap measure to improve collection before the infrastructure is put in place to effectively collect utility bills. This measure combined with other measures supported in the second phase of this operation and another energy sector loan from the World Bank is intended to reduce the government support to the energy sector. In particular, reforms supported under this DPL series are expected to reduce government guarantees for non-weather related energy imports.

III. Rationale for Bank involvement

7. **The newly elected government has signaled a strong commitment to medium-term structural reform**. A new coalition government with a stronger than usual majority assumed office in September 2013. Since then, the government has promoted fiscal transparency and significantly accelerated the pace of reforms. It has acknowledged the existence of payment arrears and undertaken a comprehensive assessment of the stock of arrears, accumulated over the last several years. It has also shown interest to address long-standing structural challenges in pension and energy sectors. Contrary to previous budgets, the 2014 budget is based on realistic assumptions of growth and other determinants of budgetary performance and includes some fiscal consolidation: The 2014 budgeted fiscal deficit without arrears is 4.2 percent in 2014 which compares to a budget deficit of 4.8 percent in 2013.

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

9. **Albania has reached an agreement for an Extended-Fund Facility (EFF) with the International Monetary Fund (IMF).** The EFF was approved by the IMF Board on February 28, 2014. The arrangement is intended to provide budget support in the amount of EUR 330.1 million (around US$457.1 million) over a three-year period. The World Bank and the IMF are collaborating closely on the reform program to ensure complementarity of key fiscal and financial sector policy measures.

IV. Tentative financing

Source:	($m.)
Borrower	0
International Bank for Reconstruction and Development	120
Others (specify)	0
Total	120

V. Tranches *(if applicable)*

	($m.)
First Tranche	120
Total	120

VI. Institutional and Implementation Arrangements

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

VII. Risks and Risk Mitigation

11. **The overall risks to the operation are high.** Key risks are related to the macro-economic outlook, the realization of contingent liabilities and governance.

12. **Macroeconomic risks stem from a potential deterioration of the Euro area economic outlook.** A slower than projected pace of recovery in the Euro area could lead to lower than expected growth, revenue collection and fiscal consolidation. Albania has a relatively high exposure to neighboring countries, especially Greece and Italy, through remittances, exports and foreign investment. The 2014 EU Winter Forecast points to a broad-based gradual recovery across EU Member States, including Greece and Italy, though. A prudent fiscal consolidation path combined with growth-enhancing structural reforms, in particular related to the business climate, and significant financial support from the World Bank, the IMF and the EU are likely to mitigate macro-economic risks. Medium-term fiscal policy is calibrated to accommodate a gradual recovery of real sector growth while steadily reducing public sector debt from 2014 onwards. Contrary to the past, the government's fiscal and macroeconomic projections for 2014 are realistic, increasing the likelihood that fiscal targets are met. Medium-term fiscal planning has been significantly strengthened.

13. **The government is facing significant fiscal risks**. Albania's energy generation relies almost entirely (98 percent) on hydropower; and recurrent energy shortages due to fluctuations in rainfall coupled with persistently high distribution losses result in high import bills for the public wholesale supplier (KESh). The government can mitigate this fiscal risk by diversifying generation sources, reducing distribution losses, improving the energy market model, implementing appropriate tariff levels, and solving the lingering dispute with CEZ Sh. A rapid and sustained implementation of the energy sector arrears clearance and prevention strategy, supported by this operation, will help to get the sector out of crisis mode and reduce fiscal risks. In addition, the World Bank is preparing a Power Sector Recovery Program, which supports improvements in cash collection and reduction of distribution losses. Fiscal risks could also arise from Albania's compensation scheme for expropriation.

14. **Political risks could arise from governance issues and public discontent with reforms.**

Sustained efforts are required to tackle governance issues, such as a weak rule of law and corruption, which could undermine, for example, the arrears clearance process and measures to increase collection of utility bills. Public discontent with reforms could also impede the government's ability to implement and sustain the needed structural reforms, in particular with respect to the power sector and pensions. A mitigating factor is that the government has accelerated structural reforms related to strengthening public administration and the judiciary, which are requirements for reaching the EU candidate status. The government's strong electoral mandate from the Parliamentary elections in 2013 and the frontloading of reforms are further mitigating factors against this risk. The Government remains strongly committed to strengthening public finances as articulated in various speeches by the Prime Minister and demonstrated by the 2014 budget. There seems a broad public consensus about the need to clear arrears and put public debt on a downward trajectory. Next Parliamentary elections will only be held in 2017 which minimizes political and stakeholder risks. The operation receives direct support from the top leadership, including the Prime Minister, the Ministry of Finance, the Minister of Social Welfare and Youth and the Minister of Energy.

VIII. Poverty and Social Impacts and Environment Aspects

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

16. **Arrears clearance and improvements in public financial management are expected to have a positive poverty and social impact.** Arrears clearance is likely to boost growth through fiscal stability, but also as the government repays construction companies for past projects and refunds VAT. Payments to government contractors are likely to reduce unpaid obligations to sub-contractors. These financial flows to the private sector are likely to increase domestic demand. Moreover, the proposed public financial management measures are likely to improve the cash flow of businesses by increasing the predictability of government payments. The government has also incurred Lek 6 billion in arrears on disability insurance. Of individuals receiving the urban disability benefit, 11 percent are poor and 32 percent are in the bottom 40 percent, while of individuals receiving the rural-disability benefit, 24 percent are poor and 56 percent are in the bottom 40 percent. The clearance of disability insurance arrears will thus likely boost income of these households.

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

17. **The direct poverty impact of the increase in the CIT rate is expected to be neutral.** At 10 percent Albania has one of the lowest CIT rates in Eastern Europe. Most Eastern European countries have rates of 19 to 21 percent. Tax rates are very rarely cited as an obstacle by formal firms in Albania. Only 4.1 percent of firms cited it as a constraint in 2007 compared to 17.5 for the ECA average.[2] Few of the poor are likely to be firm owners[3], Still, the increase in the CIT rate could potentially affect firm profits and, thus, job creation and through this channel shared prosperity and poverty reduction. Since the CIT rate does not seem to be a binding constraint for firms' growth in Albania, its increase is unlikely to affect job creation significantly. Moreover, firms are likely to significantly benefit from arrears clearance, especially of VAT refunds and contract arrears, and improvements in public financial management supported under this operation, will ensure that firms will be paid on time in the future.

18. **The potential impact of the overall pension reform will be fully assessed once reform details are decided by the government, but it is likely to be positive.** Analysis of the two proposals outlined in the pension strategy paper suggests positive poverty impacts of some reform components, particularly over the medium and long term. The reform foresees a strict inflation indexation of pensions until 2020. This will ensure that the real value of pensions is not eroded, including for the poor, while preventing fiscally unsustainable ad-hoc pension increases. In addition, a social pension will be introduced for all citizens without pension rights, providing income to elderly people who currently do not receive any kind of transfer. While this measure may currently not affect a large number of people (as most elderly today comply with the eligibility requirements given their pre-transition work history), it is likely to become more relevant in the future and keep the elderly who have not accrued sufficient pension benefits out of poverty.

19. **While energy sector reform will contribute positively to poverty reduction and shared prosperity by helping to sustain growth and reducing fiscal risks, higher energy tariff collection could have potentially negative effects on poor households. This could be mitigated through energy subsidies to the poor.** Household survey data suggests that poor households are more likely to report not having an electricity meter (4.9 percent) compared to non-poor households (1.1 percent). Of the self-reported 1.8 percent of non-metered households, 77.2 percent are in the bottom forty percent while only 4.9 percent are in the top quintile. Further, 77.7 percent of poor households reported paying an electricity bill in the last 12 months compared to 90.5 percent of non-poor households. About one in every five poor households (19.5 percent) reported running arrears on their electricity bills, which compares to about one in every ten non-poor households (11.5 percent). If poorer households are more likely not to have paid their electricity bills and as the share of electricity expenditures in their households' total expenditures is larger, enforcing collections could potentially translate into a higher burden for this group.[4] The Albanian government, however, provides energy subsidies to the poor through the subsidy which is implicit in the block tariff and through direct transfers through the social assistance system, which reimburses eligible households for the difference between the current

[2] Data from Business Enterprise Surveys.

[3] In 2012, less than 10 percent of the poor were self-employed, likely capturing own-account workers and not firm owners.

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

tariff and the 2003 tariff.

20. **The DPL is expected to have an overall positive gender impact**. The impact of public financial management reforms supported under this operation is unlikely to differ by gender. The reform of the pension system includes the equalization of the retirement age for men and women. Currently, women and men retire at age 60 and 65 years, respectively. The lower retirement age for women delinks women earlier from the labor market, thus, increasing their probability of old-age poverty due to a combination of lower contributions to the pension system and higher life expectancy. The current reform strategy envisions a gradual increase of the retirement age of women from 2015 onwards until reaching 67 years in 2056. The retirement age of men is expected to start to increase from 2032 onward to 67 years by 2056. The relative increase in the retirement age of women compared to men is expected to have a positive impact on reducing gender inequality by reducing poverty among elderly women. Based on currently available information, the energy sector reforms and the increase in the CIT rate are unlikely to have a gender-specific impact.

21. **The policies supported by the proposed DPL series are not expected to have any significant effect on Albania's environment, water resources, habitat or other natural resources.** The risk of unanticipated adverse effects to the environment and natural resources is considered very small as credible scenarios for any significant, direct or indirect negative impact appear very unlikely. The legal and regulatory changes implemented in the context of this DPL series do not modify the existing environmental regulatory framework in any way or facilitate the circumvention of any environmental regulations.

IX. Contact point

World Bank

Contact: Doerte Doemeland
Title: Senior Economist
Tel: +1 (202) 458-1238
Email: ddoemeland@worldbank.org

Borrower

Contact: Mr Shkelqim Cani
Title: Minister of Finance
Tel: +355 4 225 1388
Email:

X. For more information contact:

The InfoShop
The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 458-4500
Fax: (202) 522-1500
Web: http://www.worldbank.org/infoshop