

Albania: Joint Staff Assessment of the Poverty Reduction Strategy Paper Annual Progress Report

The attached Joint Staff Assessment (JSA) of the Poverty Reduction Strategy Paper Annual Progress Report for **Albania**, prepared by the staffs of both the World Bank and IMF, was submitted with the member country's Poverty Reduction Strategy Paper (PRSP) or Interim PRSP (IPRSP) to the Executive Boards of the two institutions. A JSA evaluates the strengths and weaknesses of a country's poverty reduction objectives and strategies, and considers whether the PRSP or IPRSP provides a sound basis for concessional assistance from the Bank and Fund, as well as for debt relief under the Enhanced Heavily Indebted Poor Countries (HIPC) Debt Initiative. The Boards then decide whether the poverty reduction strategy merits such support.

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ALBANIA

**Joint Staff Assessment of the Poverty Reduction Strategy Paper
Annual Progress Report**

Prepared by the Staffs of the International Monetary Fund and
the International Development Association

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I. OVERVIEW

1. On June 7, 2004, the government of Albania publicly presented its second Annual Progress Report (APR-2), analyzing the progress made during the second year of implementation of its poverty reduction strategy, locally known as the National Strategy for Socio-Economic Development (NSSED). The Joint Staff Assessments (JSA)¹ of the PRSP and the first Annual Progress Report identified a number of shortcomings that posed risks to the successful implementation of Albania's impressive poverty reduction strategy. While this APR-2 outlines substantial improvements in some areas, weaknesses remain that limit the effectiveness of the NSSED as a vehicle for sustained poverty reduction.

2. **The second year of NSSED implementation saw significant improvements in a number of areas, despite continuing political uncertainties and governance issues.** As recommended in the previous APR/JSA, the government has worked to raise public awareness of the overall NSSED process and its goals with a view to creating a national consensus on reforms. This has included a number of national, widely-publicized fora. The government has also worked to better link the reforms implemented or planned in the context of the Millennium Development Goals (MDGs), the Stabilization and Association Agreement (SAA) negotiations, and the NSSED. The monitoring and evaluation functions within key line ministries have been strengthened and indicators to be monitored by each line ministry defined (see annex to APR-2). A department of the NSSED (DoNESSED) has been established and fully staffed within the Ministry of Finance and has been charged with the

¹ The NSSED was known previously as the Growth and Poverty Reduction Strategy (GPRS). The first JSA covered the GPRS/NSSED and the second JSA covered the first Annual Progress Report of implementation through 2002.

coordination of all NSSD-related activities. Efforts were undertaken to more actively engage the donor community and strengthen coordination. Staffs welcome these developments and the government's commitment to improve the preparation and implementation of its poverty reduction strategy.

3. **This APR-2 presents an appropriate analysis of poverty, recent economic developments, and sectoral reforms, but it still lacks an updated medium-term macroeconomic framework, and the links between the NSSD, the Medium Term Budget Plan (MTBP), and the annual budget cycle are weak.** While the progress report includes a more comprehensive analysis of the sources of economic growth than the APR-1, in general the report tends to be more backward than forward looking. The annexes describe in more detail the policies the authorities intend to pursue through 2007, however, it is often not clear what the cost of these policies is and whether they fit into the MTBP. The APR does present a reasonably ambitious long-term vision with a set of useful monitoring targets (including the MDGs). The Albania government does have a medium-term macroeconomic and fiscal framework—which forms the basis of the IMF PRGF support—but the links to this framework are not explicitly presented in the APR-2.

II. UPDATED POVERTY DIAGNOSTIC

4. **The staffs commend the government for using information from the Living Standard Measurement Survey (LSMS) and other sources to analyze patterns in living standards and to enrich its previous diagnoses of poverty.** The analytic work builds on the national census, completed in 2001, and on the fully representative LSMS in 2002, which the census made possible. It also takes advantage of an IDA Poverty Assessment completed in 2003. LSMS analysis, using internationally accepted methodological standards, shows that one quarter of the Albanian population—or close to 780,000 individuals—live in poverty, even after receipt of income transfers. Extreme poverty is much less common, however, with less than 5 percent of the population unable to meet basic food requirements. The LSMS data also reveal substantial and complex variation in household living standards for families in different geographic areas and social circumstances. While data is presently insufficient to gain a reliable picture of income distribution trends, further work and analysis would enhance future APRs. As broad data sets such as the LSMS now become routinely available, the staffs encourage policymakers to accept the resulting challenge of utilizing them when formulating and choosing among policy options.

5. **The APR-2 poverty diagnostic validates the government's strategy to focus on economic growth, while undertaking priority investments in education, healthcare, and infrastructure.** Patterns documented in the data make most sense when viewed as reflecting an inadequate aggregate demand for labor—particularly skilled labor. Accordingly, a broadly based program to foster poverty-reducing economic growth continues to be indicated. However, the APR-2 also reveals how Albania's income poverty is often compounded by non-income dimensions of deprivation. About one-third of the population lacks access to two or more basic necessities such as basic education, water, sanitation, or heating. Problems

with the quality of health and education services, as well as access to them, also indicate the need for investments in these sectors.

6. **Measures to address the poverty and exclusion of specific social groups could be better reflected in terms of priority actions.** The APR-2 explicitly refers to ethnic dimensions of poverty, with special reference to Albanian Roma and the self-identified Egyptians, and identifies young families and youth at risk as necessary targets for public interventions. However, apart from references to education services for youth, sectoral priorities do not reflect specific actions for these groups. Similarly, while the regional variations in poverty are outlined in the diagnostics, there is little discussion as to how proposed priority actions and sectoral programs intend to better target spatial poverty.

III. IMPLEMENTATION AND UPDATING OF THE STRATEGY

7. **The APR-2 provides adequate information about developments in 2003.** However, it lacks a detailed analysis of (i) remaining weaknesses in the implementation of NSSED-inspired reforms; (ii) the link between shortfalls in budgetary revenues and the realization of programmed investments; and (iii) factors contributing to the large size of the informal economy and, correspondingly, the high degree of fiscal evasion. While the report lists public priority actions implemented during the course of the year, it does not link those to the measures foreseen as priority actions in the initial NSSED, nor discuss the criteria that have resulted in their adjustment over time.

The Macroeconomic and Fiscal Framework

8. **The macroeconomic performance of the Albanian economy has improved significantly in 2003.** Real GDP growth recovered to an estimated 6 percent in 2003, inflation was kept within the authorities' target range, the current account deficit was reduced, and there were further steps towards fiscal consolidation. The APR-2 gives the strong message that economic growth, macroeconomic stabilization and poverty reduction work hand in hand and that private investment depends more on confidence than on the level of interest rates, and confidence is the by-product of macroeconomic stability. The APR-2 associates the 2003 recovery with an increase in private investment which is perhaps too optimistic given the lack of reliable recent data. Moreover, the report sees an improvement in the business climate which it attributes in part to the relatively recent reforms introduced following the Foreign Investment Advisory Services (FIAS) study. However, improved hydrological conditions that resulted in an increase in electricity production of 50 percent in 2003 relative to 2002 are likely to have been a significant factor, which the report does not acknowledge. The APR correctly highlights the importance of the successful privatization of the largest commercial bank in 2004 as foreshadowing the rapid deepening of the financial sector, with considerable impact on the financial sector and private sector development.

9. **Albania's debt position appears sustainable over the medium- term but there are possible risks ahead.** The progress report identifies the main risks such as the cost of domestic borrowing, the large trade deficit, the likelihood that remittances will decline and

the low level of Foreign Direct Investment. Nevertheless, a comprehensive sustainability assessment remains to be done.

10. **Similarly, while the NSSED's long term vision has now been framed within the Millennium Development Goals, much remains to be done to translate this vision into concrete expenditure programs.** The APR-2 highlights the use of priority coefficients to aid the prioritization of measures proposed in the sectoral matrices, which is a welcome improvement. However, much more work is needed to develop a consistent planning framework across line ministries that will achieve efficient resource allocation for poverty reduction. Moreover, the translation of priorities identified through the NSSED into real spending allocations in the annual budget and the MTBP remains weak. The staffs note the progress by the DoNSSED towards enhanced collaboration with the Budget Department, and urge the authorities to accelerate their efforts during the preparation of the 2005 annual budget. The next APR should give greater emphasis on public expenditure management and procurement reforms, drawing possibly on the recent Report on the Observance of Standards and Codes(ROSC).

11. **The progress reports fails to recognize sufficiently the importance of improving the mobilization of domestic resources in the medium-term.** While it is true that fiscal revenue has risen faster than nominal GDP in some years, this is not the case—as is stated in the report—for all years in the recent past, and the 2003 revenue ratio is still lower than in 2000. Moreover, persistent revenue shortfalls relative to initial budget projections have frequently resulted in ad-hoc adjustments, to the detriment of priority public investments. In this regard, it is surprising that the report does not discuss the implications of the expenditure cuts in 2003—equivalent to 2 percent of GDP—on priority expenditure and investment. Similarly, it is surprising that the APR-2 does not elaborate on the use, in 2004, of half of the funds from the privatization of the National Savings Banks for urgent priority investments in health, education and infrastructure. The APR-2 also fails to mention the indexation of government wages to inflation introduced in early-2004, a source of risk for fiscal stability in the medium-term.

12. **Institutional and governance reforms are essential for further fiscal consolidation and poverty reduction.** The progress report provides a relatively comprehensive review of the main measures envisaged for 2004–07 in the area of justice, public order, public administration, decentralization, and anti-corruption in the context of discussions on the Stabilization and Association Agreement with the European Union. Nonetheless, the progress report could give more prominence to institutional development and training necessary to increase the professionalism of public officials and increase the effectiveness of public service provision.

13. **While the APR-2 recognizes that Albania's eligibility for highly concessional foreign assistance is rapidly declining, it does not underscore the need to better evaluate and rank investment projects, including by giving priority to those for which concessional financing can be identified.** The need for attention in this area was highlighted by a recent government decision to propose to parliament a project that had not

been: (i) previously analyzed in the context of the NSSD; (ii) made subject to an independent feasibility study; (iii) considered in the loan-by-loan analysis underlying the definition of the non-concessional debt ceilings, representing an important element in the government's IMF-supported economic program; or (iv) considered within the context of a debt sustainability exercise. The progress report fails to discuss the authorities' commitment to improve the overall evaluation and prioritization processes for non-concessional public investment projects in order to ensure the efficient use of funds.

14. The quality and timeliness of statistics remains a major impediment to economic analysis and to policy formulation, and not enough emphasis is placed on improving their production. Inherent weaknesses include the lack of reliable recent economic data and inconsistencies between the data in the APR and in other government documents. This point is exemplified by the fact that the APR-2 discusses in some detail the sources of economic growth through 2003 while the latest national accounts cover only through the year 2001. National accounts for 2002 should be produced rapidly and a timetable for improving the regular production of national accounts should be outlined in the next APR.

Structural and Sectoral Policies

15. A number of crosscutting and sectoral issues received better attention in the APR-2 than in the APR-1 including governance, gender issues, and decentralization. Spending priorities reflected in the APR-2 continue to reflect those of the initial NSSD and staff broadly concur with them. However, while intra-sectoral prioritization has improved somewhat, there is still a need to develop mechanisms to better prioritize spending and policy reforms across sectors.

16. The inclusion of measurable indicators of six key dimensions of governance in the NSSD is a positive step, although some of the proposed targets are very ambitious. The APR-2 surprisingly does not highlight the establishment of the High Inspectorate (HI) as an important tool to combat corruption, although there is an urgent need to ensure adequate funding for the HI. The public administration reform priorities for 2004–07 are appropriate, although more emphasis on public expenditure management and procurement reforms is warranted. Most of the ongoing administrative reforms also focus only on the central government, and with the rapid speed of decentralization, civil service reforms at the local level remain a big challenge. In the area of legal and judicial reforms, there is a clear need for addressing the legislative logjam which is holding up the introduction of important legislation. There also is a need to improve the quality of legislative drafting across the government. Although there have been a number of improvements in the execution/bailiff service, it is not yet as effective, accurate and rapid as planned.

17. Some important initiatives and reforms in the social welfare system progressed in 2003. These included reforms of the social insurance schemes (contribution rates, harmonization of the urban and rural schemes, etc.) and social assistance programs. Improvements in targeting the poorest sections of the society were evident in 2003. New plans and draft laws have also been formulated that would: (i) link eligibility for cash social

assistance benefits for many individuals to availability for community work (as a way both to tighten income testing and to promote financial independence); and (ii) provide the legal and financing framework for a potential expansion of social services. For each of these initiatives, however, the effectiveness of implementation and overall impact will need careful monitoring. A decision was also taken to protect the vulnerable segments of society from the impact of electricity tariff increases, although implementation is not expected to begin until mid 2004. Pervasive labor market difficulties— particularly the inadequate number of formal sector jobs—will need to be corrected through an overall program of economic and governance reforms that foster efficient resource allocation. Staffs note that the APR-2 continues to place too much emphasis on job creation through active labor market programs.

18. **Important progress has been made with incremental reforms in the pension system.** A number of additional measures are in the process of being implemented, including the introduction of clear rules to determine pension levels that ensure adequate protection for retirees, and changes in collection arrangements for social insurance contributions.

19. **While education reforms remain a high priority, the report describes an overly optimistic picture.** The APR-2 describes numerous initiatives in reforming the education sector in 2003, including improved efficiency in the administration of the sector, reform of the education system and curricula, and improved enrolment in basic education and vocational training. However, implementation of these reforms is only just beginning, and more analysis is needed to ascertain the effectiveness of the adopted measures and to establish output/outcome indicators for these reforms. The adoption of a sector-wide strategy expected in this year should address some of these missing links.

20. **The APR-2 notes that steps have been taken to strengthen the performance of the health sector.** These include an increase in public sector spending on health (from 2.1 percent of GDP to 2.4 percent), with targeted increases towards much needed operation and maintenance for primary health care. The government has adopted the national HIV/AIDS Strategy and a Health Promotion Strategy and is in the process of finalizing a medium-term health sector reform strategy. This sector strategy is expected to outline a program of fundamental structural reforms in the sector aimed at improving governance, efficiency and equity of access to care. Despite encouraging progress in the sectoral policy formulation process, however, the APR-2 does not clearly outline the priority sectoral reforms and set indicators and targets which could be used to measure successful implementation.

21. **Albania continues to recover from a crisis in the electricity sector.** Since the beginning of 2001, the government and the national energy company (KESH) have made progress in mitigating the impact of the 2000 crisis through the implementation of a multi-year Action Plan — agreed with the donors—and the initiation of agreed sector reforms defined in a Power Sector Policy Statement adopted by the government. To date the performance targets of the action plan have been successfully met in twelve of thirteen quarters, including all of the period covered by the APR-2. Nevertheless it is imperative that measures continue to be taken to eliminate the need for government subsidies and to attract

the substantial investments needed in the sector. These measures include continuing to vigorously implement the Action Plan, adding domestic thermal generation capacity, and creating without delay an equalizing fund to ensure that profits resulting from favorable hydrology are set aside to cover additional import costs during periods of adverse hydrology.

22. **Satisfactory progress in financial sector reforms was evident in 2003.** The banking system is now wholly under private management and reforms of the insurance sector are making good progress. In addition, the inauguration of a real-time gross settlements system was a significant landmark in the evolution of the payments system. However, the government's medium-term strategy (2004–07) for the financial sector lacks concrete measures, in particular towards increasing financial intermediation in certain parts of the economy, strengthening of the enforcement mechanism of contracts and creditor's rights, increasing transparency in financial reporting and implementation of a credit information system, as well as a timetable for implementation of these reforms. Also, the APR-2 does not discuss the authorities' intentions to channel gradually government wages through the banking system—a measure that is expected to contribute a great deal to improving business practices and strengthening law and tax enforcement—and the planned build-up of analytical capacity at the Bank of Albania in line with the authorities' intentions to move towards a more formal inflation targeting. Staffs expect however that progress will be made in all these areas following the completion of an FSAP, preliminarily scheduled for 2005.

23. **The government has made progress on improving aspects of the business climate** through the implementation of the administrative barriers action plan, with the assistance of FIAS. Key outstanding issues include further work to reduce barriers such as tax administration, unofficial monopolies (which are growing in power and stifling fair competition), as well as improving the accountability of public employees and building the capacity of critical institutions such as tax and customs administration.

24. **Good progress was made in pursuing regional trade liberalization in 2003.** However, the APR-2 appears to suggest a slowdown in the pace of further trade liberalization. This would run counter to the growth strategy of the authorities and should be avoided. It would also be important for the authorities to assess rapidly the impact of the phasing out of the Multi Fibre Agreement at the beginning of 2005 on the growth of Albania's textile exports.

25. **Environmental protection and sustainable natural resources management remains a priority.** Some steps have been taken to improve the capacity of environmental institutions and to improve the communication of environmental information. The government has made a serious commitment to reduce existing pollution and eliminate toxic substances close to inhabited areas and is working with international donors to speed up the process. Enhancing land tenure security is a key issue towards furthering the sustainable use of environmental resources and creating opportunities for the rural poor. While there has been notable progress towards improving the legal and regulatory framework, significant concerns remain about the fragility of coastal area ecosystem, which calls for a fundamental shift of current approaches towards sustainable development and land use planning.

IV. TARGETS, INDICATORS, AND MONITORING

26. **The government's efforts to strengthen monitoring and evaluation continue to be encouraging.** A total of sixteen ministries and agencies prepared monitoring and evaluation (M&E) matrices for the APR-2, which represents an impressive achievement. While the introduction of a new format and standardization of the information presented in the matrices represents an improvement compared to the APR-1, a number of the indicators appear unrealistic, and there is a need to more explicitly link the indicators and NSSED goals (including MDGs), and to include clear targets. It will be important to ensure that separate M&E systems are not developed as the M&E matrices are reviewed and updated to better align and harmonize indicators and targets with broader Albanian strategic goals, such as European Integration and NATO membership.

27. **Lack of analysis capacity remains a constraint.** While there have been notable improvements in the degree to which government agencies are gathering and presenting data to monitor policy developments, which could lead to a results-focused policy culture, the ability to truly analyze the data so as to have a meaningful input into policy making process is still under-developed in many ministries. Efforts also need to be continued to improve and strengthen systematic survey-based monitoring such as the LSMS to provide the data that will allow tracking of policy outcomes over time.

V. THE PARTICIPATORY PROCESS

28. **The participatory process was deepened further during the preparation of the progress report and efforts to institutionalize participation in policy making continued.** The DoNSSED has been fully engaged in coordinating the participatory process for the preparation of the APR-2. Under the guidance of the DoNSSED, and in close collaboration with international partners, more than 25 sectoral and regional consultations were organized with the participation of representatives of local government, civil society, and parliament. The APR-2 is, however, weak in describing the consultative process and the feedback from the consultations, as well as the ongoing role of civil society in monitoring NSSED implementation. There has been good progress in linking regional development strategies with the NSSED especially in the regions of Korca, Vlora, and Shkodra. However, the role of the Parliament remains limited to the participation of some key members in the consultations organized in different regions. Increased parliamentary involvement in the NSSED process is critical for the strengthening of the NSSED as a development instrument.

29. **The emphasis on decentralization and participation in the APR-2 is welcome.** The approach, however, remains largely top down, with more emphasis on consultations than on empowerment of stakeholders. The NSSED consultative process could do more to build on and integrate local level development planning which is beginning to take place.

VI. RISKS TO THE STRATEGY

30. **Successful NSSED implementation at the rate currently foreseen hinges largely on the government's ability to improve investors' confidence, curtail corruption and**

strengthen institutional integrity, while weathering the disturbances that may occur in the period leading up to the mid-2005 elections.

31. **The lack of clear linkages between the NSSED, the MTBP and the annual budget presents risks to achieving poverty reduction outcomes.** To avoid exacerbating this risk, it is crucial to avoid overly optimistic budgetary projections which in the past have led to frequent ad-hoc expenditure cuts.

32. **The government faces a number of inherited legacies with uncertain fiscal impacts, which could affect the development agenda.** Issues such as the proposed restitution and compensation of former landowners and politically persecuted could have large fiscal consequences. The APR-2 makes little mention of such potential liabilities.

33. **While the action plan on the electricity sector is on track, the impact of hydrological variations on Albania's macroeconomic performance remains a major risk.** The government should aggressively pursue mitigating measures, as described earlier and in particular, create without delay an equalizing fund.

34. **As the level of development assistance available to Albania falls, donor programs need to be more closely aligned with the NSSED.** Substantial progress on coordination notwithstanding—particularly towards harmonizing the NSSED and the EU accession agendas—increasing alignment of donor priorities with the NSSED will be essential to maximize poverty alleviation outcomes in the coming years.

VII. CONCLUSIONS

35. **Overall, the second year's performance in implementing the NSSED has been broadly satisfactory.** The APR-2 provides an acceptable basis for the continued implementation of the NSSED. Although there are significant improvements in a number of areas, the realization of related measures foreseen for 2003 and the quality of the APR-2 do not meet the expectations raised earlier. Future reports need to be considerably more candid and analytical, and should not only assess progress made based on data and other evidence but also focus on obstacles and identified constraints that impede reduction of poverty.

36. Priority areas for attention over the coming year, which should be addressed in the next Annual Progress Report include: (i) translating the priorities of the NSSED into concrete spending plans through the MTBP and the annual budgets; (ii) strengthening the evaluation and prioritization of investment projects to ensure efficient use of funds and debt sustainability ; (iii) ensuring that spending plans are consistent and fit within an explicit medium-term fiscal and macroeconomic framework; (iv) improving the data for monitoring poverty outcomes and analytical capacity within the government; and, (v) further strengthening the participatory process, particularly the role of parliament in the formulation, implementation and oversight of the NSSED.

37. The staffs of the World Bank and the IMF consider that the country's efforts towards implementation of the strategy provide sufficient evidence for its continuing commitment to

poverty reduction, and therefore the strategy continues to provide a credible framework for Bank and Fund concessional assistance. The staffs recommend that the respective Executive Directors of the IMF and the World Bank reach the same conclusion.