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COMMISSION STAFF WORKING DOCUMENT

ECONOMIC REFORM PROGRAMME

OF

ALBANIA
(2016-2018)

COMMISSION ASSESSMENT

Table of contents

| | |
|---|-----------|
| 1. EXECUTIVE SUMMARY | 2 |
| 2. ECONOMIC OUTLOOK AND RISKS | 4 |
| 3. PUBLIC FINANCE | 7 |
| 4. STRUCTURAL REFORMS | 11 |
| ANNEX 1: OVERALL ASSESSMENT OF PROGRAMME REQUIREMENTS..... | 18 |
| ANNEX 2: IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2015..... | 20 |

1. EXECUTIVE SUMMARY

Albania is experiencing a gradual economic upturn that is expected to continue in 2016-2018. GDP growth is driven by private investment, mainly in the form of foreign direct investment in the energy sector, and is projected to average well above 3%. Consumption spending is also expected to pick up on the back of rising disposable income and employment gains. Nevertheless, the recovery is facing downside risks, notably due to sluggish bank lending amid a still high share of impaired loans and because falling commodity prices have weakened the outlook for the extractive industry, which has been an important growth driver in recent years.

Albania's economic reform programme (ERP) reflects an appropriate policy mix, with an accommodative monetary policy and plans for continued fiscal consolidation. The economy is still operating below its potential. This keeps a lid on price rises and allows the central bank to pursue loose monetary policy in an effort to steer persistently low inflation back towards the target. At the same time, the economic upswing provides a good opportunity for fiscal consolidation and the programme sets out an ambitious plan for continued budgetary adjustment. The completion of the wide-ranging exercise to clear accumulated central government arrears and the resulting decline in expenditure will also help reduce the headline deficit.

Lowering vulnerabilities and realising the economy's growth potential are major challenges facing Albania. Tackling macroeconomic imbalances and rebuilding policy buffers would make the country more resilient to adverse external shocks. At the same time, implementing structural reforms is key to achieving high rates of sustained economic growth beyond the current cyclical improvement. The main challenges are:

- **Debt-related vulnerabilities are high and there is little room for manoeuvre of fiscal policy in the face of shocks.** Despite efforts to consolidate the budget since 2014, Albania's public debt remains high at more than 70 % of GDP, and is associated with significant rollover and exchange rate risks. The country's fiscal adjustment plans are ambitious and are based mainly on ensuring better tax compliance and tightly controlling expenditure. However, implementing these plans will likely be challenging. Additional budgetary risks stem from contingent liabilities in the electricity sector, spending commitments in public-private partnerships and potentially significant local government arrears.
- **Improvements to the fiscal framework would support fiscal credibility and underpin the consolidation process.** Multi-annual commitment control has been strengthened to prevent arrears recurring, but there is considerable scope for making medium-term budgeting more binding, eliminating the optimism bias in macroeconomic and revenue forecasts and improving the capacity to plan and manage capital expenditure. A fiscal rule has been under preparation for some time; if well-designed it would greatly support budgetary discipline and help anchor fiscal policy.
- **Obstacles to resolving non-performing loans still burden banks' balance sheets and impede the functioning of the bank lending channel.** Banks are well capitalised and highly liquid, and the banking system withstood well the turbulent period following the introduction of capital controls in Greece. Still, declining but high non-performing loans and loan euroisation continue to be major challenges, both to the stability of the banking system and to the conduct of monetary policy.

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- **Attracting foreign direct investment into tradable sectors would help boost productivity and broaden the export base.** A large gap in the trade balance means that the current account deficit exceeds 10 % of GDP and is expected to widen in the coming years. However, financing the current account deficit relies little on debt-generating flows. Foreign direct investment has been relatively high since 2007 and is expected to increase further, but it is concentrated in non-tradable and natural resource intensive industries as significant obstacles in the investment environment have so far undermined Albania's attractiveness to higher value added activities.
 - **Although it has already implemented many reforms, Albania still faces several challenges to improving the business climate.** Businesses, which are predominantly SMEs, are burdened by a lack of access to finance, a high level of informality, still unclear land ownership and an excessive regulatory burden. The economic reform programme identifies the main obstacles in these areas, and the measures it proposes, if implemented smoothly and without delays, could bring significant improvements. However, combatting informality and widespread corruption requires sustained political commitment and a coordinated approach.
 - **Further liberalisation of network industries would be beneficial for investment and economic development.** Given Albania's limited fiscal space, the need for large-scale investments, especially in the energy and the transport sectors, can only be met by creating favourable conditions for private investment. Steps towards further liberalisation of the energy market are already planned, and the ongoing Trans-Adriatic Pipeline project will help the country to diversify its energy sources.
 - **Increased economic activity has not translated into significant gains on the labour market.** High youth unemployment is linked to widespread skills mismatches. Labour market participation of women is particularly low and high informality continues to act as an impediment to growth. The coverage and outreach of employment services and the measures to encourage labour market activity are insufficient. The inadequate overview of social needs hinders the targeting and outreach of social services.

The macroeconomic and fiscal framework of the ERP is coherent, consistent and provides an adequate basis for policy discussions, while the structural reform section has improved compared to last year. The reform measures correspond well to the key obstacles to growth and competitiveness identified in the diagnostics. Moreover, they cover not only public investment projects but also long-term strategies and market economy-oriented adjustments of the legal framework.

Last year's policy guidance has been partially implemented. Budget revenues have not stayed on track and capital spending has been under-executed, but tentative progress has been made towards devising a fiscal rule. Electricity-sector reforms have yielded significant financial improvements and further policy measures have been agreed to facilitate the resolution of non-performing loans. Other positive achievements include the adoption of the laws on higher education and the power sector and the establishment of the National Business Centre to streamline business registration and licencing. Some steps have also been taken to improve the vocational education and training (VET) and higher education systems. However, no real progress has been made on the important issue of the land cadastre strategy.

2. ECONOMIC OUTLOOK AND RISKS

Albania's economic reform programme (ERP) projects that economic recovery will gradually strengthen on the back of robust growth in domestic demand. After three consecutive years of contraction, in 2015 the investment cycle started to revive. In the immediate term, investment is expected to remain the main growth driver, supported by strong foreign direct investment (FDI) inflows and a gradual easing of financing conditions for corporates. Private consumption is set to recover from the fall recorded in 2015 thanks to lower precautionary saving by households and a projected steady increase in employment and wages. On the other hand, the envisaged fiscal tightening will mean that growth is not buoyed by public consumption. Foreign trade is predicted to contribute negatively to growth throughout the programme horizon as the projected pick-up in exports is expected to be outweighed by the effect of robust import growth, especially in 2016-17 when some import-intensive large investments will be implemented. On the production side, the ERP projects that all main branches of the economy will contribute positively to growth in 2016-2018, especially agriculture and, in line with growing consumption, the services industry. The extractive industry, which has been an important growth driver in recent years, is set to undergo a mild recession in 2016 as lower prices for oil and other commodities trigger production cuts. However, it is expected to recover quickly in the following years. All in all, the ERP projects that economic growth will accelerate from an expected 2.6 % in 2015 to 4.2 % in 2018.

Table 1:

Macroeconomic developments and forecasts

| | 2014 | | 2015 | | 2016 | | 2017 | | 2018 | |
|--|-------|--------------|-------|--------------|-------|--------------|-------|--------------|------|--------------|
| | COM | ERP | COM | ERP | COM | ERP | COM | ERP | COM | ERP |
| Real GDP (% change) | 2.0 | 2.0 | 2.7 | 2.6 | 3.2 | 3.4 | 3.5 | 3.9 | n.a. | 4.2 |
| <i>Contributions:</i> | | | | | | | | | | |
| - Final domestic demand | 1.9 | 2.7 | 1.1 | -0.2 | 4.4 | 5.5 | 4.4 | 4.7 | n.a. | 4.5 |
| - Change in inventories | 1.9 | 0.8 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | n.a. | 0.0 |
| - External balance of goods and services | -1.8 | -1.5 | 1.6 | 2.7 | -1.2 | -2.2 | -1.0 | -0.8 | n.a. | -0.3 |
| Employment (% change) | 1.6 | 1.3 | 2.0 | 2.4 | 2.2 | 4.1 | 2.5 | 4.4 | n.a. | 3.4 |
| Unemployment rate (%) | 17.9 | 17.9 | 17.5 | 17.3 | 16.9 | 15.9 | 16.0 | 14.4 | n.a. | 13.1 |
| GDP deflator (% change) | 1.6 | 1.6 | 0.6 | 0.6 | 2.0 | 2.5 | 2.4 | 3.0 | n.a. | 3.1 |
| CPI inflation (%) | 1.6 | 1.6 | 1.9 | 1.8 | 2.3 | 2.3 | 2.6 | 2.7 | n.a. | 3.0 |
| Current account balance (% of GDP) | -12.9 | -12.9 | -10.9 | -10.1 | -11.9 | -10.7 | -12.3 | -11.2 | n.a. | -11.0 |

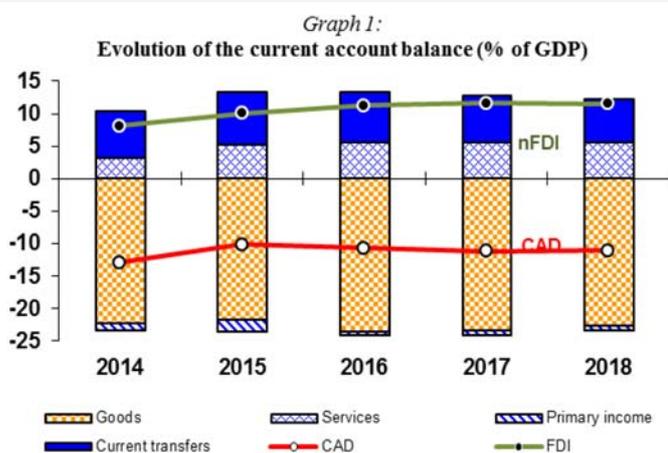
Sources: Economic Reform Programme (ERP) 2016, Commission 2016 Winter Forecast (COM)

The assumed growth drivers are plausible, but the ERP's projected growth trajectory appears optimistic and exceeds the Commission's winter forecast. While FDI-financed large investments in the energy sector (into a major gas pipeline and two large hydropower plants) are boosting gross fixed capital formation, tight credit standards for businesses amid lingering challenges to bank loan portfolios may continue to constrain investment financing for some time. Moreover, although the repayment of government arrears over 2014-2015 improved corporate liquidity, its impact will wane over time. The pick-up in household spending is partly based on improving sentiment, but consumer confidence has been volatile lately, pointing to protracted uncertainties. Moreover, the projected employment growth, at 4 % on average and based solely on private sector job creation, appears overly optimistic and would imply declining labour productivity in 2016-17. On the external side, it is realistic to assume that Albania would benefit from the expected gradual recovery of its main trading partners in the EU, even if

close links with Greece mean that unfavourable developments there may well spill over to Albania. Furthermore, the oil sector, which is one of the country's major exporters, might suffer a deeper contraction if oil prices stay low for longer than expected. Agriculture and electricity production remain subject to weather-induced volatility. It therefore appears that, even if it has been revised down from last year, the ERP's growth trajectory is still somewhat optimistic and subject to downside risks, as the programme itself acknowledges.

Persistently below-target inflation suggests that monetary policy will remain loose, but its effectiveness continues to face constraints. Annual inflation has remained below the central bank's 3 % target for three consecutive years, reflecting subdued price pressures from still below-potential output and low imported inflation. The central bank cut its policy rate twice in 2015 to a historic low of 1.75 %, but although financial conditions have continued to ease, the bank lending channel is still impaired by a protracted deterioration in the quality of banks' assets. The central bank has signalled its intent to maintain an accommodative monetary stance for an extended period as it now expects the economy to return to its potential output at the beginning of 2017 and inflation to reach the 3 % target in the following year. There might still be some, albeit diminishing, room for further lowering the policy rate if these expectations are not met. Moreover, lower government borrowing should also help improve the pass-through of monetary policy impulse by exerting downward pressure on market interest rates. However, under a free-floating exchange rate regime, further monetary easing might face constraints stemming from the high proportion of foreign-currency loans to unhedged borrowers, even if the lek's exchange rate against the euro has remained stable for years.

The current account deficit is expected to widen as a result of strong growth in import-intensive investments. A substantial trade deficit, caused by a narrow production and export base and partly funded by remittances from Albanians living abroad, is the main factor driving Albania's historically large current account shortfall. In 2015, the current account deficit is estimated to have narrowed substantially from 12.9 % of GDP recorded a year earlier because a pick-up in investment was more than offset by increased precautionary saving by households. Going forward, the programme expects that import growth, driven by strong investment and rising private consumption, will outweigh the



Source: Economic Reform Programme (ERP) 2016, ECFIN calculations

impact of a steady increase in exports, especially of agricultural and textile products and tourism. Remittances are forecast to stay broadly flat in 2016-2018, while the primary income balance is expected to remain in deficit due to continued profit repatriation by an expanding FDI base. Overall, the programme projects that the current account deficit will widen gradually from an estimated 10.1 % of GDP in 2015 to 11.2 % in 2017, before falling back to 11 % in 2018. This probably underestimates somewhat the magnitude of prospective deficits, partly because the 2015 outturn might be worse than expected in the ERP, and also because the projected real growth in exports, at 6.3 % a year on average, might be overstated in the context of low commodity prices and sluggish overall global trade. In terms of the saving-investment balance, rising investment relative to GDP is

impact of a steady increase in exports, especially of agricultural and textile products and tourism. Remittances are forecast to stay broadly flat in 2016-2018, while the primary income balance is expected to remain in deficit due to continued profit repatriation by an expanding FDI base. Overall, the programme projects that the current account deficit will widen gradually from an estimated 10.1 % of GDP in 2015 to 11.2 % in 2017, before falling back to 11 % in 2018. This probably underestimates somewhat the magnitude of prospective deficits, partly because the 2015 outturn might be worse than expected in the ERP, and also because the projected real growth in exports, at 6.3 % a year on average, might be overstated in the context of low commodity prices and sluggish overall global trade. In terms of the saving-investment balance, rising investment relative to GDP is

projected to outstrip the expected increase in the domestic saving rate. Two-thirds of this increase is to come from the public sector as a result of fiscal consolidation.

Non-debt-creating flows, primarily in the form of FDI, are expected to finance a large and increasing part of the current account deficit. Between 2007 and 2014, almost two-thirds of the current account deficit was financed by FDI and nearly 72 % of it by non-debt-generating flows, including capital transfers. Consequently, external indebtedness, at 73 % of GDP in the third quarter of 2015, does not give rise to immediate concerns. This is also because external debt is composed mainly of government long-term borrowing and intercompany lending between direct investors and subsidiaries. At the same time, foreign reserves covered 6.6 months of imports of goods and services, providing an adequate safeguard against adverse shocks. In the years to come, the ERP expects rising FDI inflows to finance the entire current account deficit and to contribute to a steady increase in foreign reserves. Downside risks to this outlook stem from persistently low commodity prices weighing on FDI into the extractive industry. Moreover, despite Albania's relative recent success in attracting foreign investments, these remain heavily concentrated in non-tradable and natural resource-based industries. Moving into higher value-added activities and better integration into global supply chains would help boost productivity and create more and better jobs, but would require wide-ranging structural reforms to bring about substantial improvements in the investment environment.

Impaired loans still burden bank balance sheets and hamper a revival in lending, even though banks are well capitalised and highly liquid. The non-performing loan (NPL) ratio decreased to 18.2 % at the end of 2015 from 22.8 % a year earlier mainly due to mandatory loan write-offs. High NPLs are a major factor behind tight lending standards, especially for corporates, and contribute to weak lending to the private sector. Private credit in Albania grew by only 2.2 % in the year to December 2015 (adjusting for the impact of the NPL write-off). Supported by international institutions, the government and the central bank agreed on a comprehensive NPL action plan in September 2015 that involves legislative and regulatory measures and is expected to speed up NPL resolution and credit recovery. On the other hand, monetary easing has led to a decrease in the lek-euro interest rate spread and has supported a gradual shift towards lending in lek. However, liability euroisation remains high; foreign currency loans to unhedged borrowers still make up around a third of the total loan stock, making their repayment vulnerable to a sharp depreciation of the lek. The banking system overall maintains adequate buffers to absorb shocks as capital adequacy and liquidity ratios exceed regulatory requirements and profitability has been improving. Banks are also not reliant on foreign-based parents for funding because the ratio of loans to domestic deposits is only 55 %. However, the preponderance of short-term deposits among funding sources leads to maturity mismatches and hinders long-term financing by banks. On the asset side, government securities have a share of around 24 %, exposing banks to sovereign risk.

Table 2:

Financial sector indicators

| | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|-------|-------|-------|-------|-------|
| Total assets of the banking system, mEUR | 8,102 | 8,503 | 8,803 | 9,234 | 9,306 |
| Foreign ownership of banking system by asset, % | 90.4 | 89.8 | 88.6 | 87.1 | 84.1 |
| Private credit growth, % | 10.4 | 1.4 | -1.4 | 2.0 | 2.2* |
| Deposit growth, % | 13.1 | 7.3 | 3.4 | 4.5 | 2.6 |
| Loan to deposit ratio | 61.6 | 58.6 | 55.6 | 55.5 | 53.2 |
| Financial soundness indicators, % | | | | | |
| - non-performing loans to total loans | 18.8 | 22.5 | 23.5 | 22.8 | 18.2 |
| - core capital to risk weighted assets | 14.3 | 14.6 | 14.9 | 13.8 | 13.5 |
| - liquid to total assets | 26.5 | 29.4 | 27.6 | 31.9 | 32.3 |
| - return on equity | 0.8 | 3.8 | 6.4 | 10.5 | 13.2 |
| - forex loans to total loans | 67.9 | 64.5 | 63.0 | 62.4 | 60.8 |

*: Adjusted for loan write-offs

Sources: Economic Reform Programme (ERP) 2016, Bank of Albania

3. PUBLIC FINANCE

In 2015, revenue fell significantly short of target, but due to under-execution of expenditure the budget deficit was somewhat lower than planned. Revenue underperformed by 8 % against the initial target and 4.3 % against the revised plan adopted in July 2015. The shortfall was caused mainly by reliance on a high assumed 2014 revenue base as well as overoptimistic assumptions about nominal GDP growth and collection efficiency gains. Reasons specific to individual taxes, such as lower-than-expected oil prices and deposit interest rates, also played a part. Overall, the ratio of revenue to GDP increased only marginally against an expected rise of 1.9 pps. in the ERP for 2015, of which half was supposed to come from discretionary tax measures. At the same time, expenditure remained 7.7 % below the initial plan mainly due to savings in interest costs and the underspending of capital budgets, which occurs repeatedly and points to weak capacity to manage investments. All in all, the headline budget deficit was lower than the 4 % target in 2015 and declined to 3.8 % of GDP from 5.1 % recorded in 2014. This outcome was supported by a decrease in payments linked to the clearance of government arrears from 2.4 % of GDP in 2014 to 1.2 % in 2015. There was no improvement in the underlying primary balance net of these expenses.

The ERP commits Albania to an ambitious fiscal consolidation path to tackle vulnerabilities stemming from high public debt. This commitment translates into a plan to improve the headline deficit by an annual average of 1.1 pps. to -0.5 % of GDP in 2018. The bulk of the adjustment is anticipated to come initially from raising the revenue-to-GDP ratio by 1 pp. in 2016, following which it would remain stable. In 2017-2018, spending restraint is expected to drive fiscal consolidation as expenditure relative to GDP is projected to decrease by 0.9 pps. annually. As a result, the primary surplus (excluding the arrears clearance that took place in 2014-2015) would improve from 0.1 % of GDP in 2015 to 2.4 % in 2018. If these targets are met, both the headline and the primary balance will record its best performance since Albania's transition to a market economy began 25 years ago. On this basis, the public debt ratio (including state guarantees) will start declining in 2016 and will fall below 64 % in 2018.

Table 3:

Composition of the budgetary adjustment (% of GDP)

| | 2014 | 2015 | 2016 | 2017 | 2018 | Change: 2015-18 |
|---|------|------|------|------|------|--------------------|
| Revenue | 26.2 | 26.4 | 27.4 | 27.3 | 27.3 | 0.9 |
| - Taxes and social security contributions | 21.1 | 20.9 | 21.4 | 21.6 | 21.6 | 0.7 |
| - Other (residual) | 5.1 | 5.5 | 6.0 | 5.7 | 5.7 | 0.2 |
| Expenditure | 31.3 | 30.2 | 29.6 | 28.7 | 27.8 | -2.4 |
| - Primary expenditure* | 26.1 | 26.3 | 26.8 | 25.8 | 24.9 | -1.4 |
| <i>of which:</i> | | | | | | |
| Gross fixed capital formation | 5.1 | 5.4 | 5.8 | 5.4 | 5.1 | -0.3 |
| Consumption | 8.8 | 9.1 | 8.9 | 8.4 | 8.1 | -1.0 |
| Transfers & subsidies | 11.8 | 11.3 | 11.6 | 11.4 | 11.2 | -0.1 |
| Other (residual) | 0.4 | 0.5 | 0.5 | 0.6 | 0.5 | 0.0 |
| - Interest payments | 2.9 | 2.7 | 2.8 | 2.9 | 2.9 | 0.2 |
| Budget balance | -5.1 | -3.8 | -2.2 | -1.4 | -0.5 | 3.3 |
| - Cyclically adjusted | -4.9 | -3.7 | -2.2 | -1.5 | -0.6 | 3.1 |
| Primary balance* | 0.2 | 0.1 | 0.6 | 1.5 | 2.4 | 2.3 |
| Gross debt level | 71.8 | 72.2 | 70.6 | 67.7 | 63.6 | -8.6 |

*: Excluding arrears clearance

Sources: Economic Reform Programme (ERP) 2016, ECFIN calculations

The 2016 budget optimistically projects strong growth in revenue, relying to a large extent on better tax administration and compliance. Nominal GDP is assumed to grow by 5.9 %, which exceeds the Commission's winter forecast of 5.2 %. However, the increase in revenue is projected to be even higher, as its ratio to GDP is expected to rise by 1 pp. This is only partly explained by discretionary tax measures, which are anticipated to yield about 0.4 % of GDP.¹ The high assumed tax elasticity should also get some support from expected changes in the composition of GDP, with tax-rich private consumption predicted to return to growth. However, a large part of the planned increase in revenue is attributed to the impact of the government's renewed efforts to curb tax evasion, non-compliance and the informal economy by stepping up checks and penalties and through better tax administration. The first results in terms of growth in the number of social security contributors and registered businesses are encouraging, but it is not clear whether the impact will be large enough to help achieve the expected fiscal result. If revenue again falls short of plan, expenditure will need to be cut to meet the deficit target. A small contingency line of about 0.1 % of GDP and somewhat over-budgeted interest costs may cushion this somewhat. However, in the past capital expenditure bore the brunt of spending cuts. This was not conducive to supporting long-term growth and also contributed to the build-up of arrears. This pattern might repeat itself since capital expenditure continues to provide the main discretionary item to be reduced to compensate for errors in forecasting revenue.

¹ See box for details on the impact of revenue measures approved in the 2016 budget.

Box: The budget for 2016

The 2016 state budget was approved by the Parliament on 17 December 2015. It assumes real GDP to grow by 3.4% and the GDP deflator to increase by 2.5%. The budget deficit is expected to fall to 2.2% from 3.6% recorded in 2015.

Table: Main measures in the budget for 2016 and their estimated net savings impact

| | |
|---|-----------------------|
| – Changes in local taxes: extension of property tax on urban land; removal of the simplified income tax for small businesses; increase in the infrastructure impact tax; redefinition of the tax on billboard advertising | (0.1% of GDP) |
| – Applying VAT to certain inward processing activities | (0.1% of GDP) |
| – Introduction of reference wages for self-employed professionals to calculate social security and health insurance contributions | (0.07% of GDP) |
| – Increase in the gross written premium tax from 3% to 10% | (0.04% of GDP) |
| – Replacing ad valorem royalty on non-metallic minerals with quantity based royalty | (0.03% of GDP) |
| – Introduction of a registration fee and an annual circulation tax on luxury cars | (0.02% of GDP) |
| Total tax revenues effect | (0.4 % of GDP) |

Source: ERP 2016

Beyond 2016, plans for fiscal consolidation rely on spending restraint, but the underlying measures are often unclear. Expenditure relative to GDP is expected to decline by 1.8 pps. between 2016 and 2018, with the main spending categories all sharing the burden of retrenchment as their planned increase stays below that of nominal GDP. The rise in social insurance outlays, the biggest expenditure item, is expected to be linked to the annual rate of inflation, as required by law. Improving the efficiency of public administration and better targeting social assistance schemes may create savings, but the ERP is short on details. Total capital expenditure is projected to stay flat after 2016 and fall back as a share of GDP to 5.1 % in 2018 from 5.8 % in 2016. This is still relatively high, although capital budgets tend to be under-executed. Local government spending is expected to increase in 2016, but to then experience one of the biggest relative declines in 2017-2018. However, this is not consistent with decentralisation plans resulting from recent reforms to territorial administration. All in all, the implementation of the envisaged expenditure-led consolidation faces downside risks, not least because spending pressures might emerge in the run-up to the parliamentary elections expected in 2017, just when Albania's IMF-supported programme, which currently acts as a disciplinary anchor, expires. On the revenue side, risks mainly stem from optimistic projections of nominal GDP growth.

Box: Alternative scenarios

The programme presents alternative scenarios in terms of growth and budget outcomes to take into account some of the risks surrounding the baseline assumptions. In addition to the baseline assumption, the ERP looks in particular at the low growth and favourable growth scenarios and their effect on public finances. In case of feeble growth, the assumptions also include lower tax elasticity. The low growth scenario expects real GDP growth of only 1 % in 2016, 2.2 % in 2017 and 3 % in 2018, with a corresponding negative impact on revenue. Under this scenario, half of the revenue shortfall is offset by spending cuts, exhausting the contingency line for deficit protection and reducing capital spending, while the other half increases the deficit (to 2.9 % in 2016, 2.3 % in 2017 and 1.5 % in 2018). This would still cause the public debt ratio to fall to 69.5 % in 2018. If growth is more robust than planned, half of the extra revenue would be used

for public investment, and only the remaining part would be saved and thus used for deficit reduction. Presenting alternative scenarios, even if they are relatively mild, enhances the soundness of the ERP. However, it is not clear whether the scenarios were developed solely for the purpose of the ERP or whether they are also anchored formally in the documents guiding the medium-term budget.

A number of additional fiscal risks linger and are not fully evaluated. Apart from risks inherent in its ambitious plan for fiscal adjustment, Albania’s budgetary position may be affected by financial obligations entered into by the public sector for which the government can ultimately be held responsible. Public guarantees represent one such source of risks, even if they are fully accounted for in the public debt and were reported to amount to 3.9 % of GDP at the end of 2015. The financially unviable electricity sector has long been a major beneficiary of public guarantees, but major reforms have started recently and the sector’s financial situation has improved. The ERP now expects to completely eliminate power sector subsidies by 2020.

A further long-standing risk to the budget outlook is posed by the obligation, confirmed by international court rulings, to provide compensation to former owners expropriated during Communism. The medium-term budget has increased allocations for this purpose to some 0.3 % of GDP annually, and a recently-approved law aims to adjust the existing scheme to make this compensation financially more affordable. However, there are still legal hurdles to implementing this new law. Moreover, it is not clear to what extent the fiscal bill, previously estimated at as much as 70 % of GDP, would be reduced as a result of these changes.

The ERP also reports on efforts and plans to increase transparency over liabilities linked to public-private partnerships and over non-debt obligations of local governments, both of which may amount to several per cent of GDP. There is also scope to better evaluate the long-term impact on fiscal sustainability of the recently-reformed pension scheme and the health care system.

| <i>Table 4:</i> | | | | | |
|--|-------------|-------------|-------------|-------------|-------------|
| Composition of changes in the debt ratio (% of GDP) | | | | | |
| | 2014 | 2015 | 2016 | 2017 | 2018 |
| Gross debt ratio [1] | 71.8 | 72.5 | 70.9 | 67.9 | 63.9 |
| Change in the ratio | 1.7 | 0.8 | -1.6 | -3.0 | -4.0 |
| <i>Contributions [2]:</i> | | | | | |
| 1. Primary balance | 2.3 | 1.4 | -0.6 | -1.5 | -2.4 |
| 2. “Snowball” effect | 0.4 | 0.5 | -1.2 | -1.6 | -1.8 |
| <i>Of which:</i> | | | | | |
| Interest expenditure | 2.9 | 2.7 | 2.8 | 2.9 | 2.9 |
| Growth effect | -1.4 | -1.8 | -2.3 | -2.6 | -2.7 |
| Inflation effect | -1.1 | -0.4 | -1.7 | -2.0 | -2.0 |
| 3. Stock-flow | -1.0 | -1.1 | 0.1 | 0.2 | 0.1 |

Box: Debt dynamics

The ERP expects the debt ratio to start decreasing as from 2016, helped by a predicted primary surplus, higher inflation and a pick-up in real GDP growth. These positive factors are projected to have an increasing impact, while the implicit interest rate is expected to rise only moderately. The low level of stock-flow adjustments indicates that the government does not expect significant net flows of guarantees or exchange rate movements. The expected debt trajectory appears to be based on optimistic forecasts of the main macroeconomic and fiscal variables.

Notes:
 [1] End of period.
 [2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other effects.
 Source: Economic Reform Programme (ERP) 2016, ECFIN calculations

High public debt, coupled with considerable short-term refinancing needs and increasing exchange rate risks, remains a cause for concern. Albania's public debt, including guarantees, exceeds 70 % of GDP. Domestic debt, at almost 40 % of GDP, still has a low average maturity and results in domestic refinancing needs in excess of 20 % of GDP annually. With a narrow investor base composed mainly of domestic banks, Albania is vulnerable to changes in market sentiment or host country regulatory requirements that could influence debt holders' willingness to hold Albanian securities. Albania stepped up foreign currency borrowing in 2015 to mitigate domestic refinancing risks and help release banking sector liquidity for private-sector lending. Consequently, external debt has risen to 34 % of GDP and increasingly exposes the government to exchange rate risk, especially in terms of a potential depreciation of the lek against the euro. The envisaged fiscal consolidation is therefore essential to mitigate debt-related vulnerabilities and rebuild room for policy manoeuvre.

Plans to improve the fiscal framework are key to supporting budget consolidation. The recent clearance of accumulated government arrears was accompanied by measures to prevent their re-emergence. These measures included improving checks on multi-year commitments and introducing more binding medium-term budgetary ceilings. However, the medium-term budgeting process still needs improvement, not least because over-optimistic macroeconomic and revenue projections and the resulting unrealistic expenditure allocations have undermined its credibility. To tackle this problem, a dedicated revenue unit has been established at the Ministry of Finance and coordination with the taxes and customs administrations will be strengthened to produce better bottom-up revenue forecasts. In addition, a draft fiscal responsibility law has been prepared at technical level and would reintroduce a fiscal rule following the repeal of the previous debt ceiling in 2012. Summoning political commitment to a well-designed fiscal rule that secures debt sustainability, counter-cyclicality and transparency would help greatly in anchoring expectations about budgetary discipline.

4. STRUCTURAL REFORMS

Albania's ongoing fiscal consolidation needs to be supported by profound structural reforms in order to bring about sustained growth. The main bottlenecks for a more competitive economy are institutional and regulatory barriers affecting both the overall business environment and foreign trade; access to finance; access to and reliability of the electricity supply; low labour market participation; the mismatch between skills demand and supply in the labour market; and the large share of the informal economy. Widespread corruption is another key obstacle figuring in the top three concerns of businesses according to the Business Environment and Enterprise Performance Survey (BEEPS).

The structural reform policy guidance adopted at the Economic and Financial Dialogue with the EU in May 2015 has been partially addressed. A new law on higher education and scientific research in higher education was adopted in 2015 and the accompanying implementing laws are to follow in 2016. An agreement was signed in 2015 between the Ministry of Education and Sport and the British Quality Assurance Agency for the independent accreditation of higher education institutions and to assist in capacity building of the national accreditation agency, in order to join the European Network of Quality Assurance. Measures to improve vocational education and training (VET) have been embedded in a National Employment and Skills Strategy, adopted in 2014, but much remains to be done to adapt training offers to labour market needs and to improve the quality and effectiveness of VET provision.

To further ease the regulatory and administrative burden on businesses, the National Business Centre was established in November 2015 as a one-stop shop for business registration and licensing. The implementation of the streamlined authorisation system is ongoing. The newly established Investment Council is by-and-large operational and helps to facilitate communication between policymakers and businesses.

Investments in the core transport network will be prioritised by establishing a single project pipeline. The power sector law entered into force in June 2015 and work is progressing on bylaws, especially those aimed at unbundling the energy sector. No real progress has been made on adopting a land cadastre strategy.

The ERP correctly identifies key obstacles for growth and competitiveness in an analysis that underpins the prioritisation of reform measures. A number of the reform measures in the ERP have only a limited budgetary impact as they are of a more strategic, planning and programmatic nature. The overall composition of envisaged measures looks appropriate given the limited fiscal space available to Albania due to its high public debt and commitment to fiscal consolidation. However, implementation and monitoring weaknesses remain and are not sufficiently acknowledged in the ERP. One of the main shortcomings of the programme is the evaluation of the measures' expected outcomes, which are either set too high to be regarded as realistic or are not ambitious enough.

Public finance management

Weaknesses in public finance management (PFM) are well known but get limited attention in the ERP. Albania adopted a PFM reform strategy in 2014, making it the first country in the region to do so. The reform strategy contains measures to address the key systemic weaknesses in PFM. These include poor quality of public spending and no value-for-money reviews; inadequate public procurement and contract management practices; and an inadequate correlation between annual budgeting and medium term budget plans. However, PFM is not linked to a priority measure in the ERP, which fails to mention public investment management, public procurement or external audit as problem areas. The PFM reform strategy, which benefits from EU budgetary support, requires a sustained political commitment to meet the deadlines and achieve the agreed targets.

Infrastructure

Given Albania's high degree of dependency on hydro power resources for power generation, diversifying the energy supply would be beneficial for the country's economic development. The energy sector is far from being a real market as it remains overly concentrated, centralised and regulated. There are significant losses in electricity distribution, which makes it necessary to import additional electricity. The country has not yet fully implemented the Energy Community Treaty nor the soft measures agreed under the Berlin process on regional cooperation in infrastructure development.

The measures to further liberalise the energy market in accordance with the Energy Community Treaty and introduce gas to the energy mix are highly relevant in addressing the above constraints. Liberalising the energy market is essential to increase the competitiveness of the economy; however, risks resulting from it should be considered and mitigated. Large-scale investments are needed to modernise the transmission network and safeguard a reliable and sustainable energy supply. In addition, further progress in controlling illicit energy use will require faster and sustained implementation of the energy sector reform. Liberalising the market should draw the interest of private companies for a long-term engagement in Albania and relieve pressure

on the public budget. At the same time, the independence of the regulatory body also needs to be strengthened to ensure a level playing field. Increased competition on the market could also reduce prices for businesses and households, even if this is not considered in the ERP. The reform on the diversification of energy sources focuses on gasification. The actions include adopting a gas master plan and continuing the support to the Trans-Adriatic Pipeline project. These activities seem manageable and should help achieve the aims of the reform.

Albania's external trade is predominantly done by road or maritime transport. Limited public funding opportunities to further develop and implement big infrastructure projects is a key bottleneck for the transport sector. Implementing the soft measures agreed under the Berlin process on regional cooperation in infrastructure development would further support the development of transport infrastructure.

The two transport infrastructure measures concerning a highway and the port of Durrës seem relevant but a lack of analysis makes their final impact on competitiveness difficult to assess. The envisaged feasibility study for the construction and upgrade of the Adriatic-Ionian corridor is an important first step that will have the impact expressed in the ERP once the construction works are finished and the infrastructure is complete. The measure on the upgrade and construction of infrastructure in the port of Durrës will facilitate traffic in and out of the port. Deepening the port basin and rehabilitating two quays will increase the potential number and size of ships that can enter the port, while constructing an internal railway will facilitate work in the port. However, the lack of a quantified assessment makes it difficult to assess the relevance of this measure to the competitiveness of the economy as a whole.

Albania's future competitiveness depends largely on the availability of fixed broadband infrastructure capacity to manage 'big data' volumes. A proper legal and regulatory framework is necessary to ensure an investment-friendly environment for broadband development by the private sector, as broadband penetration remains extremely low at a mere 8%.

The reform involving the adoption of the new law to reduce the cost of broadband infrastructure is welcome. However, if it is to have the intended impact, the law should be implemented in synergy with the measure on the effective implementation of the digital agenda strategy. Moreover, a budget should be made available to improve broadband backbone and backhaul capacity, since there is currently no funding for this. Well-coordinated telecommunication, transport and energy infrastructure projects will allow a sharing of digging costs and attract private investment. Besides the availability of adequate infrastructure, the development of ICT services requires that competition among operators is ensured and the independence of the regulator is safeguarded.

Sector development

Agricultural sector development

Albania's agricultural sector is characterised by small and fragmented holdings. It is hampered by still-unresolved land ownership issues such as inaccurate or overlapping boundaries between properties, unregulated land use, high transaction costs in selling and buying property, and absent or not-functioning registers. Informality is widespread in this sector, safety and quality standards are not enforced, and capital investments are insufficient.

The measure to consolidate and defragment agricultural land should allow farmers to make use of economies of scale. The timeline, costs, budgetary impact and expected impact on competitiveness are all well described in the ERP, although doubts may be

raised about the level of ambition and insufficiency of funds. Property and land consolidation will require time. Consequently, in 2016-2018 it may be more feasible to concentrate on solving property rights issues, completing the legislative framework, and starting work on the electronic country-wide cadastre.

Industry sector development

Somewhat surprisingly, no information is provided on industry sector development. The industrial sector in Albania is relatively small, accounting for around 14% of GDP. Main sectors include food processing, textiles and footwear, the extracting of raw materials and the production of cement and chemicals. Industrial exports are concentrated on raw materials and textiles/footwear. There is considerable room for export diversification.

Services sector development

Services constitute the largest sector of the Albanian economy. They contribute about 70% to gross value added. Therefore, their importance and potential for further development should be recognised in future strategies and not be given less attention than the industrial or agriculture sectors. In this context, it is important to underline that the export of services is in surplus and that tourism already has a high economic impact in Albania, even though it performs below potential. The total contribution of travel and tourism to GDP, including indirect effects, is estimated at around 20%. However, the sector faces numerous challenges linked to the lack of skills of tourism professionals, low accessibility of tourism services, the absence of a sustainable natural and cultural offer, and the lack of coordination and planning both within the sector and with other relevant sectors such as vocational education and training.

In this context, the measure to standardise the tourism sector is particularly relevant. If properly implemented, this would address widespread informality and support growth and competitiveness. However, the measure on its own is rather unambitious, lacks specification, and is not explicitly linked to other sector-specific strategies such as the ones on VET, rural development, business environment, RDI, infrastructure, and land ownership.

Business environment, corporate governance and reduction of the informal economy

Despite past efforts, Albania's businesses are constrained by a host of factors in their surrounding environment. One of the main obstacles is the complicated legal and regulatory framework, which is exacerbated by an inconsistent enforcement. A simpler regulatory framework and more business-friendly administrative procedures as well as improved legal certainty brought about by a successful justice reform would increase the country's attractiveness to foreign investors. Tax legislation tends to be enforced in a non-transparent manner allowing for *ad hoc* exemptions for some businesses. Unfair competition from the informal economy is an additional serious challenge. Other bottlenecks include problems with starting a business, obtaining construction permits, enforcing contracts and the high regulatory costs to businesses. Access to finance for SMEs is also constrained and limits the development of the private sector and its integration in regional and European markets.

The creation of a legal cadastre would facilitate investment and it remains a priority for Albania. However, progress is limited. In this context it is important to analyse weak spots and strengthen capacities in order to ensure smooth legal land registration, the full functioning of the cadastre in general and especially the e-cadastre until 2019.

The planned measures to improve the business environment are important, but fighting the informal economy and corruption remains a major task. The measure on

reducing the regulatory burden for businesses focuses on making the National Business Centre fully operational as a one-stop-shop business registration and licensing body, while also introducing e-licensing and e-permits and developing IT solutions to ensure their effectiveness. The timeline for the roll-out, cost and budgetary impact are clearly set. However, the expected impact on investments, job creation and competitiveness may be slightly optimistic and may depend on other factors beyond the scope of the measure.

Technological absorption and innovation

Albania's capacity for technological absorption and research, development and innovation (RDI) is low. Key obstacles include low expenditure and investment in research and development (about 0.4% of GDP), weak links between the scientific and private sectors, as well as fragmentation of the national research and innovation system. As a result of this weak innovation policy infrastructure, almost all sectors of the economy mainly provide low-technology, labour-intensive and low-cost products and services.

Fostering cooperation between higher education, research and businesses supports innovation. The ERP focuses on the digital agenda strategy by continuing to implement the 'triple helix' model and on institutional reform on science. The triple helix should facilitate the application of innovative ideas, increase the readiness for and use of ICT in SMEs, and create an incubator for ICT start-ups. The timeline is clearly set, the challenges and costs are identified, and the objectives are measurable and clearly spelled out. If the project is well implemented, some improvement of competitiveness can be expected. In addition, the digital agenda strategy includes a number of specific measures and instruments to enable SMEs to make better use of innovation and ICT.

The aim of the institutional reform is to strengthen the scientific base through higher education restructuring. The new law on higher education and scientific research in higher education is a first step in the right direction and establishes two agencies for scientific research and higher education funding. However, the law defines only the main functions of these agencies without detailing implementation. In addition, what is missing is a clear strategy to increase capacity by inter alia capitalising on the sizable Albanian diaspora. Increased funding and a more focused RDI-strategy in a number of specific sectors (Smart Specialisation Strategy), notably in energy, agri-food and sustainable tourism, would support the country's capacity to attract investment in RDI.

Trade integration

There is substantial room to increase trade and foreign direct investment. Albania's openness to trade and per capita FDI stock lags behind most of its regional peers. Trade is held back by complex customs procedures, insufficient cooperation between agencies, and a low diversification of exported products. As the ERP correctly points out, the reduction of tariffs alone will not deliver the desired result of boosting trade integration. FDI levels remain below potential for various reasons, such as land ownership issues, the informal economy, respect of intellectual and industrial property rights and corruption. Both trade and FDI obstacles are linked with other challenges addressed by the ERP's top priorities, such as improving the transport infrastructure and reducing the number of administrative procedures. Addressing these challenges therefore necessitates a holistic approach.

Measures planned in the area of trade integration aim to address underlying structural bottlenecks to trade and FDI. The measure entitled 'facilitate trade through deep interagency cooperation' focuses mainly on strengthening the capacities of the

National Food Authority. There is scope for better aligning domestic and regional trade policies, although this is not addressed in the ERP, while the establishment of the National Trade Policy Committee is only briefly mentioned. The text puts special emphasis on Kosovo as a main export market for Albanian products, but other markets, particularly within CEFTA, could be equally relevant. The focus on the implementation of the 'authorised economic operator' concept is welcome and would speed up export procedures. The measure regarding the implementation of legislative changes to promote new investments is a response to the strong need for FDI in the absence of a robust domestic private sector. The measure focuses on the implementation of the law on strategic investment, economic zones and public-private partnerships. A key element of the implementation is ensuring the Agency for Investment and Development (AIDA) is operational so that it can implement the law on strategic investments. Albania is still struggling with reputation risks, and this may have a negative impact on FDI decisions. In this context, the proposed measure may have a real medium- to long-term effect on the country's competitiveness.

Employment and labour markets

Increased economic activity in Albania has brought some labour market improvements, but has not translated into significant gains in employment outcomes. The first three quarters of 2015 saw a slight increase in labour force participation from 63% to 64.7% (in the age group 15-64 years). The employment rate for the same age bracket has also increased somewhat, to 53.3%, while the overall unemployment rate was 17.5%. Youth unemployment (15-29 years) stood at 32.3% in the third quarter of 2015. The employment rate for men was 16.4 pps. higher than for women.

Albania continues to be faced with low labour market participation, especially among women and youth, and overall long-term unemployment remains high. Better aligning education outcomes with labour market needs remains a key challenge. Activation and outreach of active labour market policies (ALMPs) and employment services remains insufficient. High levels of informality continue to act as an impediment to growth and full participation on the labour market, which also affects the social situation of the population. Other labour market challenges relate to legal and institutional labour market framework and include deficiencies in social dialogue and stakeholder involvement.

There has been some progress in improving higher education and the VET system. The new law on higher education has been adopted and preparations for accrediting higher education institutions are underway, but there has been no progress on the higher education strategy. Gradual progress has been made in establishing VET multifunctional centres.

Albania plans to address skills-mismatches and to improve the VET system. The Albanian Qualifications Framework is planned to be implemented by 2018 and a new law on crafts is to introduce a dual education system based on the German model. Establishing an apprenticeship system and tracking VET graduates are steps in the right direction. Nevertheless, implementation capacities may pose risks to effective implementation of the measures.

Boosting the capacity of employment offices and the ALMPs is relevant, but the expected impacts are low and there is a lack of strategic focus to combat informal employment. Limited employment gains point to unaddressed inefficiencies, such as insufficient activation and high engagement in informal employment. There have been some attempts to improve activation measures through better control of unemployment

benefits and combining ALMPs with VET training, but the measures have yet to be implemented. A campaign has been conducted to increase the registration of employment, however there is no strategic and comprehensive approach to combatting undeclared work and increasing formal employment.

Social inclusion, combatting poverty, promoting equal opportunities

Albania's social protection system displays weaknesses in terms of both the efficiency and quality of social assistance and service provision. Overall, the challenges and priorities in the areas of pension and social security systems are adequately identified in the ERP, but an inadequate overview and assessment of Albania's social situation make it difficult to target and provide for sufficient outreach of social assistance.

A key challenge for the social protection system is to remove disincentives to work, while targeting assistance to those in need. The ERP presents an extensive list of expected outcomes that the reform measures should achieve, but it is often not clear how the actions will be carried out. The implementation of the 2015 pension reform appears to be showing some positive initial results, such as decreased social insurance expenditure and an increased number of contributors, but there is no comprehensive assessment of the reform. The expected outcome of reducing the dependency ratio from 80% in 2013 to 61% in 2017 appears over-optimistic. The reorganisation of social security services is only briefly mentioned in the ERP. In order to make cash assistance more targeted and efficient, a national electronic registry is planned to be established by 2017 along with a social reintegration scheme, which would link social assistance with inclusion in the ALMPs. As important elements of improving activation and targeting of social assistance, they warrant being developed more thoroughly and with strong commitment. Another important measure is introducing social inclusion monitoring, which would cover impacts on employment, education and the social and health situation in the country, and develop relevant statistical indicators.

One of the key challenges to improving the social situation of the population is improving access to and the quality of all levels of education in Albania. Poor performance in basic skills not only affects future labour market prospects, in particular of young people, but has also significant impact on the social and economic situation of the broader population, including socially vulnerable groups. With regards to this, new curricula are planned to be introduced in the pre-university education system by 2018, which will be accompanied by relevant teacher training. While the timeline is adequately prepared, the ERP gives little information on the content of the changes and there is no indication of the implementing institutions or the system that will be used to monitor progress and effects. There is insufficient focus on preparing labour market entrants for a more entrepreneurial and digital economy. There is no reference to pre-school education, which is the means of preparing children of all backgrounds to have equal chances of succeeding in formal education.

ANNEX 1: OVERALL ASSESSMENT OF PROGRAMME REQUIREMENTS

Albania's Council of Ministers approved the economic reform programme (ERP) on 27 January 2016 and submitted it to the European Commission on 29 January 2016. The programme is in line with the annual budget for 2016 and the Macroeconomic and Fiscal Framework for 2017-2019.

Ownership and internal coordination

The ERP was centrally coordinated by the Ministry of Economic Development, Tourism, Trade and Entrepreneurship. It was prepared by an inter-institutional working group with representatives and experts from relevant institutions of the Albanian Government and the Bank of Albania.

Stakeholder consultation

Stakeholders have not been consulted. The ERP was presented to the Albanian Parliament after it had been adopted. There has been no public consultation or consultation with the social partners on the ERP. Social dialogue and stakeholder involvement in the preparation of the ERP needs substantial improvement.

Macroeconomic framework

The programme presents a concise but reasonably comprehensive picture of past developments. Almost all the relevant data are covered, but weaknesses remain, not least regarding labour market and wage statistics. The macroeconomic framework is coherent, consistent and sufficiently comprehensive and provides an adequate basis for policy evaluation and discussions. This part of the ERP maintains the same quality as last year's programme, although some indicators of external sustainability have been dropped from the analysis this year. Some of the factors affecting financial intermediation could have been also covered more in detail.

Fiscal framework

The fiscal framework is detailed and well integrated with the policy objectives. It is also consistent with the macroeconomic framework. However, data on the implementation of the 2015 budget are not comprehensive as they cover only the first three quarters, which is a step backwards from the previous ERP. On the other hand, the factors behind the projected rise in revenue are presented more clearly, including the expected fiscal impact of economic growth, discretionary measures, and better tax administration. There is room to better describe the planned expenditure measures and their anticipated budgetary impact. Forward-looking plans regarding debt management are much less developed than in 2015. Fiscal data do not conform to ESA2010 requirements as regards the delimitation of general government, the distinction between financial and non-financial transactions, and the recording of accruals. Since November 2014, Albania has submitted regular excessive deficit procedure notifications to Eurostat and is expected to gradually align its fiscal statistics to EU requirements.

Structural reforms

The section on structural reform priorities follows the guidance note and presents in general a good diagnostic per area. It also reports on the implementation of the policy guidance adopted at the Economic and Financial Dialogue with the EU in May 2015. The structural reform priorities as included in the 17 measures correspond well to the key obstacles to growth and competitiveness identified in the diagnostics and are in many cases in line with the policy guidance. Taking into account the tight budgetary space, the

ERP presents a balanced blend of ongoing and new measures. It is worth mentioning that the ERP covers not only public investment projects, but also long-term strategies and market economy oriented adjustments of the legal framework.

The description of the majority of reform measures is overall sufficiently detailed in terms of specific actions, timeline, budgetary impact and competitiveness to allow adequate monitoring and follow-up.

ANNEX 2: IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2015

| 2015 policy guidance | Summary assessment |
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| <p>PG 1: Pursue fiscal consolidation in line with the objective to put the public debt ratio on a downward path and lower it to less than 66% of GDP by 2017. At the same time, preserve fiscal space for growth-enhancing public investment by making sure that revenue performance remains on track, allowing for the initially budgeted capital expenditure to be executed.</p> | <p>Albania has not addressed PG 1:</p> <ul style="list-style-type: none"> • The budget deficit came in lower than planned, at 3.8 % of GDP against the 4 % target, which also includes arrears clearance expenses worth around 1.2 % of GDP. However, this was achieved thanks to expenditure under-execution, largely affecting capital spending. Revenue significantly underperformed against the target as a result of optimistic assumptions about the 2014 revenue base, nominal GDP growth in 2015, and gains from better tax administration. • The debt ratio has yet to start falling. Forecasts assume that this will happen in 2016. The ERP's debt trajectory has been revised slightly upwards from the previous year and expects the debt ratio to fall to 68 % in 2017 and further to 63.9 % in 2018. |
| <p>PG 2: Progress towards eliminating high fiscal risks posed by the electricity sector by reducing distribution losses at an average rate of 5 percentage points in the coming years and by improving the bill collection rate. Evaluate the fiscal impact of the property compensation scheme and accommodate the costs in the medium-term budget, if necessary by adjusting the parameters of the scheme with the aim of creating a realistic, transparent and sustainable compensation framework.</p> | <p>Albania has partially addressed PG 2:</p> <ul style="list-style-type: none"> • Electricity-sector reforms yielded significant gains and distribution losses were reduced by 6 pps. in 2015 while the collection rate reached 107 % of the target. The ERP now expects that as from 2020 the electricity sector will operate without support in the form of state-guaranteed loans. • The medium-term budget increased allocations for property compensation to 0.3 % of GDP annually, and a recently-approved law aims to adjust the existing scheme by compensating former property owners at current market value based on historical land classification. However, it is not clear to what extent the fiscal bill, previously estimated at as much as 70 % of GDP, will be reduced as a result of these changes. Moreover, the law still faces legal hurdles as its constitutionality has been challenged. |
| <p>PG 3: Reinforce the budget management framework by implementing the public finance management strategy agreed with the Commission and adopted in December 2014, in particular by moving towards adopting a credible fiscal rule which will effectively ensure the sustainability of public finances in the long run and by strengthening budget forecasting.</p> | <p>Albania has partially addressed PG 3:</p> <ul style="list-style-type: none"> • A draft fiscal responsibility law has been prepared at technical level but is not reported in detail in the ERP, which only mentions that the draft is available and ready to be sent to the Council of Ministers. Contrary to the previous ERP, no date of expected adoption is given. • A dedicated revenue unit has been established at the Ministry of Finance. One of its aims is to improve bottom-up revenue forecasts. It is not clear how the inherent optimism bias in macroeconomic forecasts will be addressed. |
| <p>PG 4: Take further measures to address the issue of non-performing loans, involving all key stakeholders including the Bank of Albania as necessary, with a view to achieving a sustainable reduction of their level. In this context, addressing</p> | <p>Albania has partially addressed PG 4:</p> <ul style="list-style-type: none"> • The NPL ratio decreased to 18.2 % at the end of 2015 from 22.8 % a year earlier. This was mainly due to mandatory loan write-offs. A high-level inter-ministerial working group has |

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| <p>impediments related to judicial enforcement and collateral execution would appear helpful.</p> | <p>been established and in September 2015 an NPL action plan was adopted jointly with the central bank. It integrates and sequences reforms with regard to supervision, enforcement, debt restructuring and insolvency. The implementation of the action plan has started but is yet to produce tangible results.</p> |
| <p>PG 5: Adopt and start to implement the law on higher education, as well as the new strategy for higher education. Establish an independent accreditation system for all public and private universities. Continue the restructuring of the VET system with a view to improving the relevance of the training for the needs of the labour market.</p> | <p>Albania has partially addressed PG 5:</p> <ul style="list-style-type: none"> • The new law on higher education was adopted in 2015 and the accompanying implementing laws are to be adopted in 2016. No reference to the strategy for higher education is provided. An agreement was signed with British Quality Assurance Agency for the latter to carry out the accreditation of the higher education institutions and to assist in capacity building of the national accreditation agency, with the aim of approaching the European Network of Quality Assurance. • Measures related to VET refer to the National Employment and Skills Strategy 2020, adopted in 2014, but appear to have not yet been implemented and there is no overview of the implementing bodies provided to adapt training offers to labour market needs and improve the quality and effectiveness of provision. The new measures presented in the ERP appear to be more of a preparatory nature, postponing the actual implementation to 2016 and beyond. |
| <p>PG 6: Improve the overall business environment, including by implementing the merger of the NRC (National Registration Centre) and NLC (National Licensing Centre) to further ease the regulatory and administrative burden for businesses. Start the implementation of the simplification regime for authorisations. Make the newly established investment council fully operational.</p> | <p>Albania has fully addressed PG 6:</p> <ul style="list-style-type: none"> • The National Business Centre (NBC) was established in November 2015 as a one-stop shop for business registration and licensing to further ease the regulatory and administrative burden for businesses. • The implementation of the simplification regime for authorisations is ongoing. • The newly established investment council is by-and-large operational. |
| <p>PG 7: Adopt and start to implement the transport strategy and action plan for 2016-2020. Focus investments on the core network. Adopt and start to implement the national energy strategy and the Power Sector Law, including speeding up the unbundling of the energy sector. Prepare single sector pipeline of priority investments for both transport and energy.</p> | <p>Albania has partially addressed PG 7:</p> <ul style="list-style-type: none"> • The transport strategy is being drafted and should be completed in the third quarter 2016. • Focusing investments on the transport core network will be facilitated by project prioritisation through the single project pipeline (SPP). • The Power Sector Law entered into force in June 2015 and work is progressing on bylaws, especially on unbundling of the energy sector. |
| <p>PG 8: Adopt a strategy on the land cadastre and concrete measures to increase momentum in agricultural land consolidation.</p> | <p>Albania has not addressed PG 8:</p> <ul style="list-style-type: none"> • Specific measures to increase momentum in agricultural land consolidation are envisaged within this ERP. • No real progress has been observed on the adoption of a strategy on the land cadastre. |