



# What is the Binding Constraint to Growth in Albania?

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## Executive Summary

Albania has experienced a major transformation over the last quarter century, emerging from a particularly isolated form of communism in the early 1990s to face the substantial challenges of forming a responsive, democratic system of government and developing a modern economy. While the transition was dramatic, the transformation, in many ways, is still ongoing. Today, Albanians are eager to continue down the path of accession to the European Union and to see the kind of economic growth that will one day allow them to enjoy the same levels of income and opportunity that are found in developed Europe.

Albania's economy has gone through roughly three periods following the initial transition: (1) a turbulent period from 1990-1997 with overall negative growth, culminating the collapse of pyramid schemes and conflict; (2) rapid but fundamentally unsustainable growth over the subsequent decade up to the global financial crisis, driven by remittances, largely resource-based foreign investment, and construction; and (3) a lower growth trajectory from 2008 to the present, where Albania has avoided recession but struggled to discover new drivers of growth. This growth diagnostic attempts to identify the binding constraint to sustainably higher economic growth in Albania. In other words, what is binding Albania from converging more quickly with developed countries in income per capita?

Recognizing that economic growth requires a number of complementary inputs, from roads to human capital to access to finance and many more, this diagnostic compares across a number of potentially binding constraints using the growth diagnostic methodology to identify which constraint is most binding.<sup>1</sup> This report discusses the findings for eight constraints that were considered to be potentially binding after initial quantitative analysis and based on CID's research project with the Government of Albania, which has been ongoing since 2013.<sup>2</sup> This growth diagnostic research was conducted throughout 2016.

Despite serious issues in many other areas, the evidence shows that the binding constraint to stronger growth in Albania is a lack of **productive knowhow**. By "knowhow," we mean the knowledge and skills needed to produce complex goods and services. Albania faces a unique knowhow constraint that is deeply rooted in its closed-off past, and the limited diversification that has taken place in the private sector can, in nearly all cases, be linked to distinct inflows of knowhow. The strongest sources of knowhow inflows into Albania have been through foreign direct investment and immigrants, especially returning members of the diaspora that start new businesses or upgrade the productivity of existing businesses.

The evidence also points to particular failings in **rule of law** in Albania that play an important role in keeping Albania in a low-knowhow equilibrium. Weaknesses in Albania's rule of law institutions, including frequent policy reversals and corruption in the bureaucracy and judiciary, increase the risk of investments and transaction costs of

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<sup>1</sup> Hausmann, Ricardo; Rodrik, Dani; and Andrés Velasco (2005): "Growth Diagnostics."

<sup>2</sup> For more on the project, see the project website: <http://albania.growthlab.cid.harvard.edu/>

business. While it is difficult to separate perceptions from reality in this area, both perceptions of weak rule of law and actual rule of law failings appear to play critical roles in constraining more diversified investment in Albania. There is a pattern in the data where existing firms in Albania tend not to dwell on rule of law issues but where potential new investors are very sensitive to rule of law problems.

Two specific constraints that are interrelated with the broader rule of law issues are **access to land** and **taxation**. These two constraints were studied in depth. It is clear that there are major problems in land titling and land administration in Albania, but these are not binding most private sector decisions, especially for manufacturing and most services. Agriculture and tourism are two particular sectors that are more constrained by access to land. Taxation was studied as a constraint, both in terms of tax rates and tax administration. Tax administration was determined to be a deeper area of concern than tax rates, but neither rises to the level of being a binding constraint for investment and growth in Albania.

One common complaint and basis for donor interventions in Albania is a lack of **access to finance**. The diagnostic work shows that there are significant issues in the financial system, including weak financial intermediation and ineffective coordination of donor resources, but also that there is a lack of bankable projects to take advantage of available finance. It is clear that the Albanian economy is investment-constrained rather than finance-constrained.

In terms of infrastructure, we looked closely at the provision of **electricity** and **transportation infrastructure**. Electricity provision was arguably a binding constraint to growth in the recent past and remains weak, but the evidence points to improvement over the last several years to a level that it is no longer binding. The overall cost of electricity to firms, including the cost of outages, has been reduced, and the pressure on the fiscal balance from losses by state-owned electricity companies has been resolved. Transportation infrastructure is another input for the growth process that leaves much room for improvement but is not binding. Most aspects of transport infrastructure have improved over time, but connectivity within Albania and to other countries remains limited. Transportation costs, however, are not a priority issue for firms.

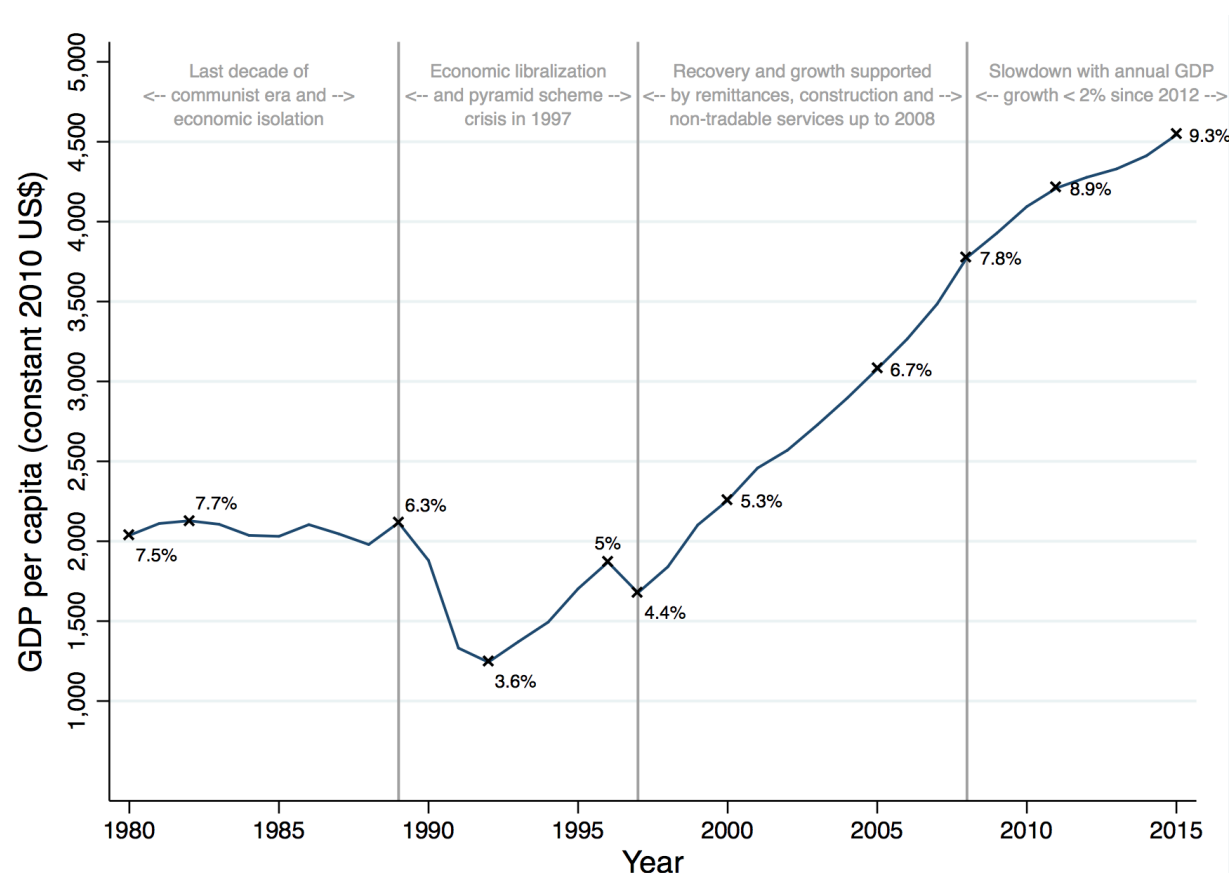
Finally, **education** was studied and determined to not be a binding constraint. Albania remains one of the least educated countries in Europe, and the education system is of overall low quality. However, recent expansions in schooling and some quality improvements have not provided a boost to growth. Increases in the quantity and quality of education in Albania will ultimately require increases in the demand for skills by the labor market.

Each constraint discussed in this report is cited by analysts within or outside the country as the biggest problem for growth in Albania. Through the growth diagnostic framework, we are able to evaluate the evidence and show that some constraints are more binding than others. We find that, in Albania today, the lack of productive knowhow is the most binding of all constraints.

## 1. Brief Background and Results

Prior to 1990, Albania was an extremely isolated country with a centrally planned communist economy for more than four decades. Following the collapse of communism, Albania entered a period of volatile economic transition, which culminated in the rise and collapse of several massive financial pyramid schemes in 1996-1997, followed by a six-month period of conflict and the overthrow of the sitting government. Albania finally returned to its pre-transition level of income per capita around 2000, at which point this income reflected a smaller share of GDP per capita in developed countries than it had a decade earlier. Convergence with developed countries only began after 2000. From 2000 to 2015, Albania's GDP per capita roughly doubled. But as of 2015 it still represented only 9.3% of the Organisation for Economic Co-operation and Development (OECD) level. The dynamics of growth differed greatly between the period before the global financial crisis, when growth was rapid and convergence was steady, and the period since, when growth was slow and convergence stalled.

**Figure 1:** Albania's GDP per capita from 1980-2014 and convergence



Note: Where marked with an "x" on the figure, Albania's GDP per capita is shown as a share of OECD (group as of 1980) average GDP per capita.

Source: World Development Indicators

### *Strong economic growth prior to 2008*

Albania experienced the most rapid economic growth in Europe in the decade prior to 2008, with real per capita GDP growth averaging over 6 percent per annum. Moreover, this growth was largely pro-poor, as consumption tended to grow faster for the bottom 40% of households than the top 60% and the national poverty rate fell from 25.4% in 2002 to 12.5% in 2008. Remittances played a major role in the growth process, with personal remittance inflows averaging 15.2 percent of GDP between 2000 and 2008. Although not the only factor at play, remittance flows helped support strong growth in domestic demand for construction and services. Growth in domestic demand, together with emigration of many working-age Albanians, drove increases in wages and investment. Some new economic activities emerged during this period. Albania diversified into finance, insurance, and professional services, including call centers, during the 2000s. Earlier, in the 1990s, Italian foreign direct investment (FDI) had already helped to establish the fashion sector (textiles and footwear) in Albania.

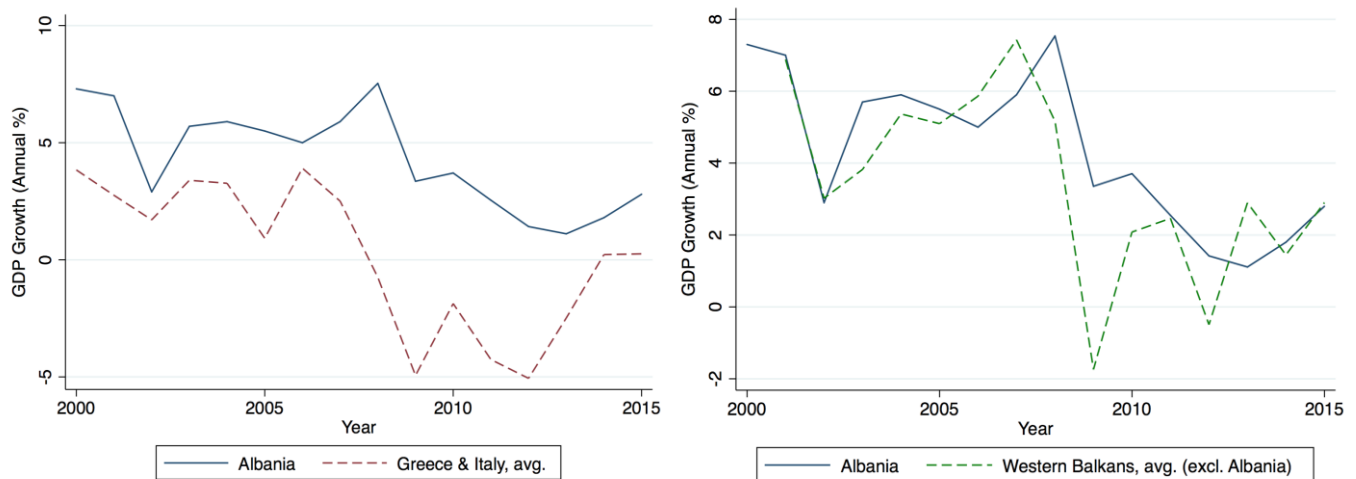
### *Slowdown of economic growth after 2008*

A slowdown in growth could not be avoided after 2008 given Albania's close trade and investment ties to Italy and Greece, two countries that entered deep recessions. Patterns of Albanian migration also meant that remittance inflows depended heavily on the economic health of these two countries. What had become primarily construction-led growth in Albania collapsed after 2008. There were also several structural factors at play. Albania's fashion sector faced growing price competition and risk of factory relocation to cheaper countries. Two sectors that were expected to play much larger role in increasing productivity, tourism and agriculture, did not experience a breakthrough. Despite all this, Albania maintained positive growth rates throughout the course of the Euro-crisis and subsequent growth was much less volatile than other Western Balkan countries (Bosnia and Herzegovina, Macedonia, Montenegro, and Serbia). Kosovo was the only other Western Balkan country to avoid recession during this period. Compared to other countries, Albania experienced a smoother transition to lower annual growth after 2008, beginning to recover only gradually after 2013.

### *Focus on 2013 to 2016*

Economic indicators for the period 2013-2016 show that Albania has not transitioned to a new high growth trajectory, but there is some indication that a slow transition to a more sustainable growth model is underway. Real GDP growth for 2016 is estimated at above 3% and Albania has seen moderate yet consistent growth across sectors and a gradually falling rate of unemployment since mid-2014. While the level of growth since 2013 should be seen as an accomplishment during a period where Albania both undertook an IMF adjustment program and saw the price of oil exports collapse, it remains insufficient to support a rapid convergence with high-income countries.

**Figure 2: Albania's GDP growth compared to Greece and Italy and the Western Balkans**



Source: World Development Indicators

## Growth Question

The growth question for Albania at the start of 2017 is: ***What is binding Albania from converging more quickly with developed countries in income per capita?*** Since the high growth period up to 2008 was largely driven by a fundamentally unsustainable construction boom and growing reliance on remittances, it is important to note that the exercise is not a search for factors that were present during the high growth period and absent now. Rather, this growth diagnostic attempts to identify the binding constraint to sustainably higher economic growth in Albania.

## Results

Despite serious issues in many other areas, the critical input that is ubiquitously missing in Albania's private sector is knowhow. By "knowhow," we mean the knowledge and skills needed to produce complex goods and services. This type of knowhow is not something typically found in a single individual, but rather something that is shared across individuals in firms and industries. Knowhow includes product-specific knowledge, like the engineering ability to manufacture a particular item, but also a diverse set of knowledge and skills that firms need in order to supply a product or a service. This includes managerial knowhow, understanding value chains of production, ability to access distribution networks and foreign markets, the capability to develop financially sound business plans, and ability to obtain finance, among others.

Albania faces a unique knowhow constraint that is deeply rooted in its closed-off past. After the fall of communism, the private sector grew out of what people knew how to do—in



areas such as agriculture, herbs and spices, and metals—and the scope of what the private sector knows how to produce has expanded very gradually only over time. Some things that Albania produced when closed off were quickly found to be uncompetitive (like agricultural machinery) when faced with competition from other countries. Other things had to be discovered and immediately compete with other countries where these industries were well established, putting Albania at a significant disadvantage. Massive brain drain of the intellectual class in the 1990s exacerbated the problem. When one looks across the private sector in Albania, one can see the discovery of new comparative advantages happening very slowly, often resulting from the movement of people, including returning members of the diaspora, and the movement of companies through FDI. In a few cases, the transfer of productive knowhow can be traced back to donor assistance.

Mirroring Albania's challenge of limited knowhow in the private sector is a public sector knowhow challenge. The capability of the state to provide the public goods and services on which the private sector depends, and to do so under a new democratic system, also had to be built from the ground up after 1990. Building these state capabilities has been a very slow and non-linear process. Today, Albania's weak state capability to ensure rule of law across several dimensions can also be viewed as a binding constraint in a certain sense. In order shift to a more rapid growth path, Albania will require the inflow of new ideas and more diversified knowhow, especially through new sources of FDI and leveraging the Albanian diaspora. But both firms and people outside of the country are very sensitive to the type of risk presented by weak rule of law institutions in Albania.

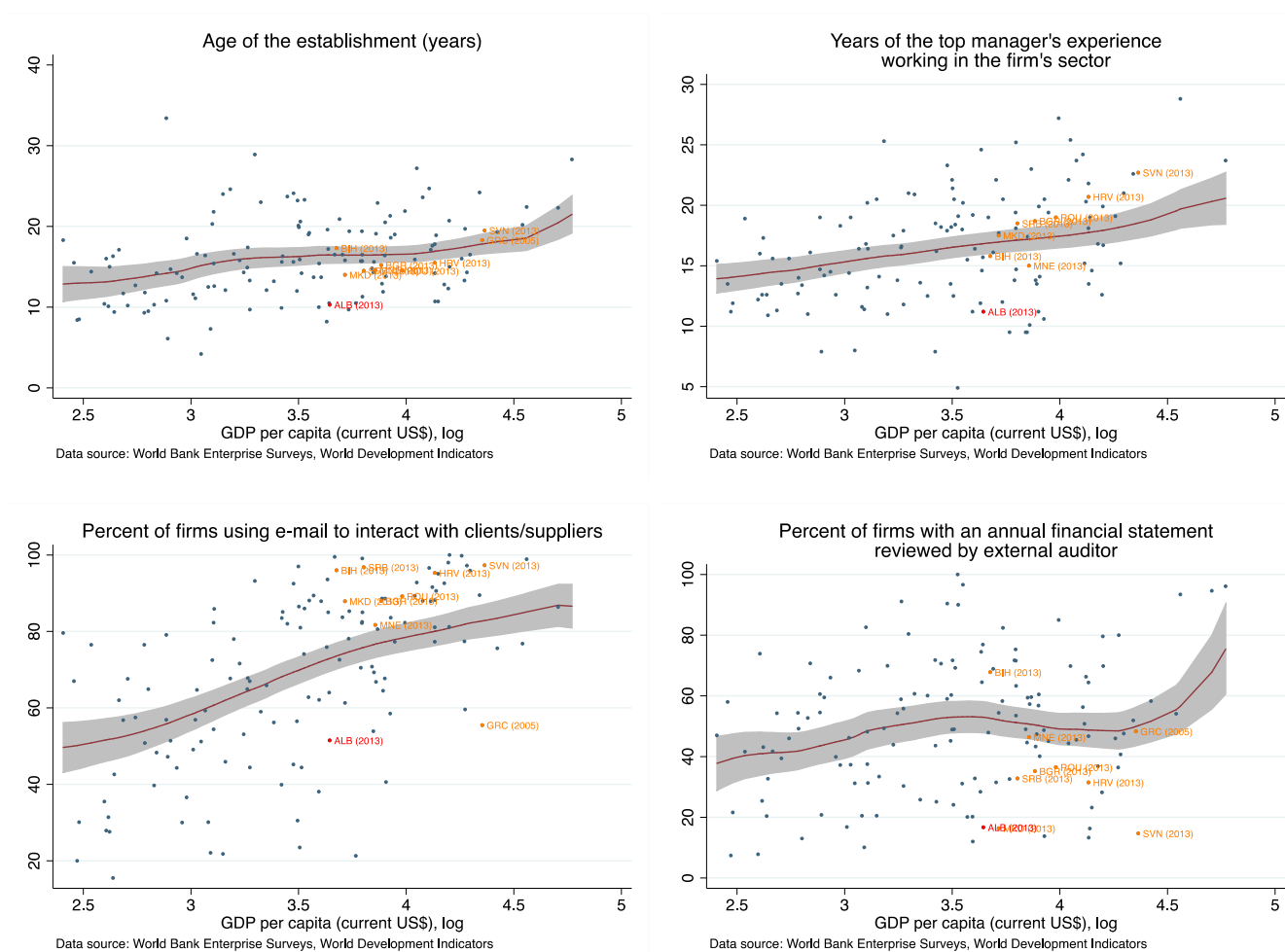
This growth diagnostic report continues as follows: the next section provides quantitative and qualitative evidence to describe the binding constraint of productive knowhow. This is followed by a discussion of rule of law institutions in Albania and the particular ways in which weaknesses in rule of law keep Albania stuck within an equilibrium of low productive knowhow. This is followed by in-depth sections on related issues—access to land followed by tax policy and tax administration—which are important but not binding constraints to more rapid overall growth in Albania. The report then presents the evidence on four additional constraints that were studied in detail as potential binding constraints: access to finance, electricity, transportation infrastructure, and education. In each of these four areas, there are significant problems to be addressed in Albania, but none represents a binding constraint to more rapid growth.

## 2. Productive Knowhow

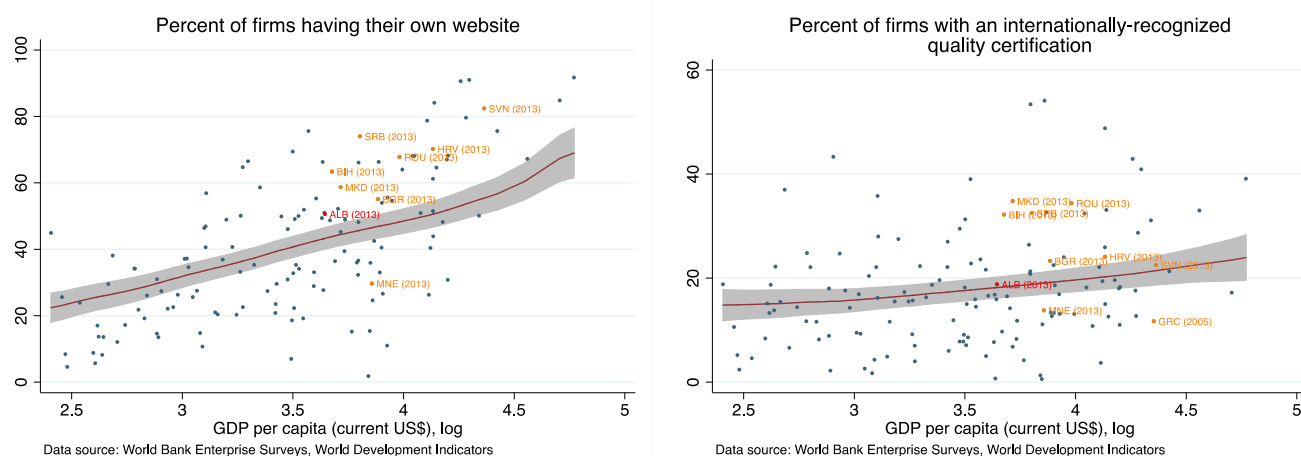
*Evidence of the knowhow constraint can be found through direct measures of business sophistication, indirect measures based on international trade data, and qualitative observations of gaps in value chains and the movement of knowhow.*

International benchmarking tools show that the typical Albanian company is unsophisticated, having relatively little sector-specific experience, missing many modern tools of the private sector, and interacting little with the financial sector. World Enterprise Survey responses show that Albanian firms lag far behind many other countries at a similar level of per capita income on several factors associated with innovation (Figure 3). This is not true for all such indicators (Figure 4) but there is a clear trend. In comparison to other countries in the region, Albania tends to have the youngest firms, the least experienced managers, the lowest usage of e-mail, and very low financial sophistication.

**Figure 3:** Reflections of low capability of Albanian firms: firm age; manager experience; use of email; and financial statements reviewed by external auditors

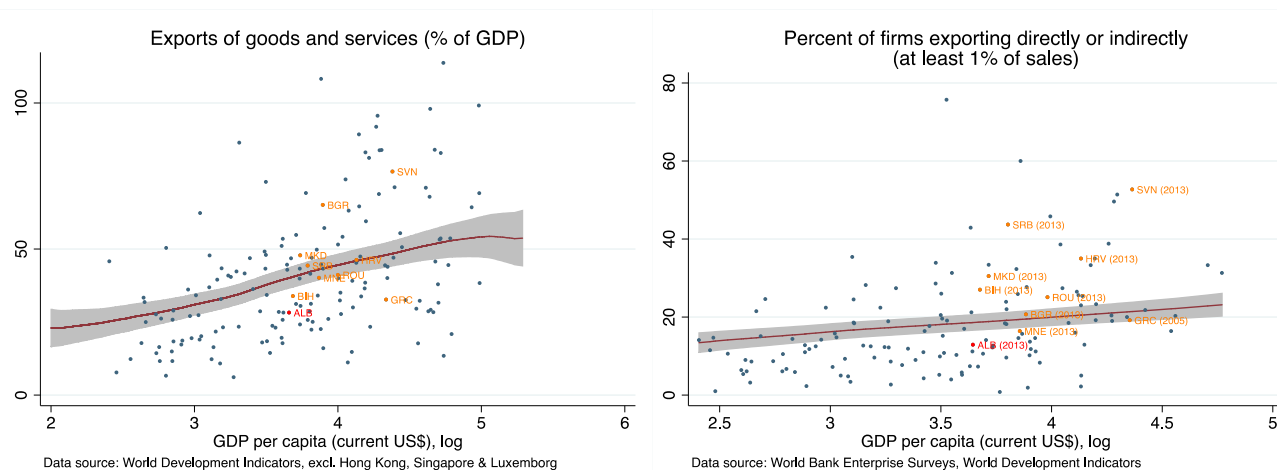


**Figure 4: Exceptions: website use and internationally-recognized quality certifications**



This lack of business sophistication is consistent with Albania's underperformance in exports. Since a country exports the products in which its firms are competitive internationally, low exports are reflective of a low level of productive knowhow among firms. Albania's exports are low as a share of GDP and only a small percentage of firms in Albania are exporters (Figure 5). On both of these measures, Albania is the lowest in the region based on the most recent data.

**Figure 5: Exports are low as a share of GDP and a few firms in Albania are exporters**

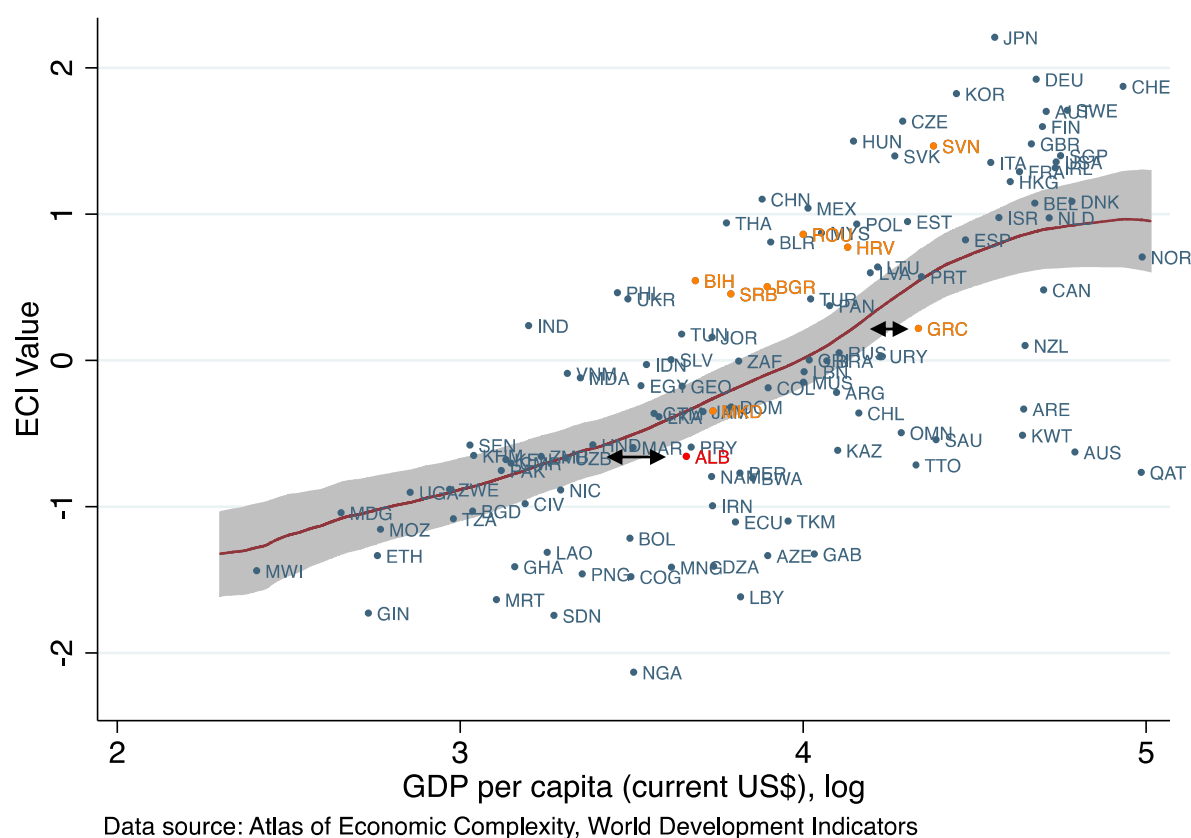


Albania's limited productive knowhow and lack of product-specific knowledge can further be seen in the composition of its exports. As of 2014, Albania's largest single export was crude oil. Mineral products and metals together accounted for 46% of Albania's exports, while footwear and garments made up 18% and 16% of exports, respectively. Together, these low value and low complexity goods make up 80% of Albania's exports. There has been very little diversification of Albania's manufactured exports over the last two decades,

as exports have remained heavily concentrated in these four categories since the mid-1990s.

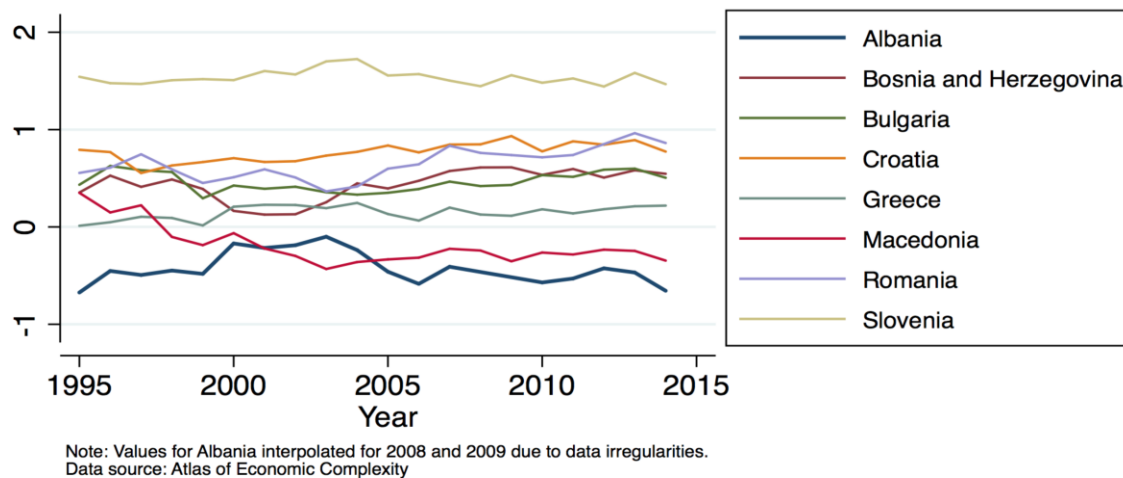
CID's Economic Complexity Index (ECI) provides a quantitative measure of a country's productive knowhow. Albania's ECI is lower than would be expected based on its level of income alone (Figure 6), which indicates that the structure of production cannot support sustainable growth. This often occurs for countries that are rich in natural resources, as is the case for Albania. Such countries are able to sustain elevated levels of income based on these resources for a period, but are vulnerable to price shocks and longer-term shifts in supply and demand. The only other country in the region on where ECI is below expectation is Greece. Albania's economic complexity has been the lowest in the region since 2005, when it was surpassed by Macedonia (Figure 7). Based on its economic complexity, CID's projected annual growth for Albania for the period of 2014-2024 is only 1.83%. This ranks 108<sup>th</sup> out of 121 countries, tied with Italy.<sup>3</sup> This projection is based on historical patterns and suggests that Albania's ECI must increase in order for growth to accelerate.

**Figure 6: Economic Complexity versus GDP per capita, 2014**



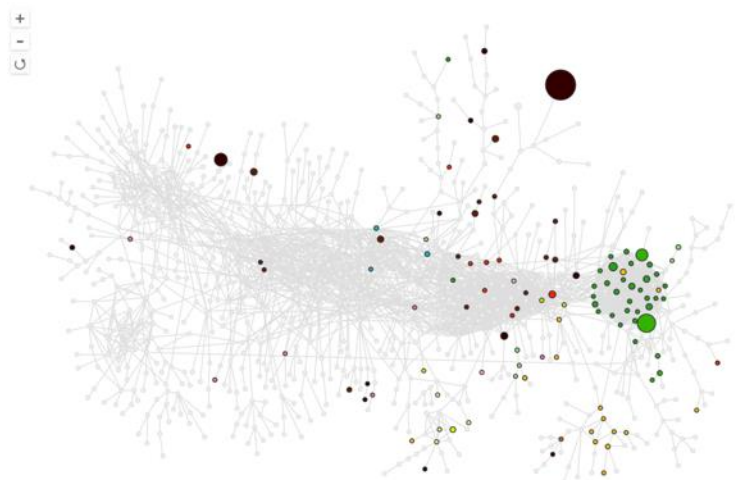
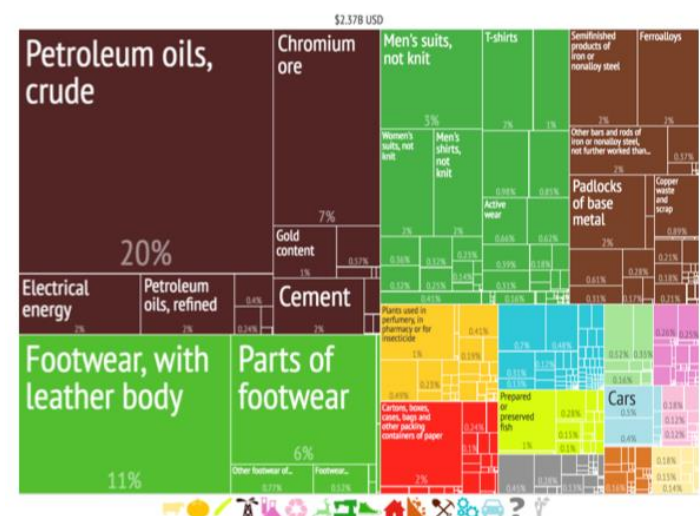
<sup>3</sup> See CID's growth projections based on trade data: <http://atlas.cid.harvard.edu/rankings/growth-predictions-list/>.

**Figure 7: Economic Complexity Index (ECI) for Albania and comparators, 1995-2014**

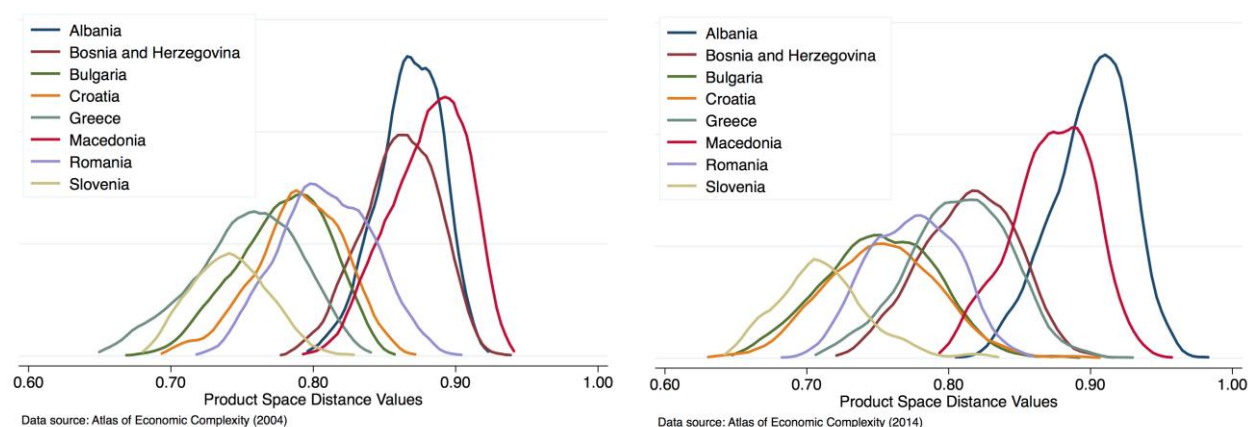


In the Product Space, which is a network visualization that reflects the similarities between products as revealed through world trade (see Box 1), one can see the products where Albania has a revealed comparative advantage and how connected (or unconnected) these are to other products. The Product Space can be used to calculate the “distance” between Albania’s current exports and potential new exports. In the Product Space, Albania’s exported products are clustered in garments and footwear (green), and scattered across agricultural products (yellow and orange), a few wood and paper-based products (red), and minerals and metals (brown). These products do not tend to be co-exported with higher complexity products like chemicals, machinery, electrical, or transportation products, which are located in the left half of the Product Space. When one calculates the “distance” to new products, Albania’s path to diversification is more difficult than that of other countries in the region (Figure 9).

**Figure 8: Albania’s exports, 2014**



**Figure 9:** Distributions of more complex products by distance, 2004 vs. 2014



Note: Trade data for Serbia and Montenegro is not available for this calculation.

### Box 1: What is the Product Space?

The Product Space is a map of the relatedness between products. It is based on patterns of world trade of 1,240 products as classified by the harmonized system (HS) at the 4-digit level. World trade patterns show that some products are similar; that is, when a country exports one product it is likely to export the other product as well. For example, men's jackets and women's jackets. One can infer that product pairs such as these must require similar underlying capabilities for production. Other products do not show any tendency to be co-exported; for example, cars and cocoa beans. The Product Space is the result of using network visualization tools to map all products based on their similarities. Similar products tend to be located close to one another and dissimilar products tend to be located far from one another in the Product Space. The Product Space shows that some types of products, like garments, electronics and pharmaceuticals, emerge in clusters and tend to be highly related. Meanwhile, some products, like oil, are very unrelated to other products and exist in the periphery of the Product Space. Any country's export basket can then be mapped onto the Product Space by highlighting those products where the country has a revealed comparative advantage based on world trade data. The Product Space also allows for a quantitative assessment of how distant new products are based on what a country currently exports. For more information and visualizations for 124 countries, see [atlas.cid.harvard.edu](http://atlas.cid.harvard.edu).

Albania's performance in service exports is not lagging to the same degree that it is for goods exports. In per capita terms, Albania's service exports exceed those of several countries in the region, namely: Bosnia and Herzegovina, Macedonia and Serbia. Albania's comparative strength is in travel services, but it is comparatively weak in transport services (despite having a coastline) and information and communications technologies. However, even in travel, when compared to the group of countries with the access to the Adriatic coastline (Greece, Montenegro, Croatia and Slovenia), Albania lags significantly behind. One can therefore infer that productive knowhow is limited for services as well.

**Figure 10:** Service exports per capita in 2014 for Albania and regional comparators

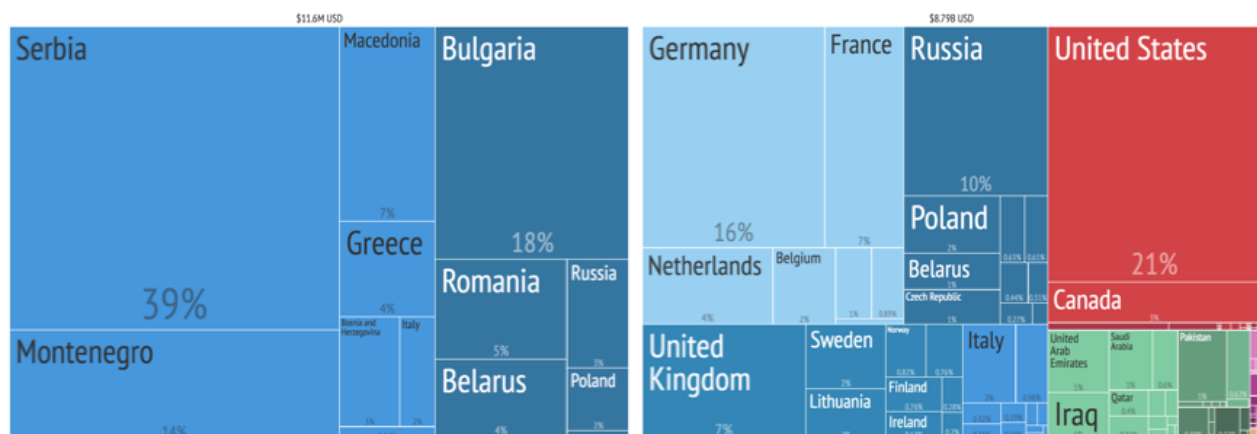
	Service Exports per capita (current USD)				
	Total	Transport	Travel	ICT	Insurance & Finance
Albania	861	67	587	85	5
Bulgaria	1,241	293	549	262	50
Bosnia and Herzegovina	468	89	185	25	2
Greece	3,796	1,603	1,639	306	70
Croatia	3,223	313	2,327	397	28
Macedonia, FYR	817	186	142	185	2
Montenegro	2,201	377	1,460	180	9
Romania	1,006	293	92	374	20
Serbia	707	164	160	247	11
Slovenia	3,574	984	1,324	794	86

Source: WDI (2014)

The ability of firms to reach new markets and new buyers is also a type of knowhow that is lacking in Albania. Several of Albania's largest exports serve fairly undiversified markets. This is the case for tomatoes (Figure 11), for which agricultural exporters lack quality certifications required by the EU, and for most garments and footwear (Figure 12), for which Albanian producers in the "fason" sector remain highly reliant on Italian companies as clients. Albania's exports of herbs and spices are able to reach the U.S. and European markets, but are not able to access large markets in Asia. Interestingly, firm surveys conducted by CID revealed a strong link between firms that were able to export to the U.S. market and returned members of the Albanian diaspora who had spent time living in the United States.

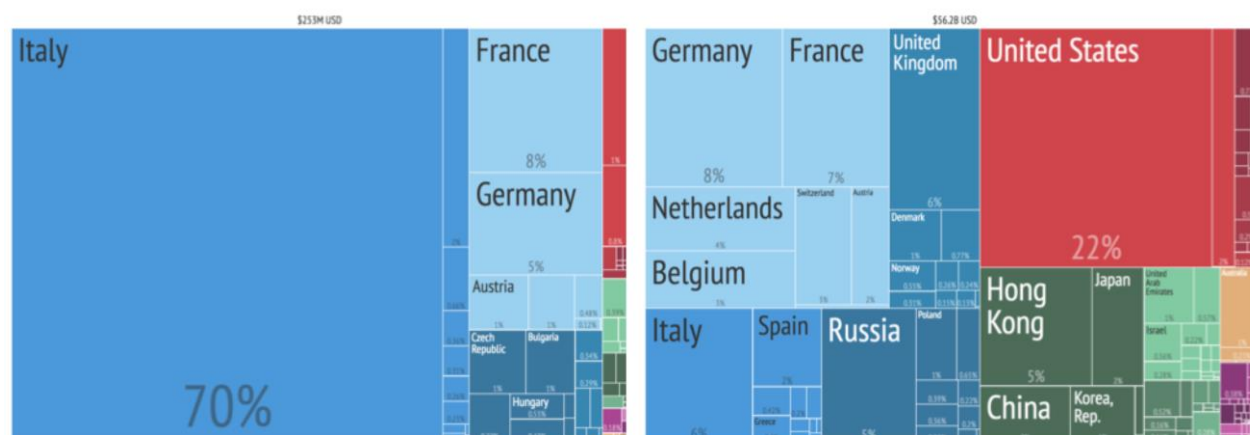
CID has also conducted value chain analyses for several specific agriculture and aquaculture products. Common across these studies was the finding that value chains have critical missing links in Albania. In particular, neither the private sector nor the government has been able to provide necessary quality testing and certification mechanisms for a number of agriculture and aquaculture products. These studies also found that firms had low capabilities to understand international market trends and reach new buyers. In general, these studies showed that increased productivity and profitability of such industries in Albania is not contingent on new capital investments as much as organizational improvements through increased private sector coordination and improved public-private coordination.

**Figure 11:** Albania's exports of tomatoes (left) and world imports of tomatoes (right)



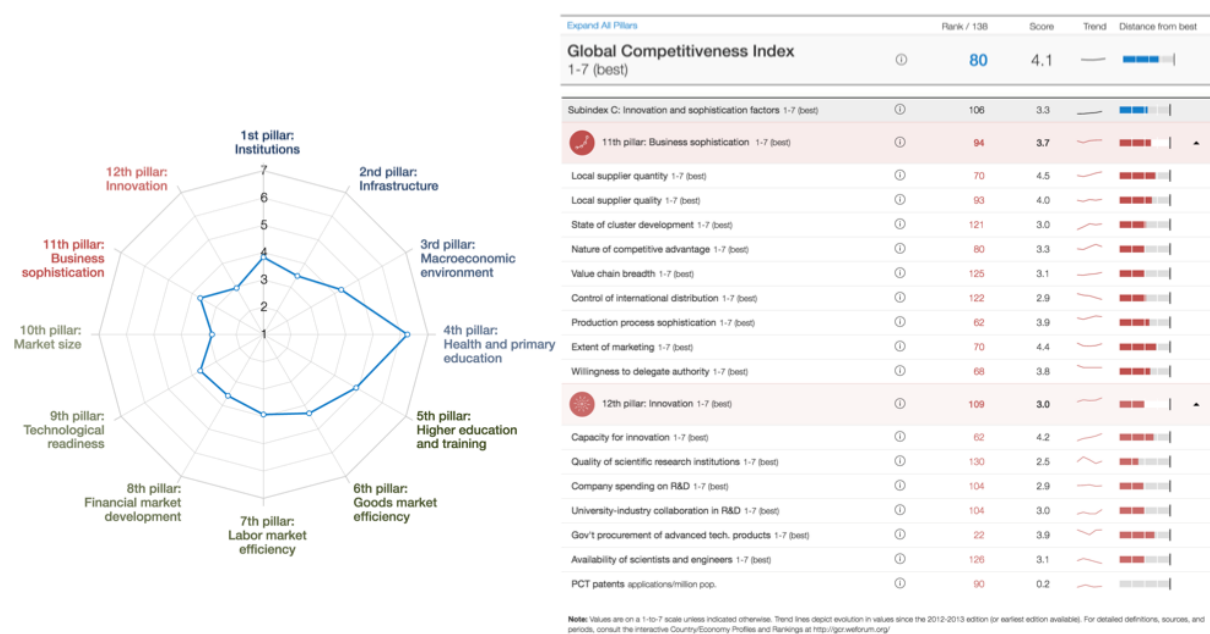


**Figure 12:** Albania's exports of leather footwear (left) and world imports of leather footwear (right)



A similar pattern appears in the World Economic Forum's Global Competitiveness Index, where Albania is seen as competitive in terms of its human capital (see pillars 4 and 5), but not competitive in terms of its firms (pillars 11 and 12). Low business sophistication can be seen once again in the weakness of value chains, absence of developed industry clusters, and lack of control of international distribution, among other indicators. Albania also shows low competitiveness for innovation, including a low presence of research and development capabilities.

**Figure 13:** Weakness in areas of Innovation and Business Sophistication in WEF benchmarking



Source: World Economic Forum, Global Competitiveness Index 2016-2017



## Where has new knowhow come from?

*The knowhow constraint can be better understood not just by showing where knowhow is lacking but by tracking what happens when new sources of productive knowhow enter the country. If a constraint is binding, the movement of the constraint should produce a response in production. If a constraint is not binding, this response should be limited as other constraints would get in the way.*

Firm interviews conducted by CID revealed a distinct pattern whereby firms and industries developed as a response to productive knowhow entering Albania from somewhere else. From these interviews and available data, we have identified four important and interrelated ways that knowhow has been acquired by the private sector in Albania:

1. Foreign investment or ownership;
2. Immigration, diaspora and return migration;
3. Donor assistance; and
4. The gradual evolution of existing industries through the discovery of new products and markets, often spurred by the above.

Table 1 traces the sources of knowhow for several important industries in Albania. For just about every major industry in Albania today, one can trace its development back to a source of knowhow from another country. In some cases, a source of foreign knowhow was instrumental to the appearance in the industry while, in other cases, outside knowhow allowed for productivity gains or transformation in the industry.

**Table 1:** Examples of the sources of knowhow by the private sector in Albania

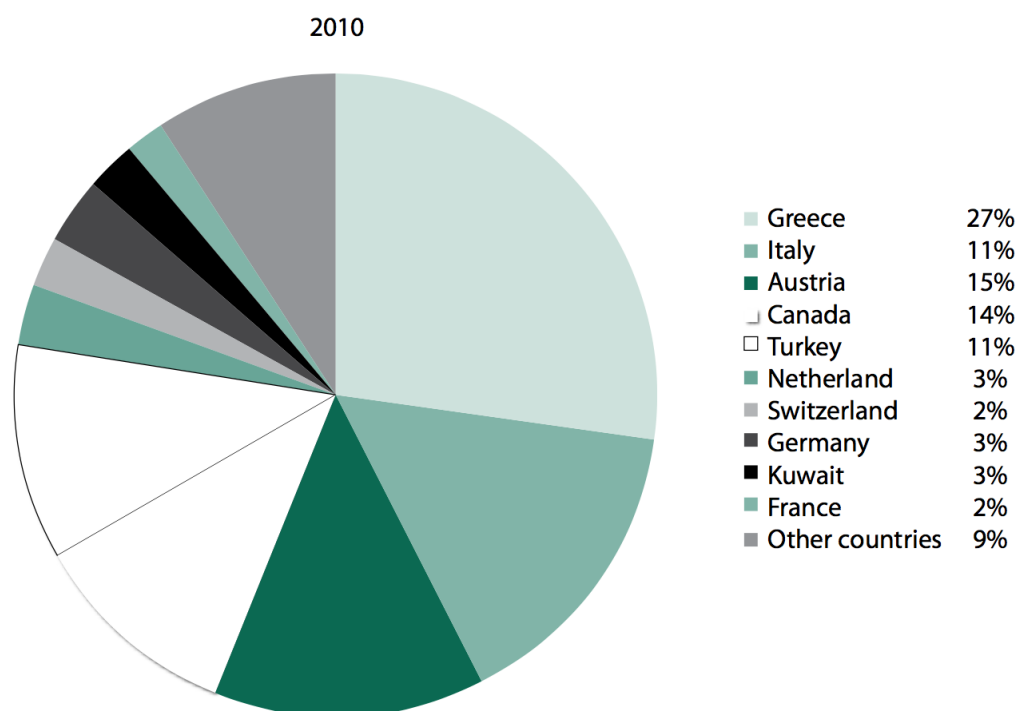
<i>Pathway</i>	<i>Industry</i>	<i>Origin/Description</i>
<b>Foreign investment or ownership</b>	Concrete and cement	Greece
	Building materials	Macedonia
	Packaging using recycled materials	Turkey
	Garments (fason)	Italy
	Oil	Canada
	Chromium	Austrian, Russia
	Telecommunications	UK, Germany, Turkey
	Banking & Insurance	Austria, Greece, USA
	Call Centers	Italy, France

<b>Immigration, diaspora and return migration</b>	Agriculture (detailed in Box 2)	Return migration from Greece led to technology and productivity increases
	Herbs and spices	Return migration from the U.S. allowed companies to discover new markets
	Tourism	Return migrants from Italy helped to establish hotels
	Lights and lighting systems	New venture by a return migrant from the U.S., using South Korean technology
<b>Donor assistance</b>	Meat processing	Supported by USAID
	Olive oil	Supported by USAID-GIZ
<b>Gradual evolution of existing industries</b>	Herbs and spices	Developing direct interactions with buyers and increasing processing to add value to product
	Garments (fason)	Gradually diversifying into products (like swimwear) by increasing capabilities (cutting fabric)
	Tourism operations	One firm began by serving Albanians travelling abroad post-1990 and gradually diversified into new ventures

Foreign direct investment is the most direct channel through which knowhow has moved into Albania, but the diversity of this FDI remains limited. FDI in Albania has been high since 2008, with net inflows of FDI averaging around 9 percent of GDP over this period. This is more than three times the average of middle-income countries. However, very little FDI has flowed into non-mining manufacturing. Foreign direct investment has also been concentrated among a few source countries (Figure 14). Greek FDI amounts to about a quarter of the total and the top five source countries tend to account for around three-quarters of FDI in Albania. Of the top five, only Italy and Turkey tend to supply investment in non-mining manufacturing industries.

Increasing productive knowhow and the viability of new industries in Albania will continue to be strongly influenced by the type of foreign investment that Albania is able to attract. Currently, foreign investments remain concentrated in a few activities that are not labor intensive (electricity generation, mining, and telecommunications) and a few non-tradable activities (construction and wholesale trade). This breakdown is provided in Table 2.

**Figure 14:** Breakdown of FDI in Albania by source country, 2010



Source: UNDP Report on Foreign Direct Investment in Albania, 2011, using data from the Bank of Albania

**Table 2:** Primary industries of investment in Albania

Selected industries (values in mln US\$)	Invest ments	o.w.		Employ ment	Value Added	2010-14 growth	GVA per employee
		SME	Large				
Electricity	470	107	363	7,984	227	-6.0%	28
Extraction of oil and gas	338	27	311	3,736	429	15.9%	115
Construction of buildings	201	117	83	17,360	303	-7.1%	17
Telecommunication	119	5	114	5,241	119	-7.9%	23
Wholesale trade	111	94	16	29,836	433	3.1%	15
Manufacturing excl. fason	70	37	32	30,547	411	0.9%	13
Retail trade	59	48	11	20,503	256	1.2%	12
Fason	20	4	15	34,284	200	6.5%	6
Hotels and food services	12	8	3	19,500	131	-3.0%	7
Office support services (call centers)	9	1	7	16,593	125	27.3%	8

Source: INSTAT, Structural Survey of Enterprises

However, foreign investment is not the only way that productive knowhow is being accumulated in Albania. On a smaller scale, the immigration of individuals, especially members of Albania's diaspora, helps open doors to new industries and increase productivity in existing industries. This is an opportunity that remains largely untapped for Albania since the country's large diaspora includes many people who have acquired

substantial productive knowhow from working (and sometimes merely from living) abroad, including in high-income countries in Western Europe and in the United States.

**Box 2: The case of agriculture – knowhow via return migration**

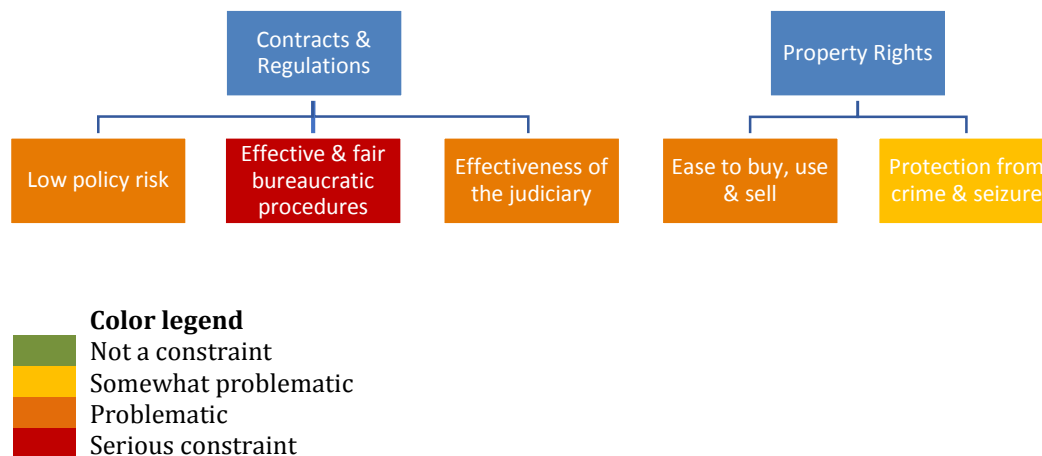
The recent Greek economic crisis hit the population of Albanian migrants in Greece particularly hard, spurring a wave of return migration to Albania that increased the Albanian labor force by 4.8% between 2011 and 2014 alone, and probably much more if we could have measured the inflow since 2009. We studied how this return migration affected the employment chances and earnings of those Albanians who never migrated. We found positive effects on employment and even slight positive wage effects for some groups. The gains are particularly significant for the low skilled non-migrants and they more than offset the sharp drop in remittances in the observed period. The employment gains were concentrated in the agricultural sector, where most of the return migrants found self-employment opportunities and opportunities to run own farms. Businesses run by return migrants pulled Albanians from self-employment and subsistence agriculture into formal employment and commercial agriculture, oftentimes through the introduction of simple, but powerful innovations such as greenhouses.

### 3. Rule of Law

This section discusses the degree to which weak rule of law institutions are a constraint to growth in Albania. Institutions are the rules of the game in a society, or more formally, the humanly devised constraints that shape human interaction.<sup>4</sup> By rule of law institutions, we are referring to the broad set of rules and norms that provide (or fail to provide) adequate stability and predictability for private sector investment, especially in terms of securing factors of production, structuring business relationships, resolving disputes, and restricting arbitrary official action. How free are businesses and individuals to buy, use, and sell their property, tangible or intangible, without restrictions imposed by the state or other sources of authority (including kinship groups, political groups, criminal groups or religious authorities)? How much risk do such groups impose on the stability of business contracts? What risks do businesses face from frequent or unpredictable changes in policies or the implementation of regulations? How well does the judiciary protect businesses in cases of contract violation by the state or other non-state actors?

Overall, rule of law institutions are very weak in Albania. We find that weaknesses in both the enforcement of contracts and regulations and in the protection of property rights have direct adverse effects on the entry and survival of foreign investors. Weakness in rule of law institutions partially underlies the knowhow constraint in Albania, as it keeps the country in a bad equilibrium where industries that are less sensitive to gaps in rule of law can succeed but where new investment by new firms is perceived as high risk. In particular, foreign investment is high risk in industries where market power is low and direct protections from government are absent. Additionally, members of the Albanian diaspora, who often have spent time living in countries where rule of law is strong, view opportunities in Albania with caution.

**Figure 15:** Illustration of the issues analyzed under Rule of Law



<sup>4</sup> North, Douglass C. *Institutions, institutional change and economic performance*. 1990.

## **Introduction**

The current government has worked toward establishing more rights and opportunities for investors. During 2015, a number of significant statutes were adopted, such as the laws on technological and economic development areas, strategic investments, tourism, and public-private partnerships. The aim of these laws was to provide investors with a number of additional tools and incentives—including tax breaks, access to clear land, more responsive government support and simpler bureaucratic processes, and alternative dispute settlement mechanisms—in order to catalyze new investment. There now exists an adequate legal framework that governs investments, whether domestic or foreign, which creates rights and duties for investors and the state apparatus respectively.

However, the situation with rule of law institutions and implementation of policies and regulations remains problematic and risks undermining the progress made in creating substantive rights by the above-mentioned legislation. While there was significant progress in creating legislation around property and economic rights, that progress of *implementing* these is marred by negative perceptions related to corruption, organized crime, a dysfunctional judiciary, and overall weak state capacities. Albania is situated in the heart of Europe, which puts its rule of law institutions under scrutiny by a number of international organizations. It has been subject to further scrutiny as a result of its bid to join the European Union. This makes the country's rule of law failings very visible to potential investors and others outside Albania.

## **Enforcement of Contracts and Regulations**

The enforcement of contracts between business partners, or between the state and businesses can be obstructed by: (a) an inordinate degree of policy risk, (b) ineffective or corrupt public administration, and/or (c) ineffective or corrupt courts.

### ***Policy risk***

Rule-based governments function by following regulations and norms that provide a predictable and durable legislative process, which tend to outlive changes of ruling parties. The decisions of civil servants in rule-based governments are also constrained by stable and transparent rules and norms, rather than by direct approvals and orders by their superiors. In Albania, on the contrary, the government enjoys discretion to determine whether to enforce the law or not. The public administration in Albania is organized around the principle of “order” issued by the highest-ranking official to authorize individual actions by even the lowest ranking officials in a given organization, including in cases when legislation has direct effect and does not require further specification or authorization. As a consequence, civil servants have to require formal approval from superiors for actions that are explicitly called for by the law. This type of organization leaves much discretionary power with the state officials and undermines the meaning, stability and continuity of public policies.

The issue of policy uncertainty is partially elaborated in a later section specifically on tax policy and tax administration, where we conclude that the frequent changes of tax policy are not conducive to business in Albania, but that they are not serious enough to constitute a binding constraint to growth. We conclude this also because the current government adopted budget legislation (amendments to the Organic Budget Law) that should better safeguard against rapid and frequent changes in tax policy moving forward.

Outside taxation, breaches of contracts are common, and they have directly affected the returns on investment of small hydropower plants and the recycling industry (see Box 3). Based on the experience of American companies operating in Albania, the U.S. Department of State, in its [2016 Investment Climate Statement for Albania](#), concluded that, “validity of contracts with the government is an ongoing concern, with incoming governments often seeking to nullify or modify contracts signed by previous governments. [...] Regulations and laws governing business activity change frequently and with little meaningful consultation with the business community.” However, it is important to note that, in spite of these serious impediments, investments in energy, and in particular hydropower have grown in an unprecedented way in the last few years. This may mean that instead of affecting the overall level of investment, the lack of certainty affects the types of companies that ultimately thrive in Albania.

### **Box 3: Policy uncertainty in two industries**

#### **Recycling**

In 2011, the previous government made it legal for Albania to import waste, mainly for the purposes of the recycling industry. Following this, the recycling industry invested accordingly in expanding its recycling capacity. The law was then abandoned by the new administration in 2014, resulting in large capacity under-utilization. It was reintroduced in November 2016.

*Sources:*

<http://www.intellinews.com/albanian-parliament-adopts-controversial-law-on-waste-imports-despite-protests-106672/>

<http://www.reuters.com/article/albania-protests-waste-idUSL8N1C64N1>

#### **Renewable Energy**

In the summer of 2016, the Energy Regulatory Entity significantly altered a law on renewables, through adoption of a Decree by the Council of Ministers, without prior consultations with the existing investors. This redefined the role of the small hydropower producers that had already invested in Albania from one where they were guaranteed a role of energy production and delivery to the state energy generation firm KESH to one where they act as traders with the state-owned electricity distribution company OSHEE.

*Sources:*

<http://www.areasso.org/?news=area-press-release-government-breaks-dcm-energy-purchasing-contract-investors-shpp-albania-2>

<http://www.areasso.org/?news=albanian-infringements-eu-acquis-ppas-risk-bankruptcy-shhp-dr-lorenc-gordani>

When there is expectation that the state frequently changes important policies (tax, subsidies, large state-financed programs etc.), the planning horizon of businesses shortens. As businesses focus on investments with quick returns, other serious investors who aim to make long-term investments under manageable levels of risk tend to shy away from such places. In a 2015 survey of foreign investors by the Foreign Investors Association of Albania (FIAA), frequent changes in legislation and tax procedures were listed as the second most severe problem, just after courts.

### ***Bureaucratic procedures***

The public administration in Albania is characterized by low overall capacity to implement policies, incentive structures that are not aligned with problem solving or meritocracy, and a high prevalence of corrupt behaviors.<sup>5</sup> These weaknesses, which are interrelated, affect the quality of the bureaucratic processes that companies are subject to. As is the case with the private sector in Albania, the public sector has only slowly accumulated new capabilities since 1990. Bureaucrats within the public administration also tend to have little experience outside of Albania or in private sector management positions, deepening the challenge of increasing state capabilities.

**Figure 16: FIAA 2015 Business survey results**



Corruption exacerbates the problem as it creates an environment where human capital becomes systematically eroded, and civil servants with little experience in rules-based systems are easier to corrupt. Employees that hold their positions for reasons other than merit may not respond to promotion and demotion incentives and are consequently difficult to motivate to perform their jobs in a professional manner. Ultimately, the primary social losses of corruption come from bolstering inefficient firms and the allocation of talent, technology and capital away from their most socially productive uses. Corruption and the related problem of illegal competition were among the most commonly cited

<sup>5</sup> Corruption, understood as the abuse of a power position for personal gains, continues to be perceived as endemic in Albania. It is said to be encountered at all levels of government, often taking the forms of bribery, nepotism along party, social or familial ties when it comes to recruitment in public administration but also private and non-profit sectors, psychological coercion, demands for sexual favors, and kickbacks for public procurement tenders.



problems in the 2015 FIAA survey, along with the courts. Moreover, according to the [U.S. Department of State \(2016\)](#):

“Major foreign investors report pressure to hire specific, politically connected subcontractors and often raise concerns about operating in Albania while complying with the Foreign Corrupt Practices Act. Reports of corruption in government procurement are commonplace. Numerous U.S. companies complained last year [in 2015] that they were disqualified from public tenders despite offering the lowest bid in order to award tenders to companies with politically connected local partners.”

The U.S. Department of State findings above explicitly show how highly productive companies are being squeezed out by less productive but better-connected companies. Along the same lines, in a discussion with the American Chamber of Commerce,<sup>6</sup> we learned that being asked to engage in corrupt practices or initiating a corrupt practice is not unusual, and is seen as the norm rather than the exception. At the more local level of public administration, the case of EMS APO, a German port operator in Durrës, exemplifies how corruption can help preferred businesses to obstruct the lawful operations of the company (see Box 4).

**Box 4: Durrës Port Authority and the failure to protect investor’s property rights**

EMS Albanian Port Operator Shpk (EMS APO) has been operating the East Terminal of the Port of Durrës since July 2013. In June and September 2015, EMS APO reported that workers and vehicles from rival companies occupied their premises, forcing its cranes and other equipment to cease operations for several days in a row. According to EMS APO’s managing director, the Port Authority did not respond to the company’s requests to react to the unlawful occupation of the premises. The company appealed to the Prime Minister after the local authority and the Ministry of Transportation failed to react.

Source: <http://www.intellinews.com/german-investor-accuses-competitors-of-blockade-at-albania-s-durres-port-500447343/?archive=bne>

In October 2016, CID conducted interviews with a small sample of firms across a range of industries. These interviews continued to show that corruption is seen as ubiquitous by Albanians and occurs at all levels of government. Firms noted several channels through which corruption affects business. This included the extraction of bribes using unclear regulations and frequent interactions between officials and businesses, causing confusion to the point where firms may not know whether they are paying a legitimate fine or a bribe. Similarly, firms reported that bribes were demanded for some essential government functions (i.e. approving quality standards) or kickbacks were demanded when applying to government support programs, grants or during government procurement. Another way

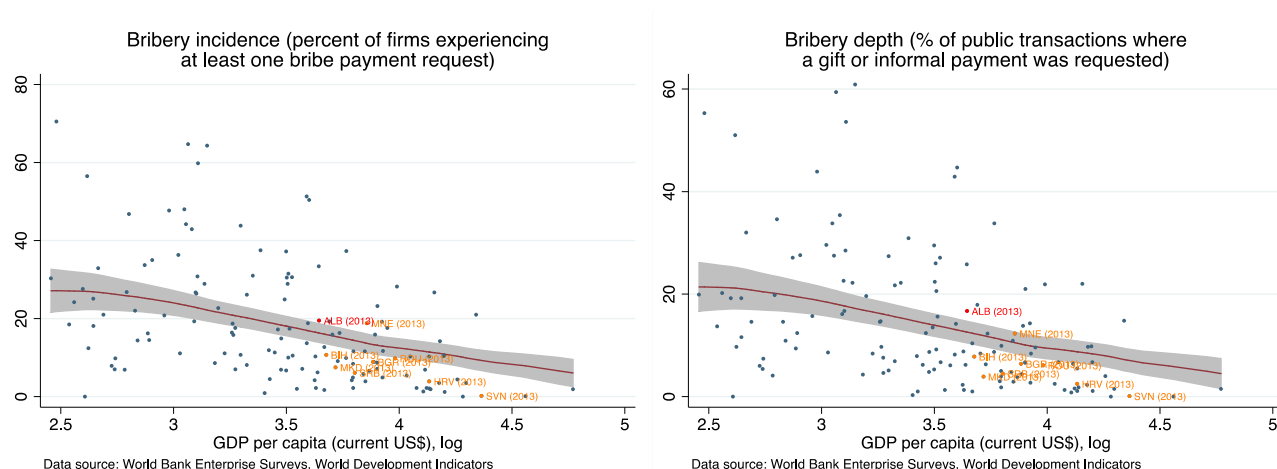
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<sup>6</sup> In discussion with the American Chamber of Commerce, conflicts with local communities, policy inconsistencies, concerns over the willingness of the government to abide by international arbitration rulings, corrupt courts and weak enforcement of courts’ decisions are perceived as most important reasons international businesses cite when they decide to leave Albania.

that corruption reportedly affects business is through the prevalence of paying bribes to purposefully shortcut regulations and cut costs, which results in unfair competition. This problem puts some international firms that have to follow international standards at a disadvantage. However, firms were also consistent in responding that corruption in Albania is not significantly worse than in other Balkan countries and that they viewed corruption as a manageable cost of business. One respondent said, “Corruption is like traffic. It is present everywhere and you need to know how to navigate it.” Another said, “We love corruption. It speeds things up.”

This duality where corruption is ubiquitous but not seen as a major constraint by firms in the country is matched across international benchmarking exercises. Enterprise Survey results from 2013 show that bribery in Albania is the highest in the region and high for its level of income. This was true for both bribery incidence (the percentage of firms experiencing at least one bribe payment request) and bribery depth (the percentage of public transactions where a gift or informal payment was requested). The survey results also show that bribery was the highest for the private sector when paying taxes, competing for government contracts and getting construction permits.<sup>7</sup>

**Figure 17:** Albania’s bribery incidence and depth are high

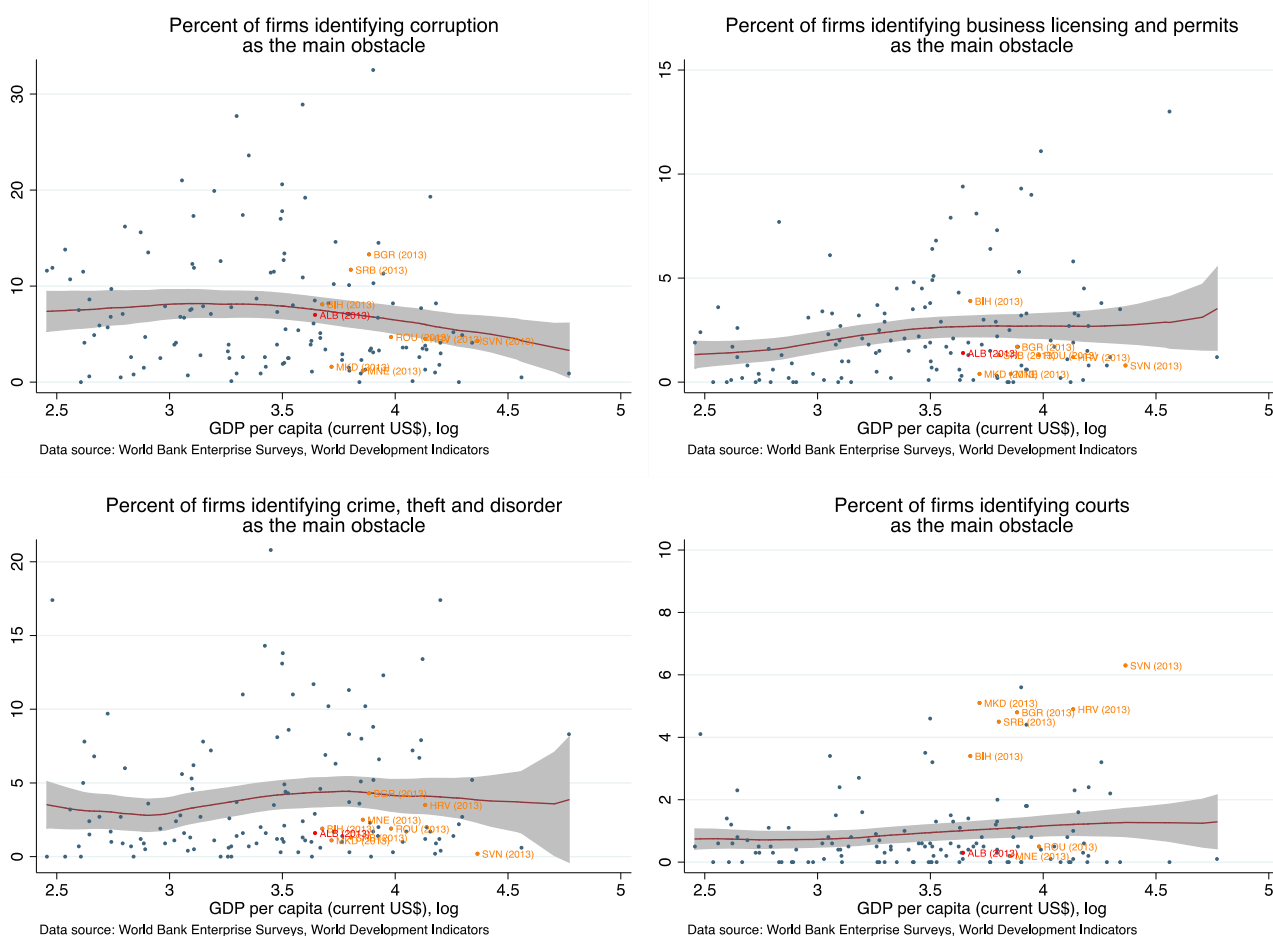


But when firms in Albania were asked to choose what was their biggest obstacle to business, they did not report corruption as their biggest obstacle at a particularly high rate. The same was true for other constraints related to rule of law, including business licensing and permits, crime, and the courts as well (Figure 18). Thus, there is evidence is consistent

<sup>7</sup> More information on bribery from the 2013 Enterprise Survey: It is informative to compare across the situations where the Enterprise Survey asks about bribery. Albania is an outlier for its high levels of bribery when firms meet with tax officials, try to secure government contracts, and try to obtain construction permits. Albania is not an outlier when firms try to get an operating license or an electrical connection, and in terms of giving gifts to public officials “to get things done.” Finally, bribery is reported as low when firms try to get an import license and when firms try to get a water connection.

that rule of law problems stemming from weak public administration are not the binding constraint to growth of industries that already exist in Albania. However, the acute weaknesses in this area do appear to be very important constraints for foreign investors who might consider Albania as a new location for operations. In this way, it is clear that problems of rule of law in Albania sustain a bad equilibrium, where firms that are less sensitive to the risks can survive, but where new investment is limited.

**Figure 18:** Albanian firms do not report corruption; business licensing and permits; crime, theft and disorder; or the courts as their main obstacle at unusually high rates



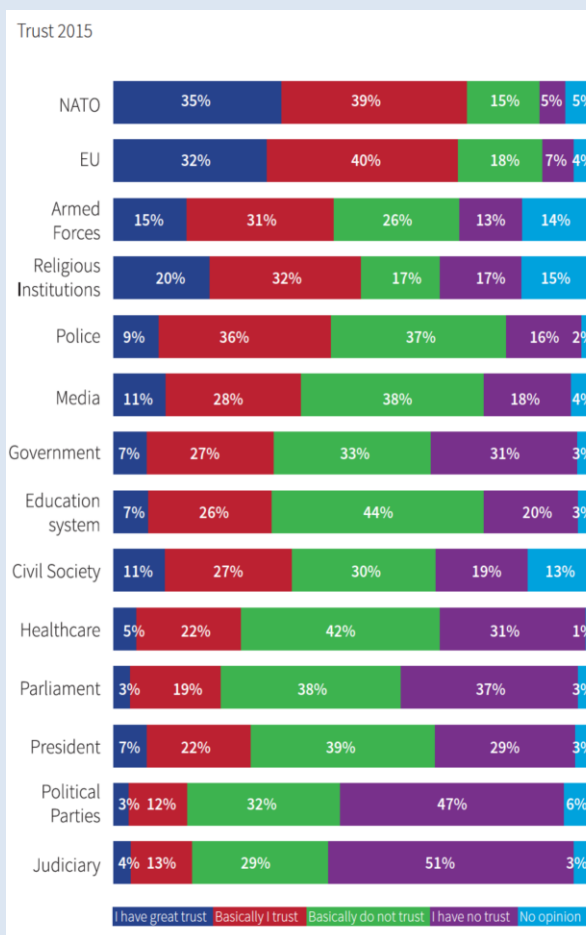
Beyond the private sector, this same type of pattern can also be seen within surveys and polls of the public (Box 5). Since corruption is a ubiquitous problem in Albania, the expectations of the public are low. But public trust varies greatly by government institution. The judicial system, discussed next, is among the least trusted parts of government. These results are also in line with CID's own findings from a [survey of about 900 Albanian-Americans](#), who ranked corruption and weak legal protection as the top two concerns when thinking about doing business in Albania. Thus, while expectations may be low within Albania, rule of law is a big concern to Albania's large diaspora.

### Box 5: Survey and poll evidence of perceptions of corruption by the public

Patterns of responses by the public mirror those of the private sector in Albania. According to recent survey evidence, the rate of bribery for basic services in Albania is among the highest for all countries in Europe and Central Asia, but the rate at which survey respondents say that corruption is one of the three biggest problems facing the country is average for the region (Transparency International, 2016). Based on the same survey work, more than half of Albanians say that “most” or “all” MPs are corrupt (among the highest in the region), but Albanians are also among the most satisfied with government actions to fight corruption, with one of the lower rates of respondents saying that government efforts are “very bad” or “fairly bad.”

A 2015 opinion poll conducted by the “Advocacy for Open Government” project, funded by the European Union and implemented in Albania by the Institute for Democracy and Mediation, shows that the institutions with the lowest trust in Albania are the judiciary, political parties, and Parliament, while the highest trust is for NATO and the EU (see figure). The government overall scores more toward the middle.

#### Opinion poll results on trust in Albania



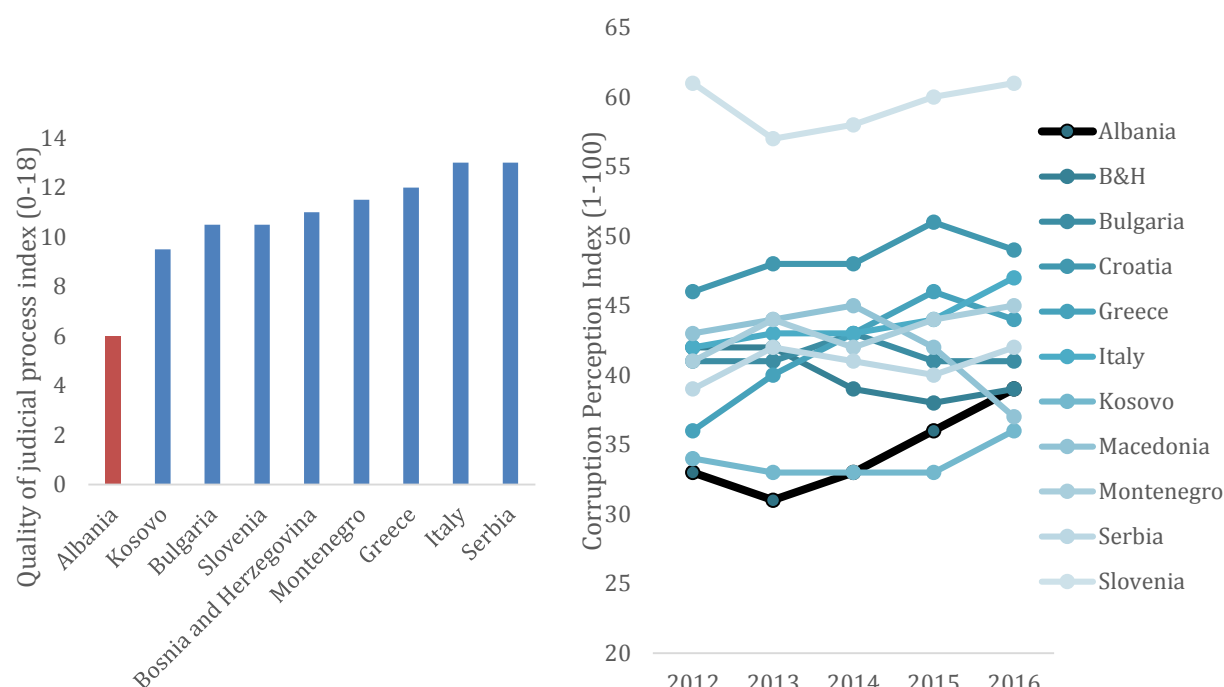
### The Judicial System

The Albanian courts have a long-standing reputation of being politicized, biased, under-resourced, and corrupt. Foreign investors typically avoid dealing with Albanian courts. In the 2015 FIAA survey of foreign investors in Albania, courts were the most commonly cited problem for doing business. European Commission’s annual progress reports since 2001 have repeatedly indicated that endemic corruption stands in the way of faster integration with the EU, and the judiciary is in the eye of this public storm. According to reports from the European Union, its functioning is affected by politicization, limited accountability, high discretion over professional careers, poor inter-institutional cooperation, and inadequate resources. The problems with the judiciary have been identified by European Commission reports as perhaps the single most important cause holding Albania back from deeper integration in the EU, economic development, and democratization. Due to this pressure, Albania has been undertaking a prolonged process of judicial reform, which has moved forward in fits and starts.

However, the purpose of this growth diagnostic is not to pinpoint what constrains Albania from joining the European Union, but rather what constrains it from achieving more rapid economic growth. The same duality applies here as with other parts of the public administration. Available evidence suggests that, despite the judicial system being very ineffective, existing firms are not constrained by the judicial system. This is the result of most firms not depending on the courts and at least some firms benefiting from being able to use the judicial system's weaknesses to their benefit. The World Bank Enterprise Survey from 2013 shows that firms in Albania, for the most part, do not worry about the court system (Figure 18, bottom right). During CID's interviews with firms, the topic did not often come up, as firms know that they cannot rely on the judicial system to be fair and responsive. One firm reported that this is a problem because suppliers and even land claimants understand how to game the system, knowing when the business will have no legal recourse, and use it to their benefit. However, this firm also stated that this problem was not one of its biggest concerns.

At the same time, the World Bank ranked Albanian courts as the worst performing among the countries in the Balkans with a score of 6 on a scale of 0 to 18, with 18 being excellent. Albania is overall also perceived as one of the most corrupt countries in the region, although the recent progress in the judiciary reforms is rapidly improving perceptions (Figure 19, right).

**Figure 19:** Quality of Judicial Process Index (0-18) and Corruption Perception Index (1-100)



Source: World Bank 2016, Doing Business (left) Transparency International Corruption Perception Index (right)  
Note: QJPI ranges between 0 and 18, with 18 being excellent. CPI ranges between 0 (highly corrupt) and 100 (very clean)

Many international firms also manage to partially bypass this constraint. To minimize risk stemming from the judicial system, foreign investors include international arbitration

agreements in their contracts with counterparts in Albania. In the period 2007-2016, there have been four major investment disputes between the Albanian government and U.S. companies, three of which led to international arbitration (U.S. Department of State, 2016). As a consequence, the State Department encourages U.S. investors to include strong binding arbitration clauses in all agreements with Albanian counterparts, stating in its [2016 Investment Climate Statement for Albania](#):

“Many U.S. citizens of Albanian origin have long-running restitution disputes. Court cases tend to drag on for years without a final decision, forcing many to take their case to the European Court of Human Rights in Strasburg, France. The Court has so far issued 23 (5 just in 2015) decisions in favor of Albanian citizens in civil cases involving protection of property with an assessed financial cost of approximately \$30 million. Reportedly, there are approximately 400 applications pending for consideration. Even after settlement in Strasburg, enforcement of the decision is often slow or nonexistent.”

Although international arbitration can generally help big foreign investors through mitigating risks posed by courts and lengthy judicial proceedings when it comes to state-investor disputes, this arrangement is less effective in preventing investors from being dragged to local courts by subcontractors, business partners, individuals from local communities, and, occasionally, state authorities as well. The American Chamber of Commerce in Albania has been vocal in its public criticism of the justice system in the country and how the system’s failings impact foreign investment. This remains true as a big push toward judicial reform is ongoing (Box 6).

#### **Box 6: Ongoing judicial reform in Albania**

In Albania, a broad set of reforms that aim to empower the justice sector and eliminate corruption is in the process of being adopted and implemented. These reforms cover several main areas: restructuring of the judiciary and prosecutorial authority; reforming the criminal justice system; changes in legal education, legal services and the profession; anti-corruption policies; as well as financing and logistical support for the justice system.

During summer 2017, the Parliament passed a number of constitutional amendments to restructure the judicial and the prosecutorial authorities in order to increase their independence from political parties, strengthen their integrity, ensure professionalism among judges and prosecutors, and establish special investigative and prosecutorial bodies. Currently, as part of the measures to fight corruption and re-establish public trust in the judiciary, judges and prosecutors are being vetted and re-evaluated.

It is worth noting that the justice sector reform has mobilized unprecedented attention from the United States and the European Union (working through the European Commission, the European Parliament, and individual Member States such as Germany and France), which has turned the passage of said reforms into an international cause. In particular, the European Union has tied the opening of accession negotiations to the passage and implementation of the reforms. If the reform process continues unhindered, it will be a step forward in creating a justice system with integrity, professionalism, and competency to take on the challenges that Albania faces.

## Property Rights

Property rights mainly relate to the ease of acquiring, using (for profit), and selling or transferring property. In some countries, problems with property rights are closely related to problems with crime. The enforcement of property rights in Albania is characterized by the same weaknesses discussed above for enforcing contracts and regulations. These weaknesses in policymaking, public administration and the judiciary all increase the risk to firms that the implementation of property rights will be at the discretion of individuals and groups within government rather than subject to the rules and procedures provided in formal legislation.

A specific area of property rights is discussed at length in the next section on access to land. We emphasize issues having to do with land access because other areas of property rights such intellectual property rights, buildings, equipment, are much less relevant in the discussion of what binds investment and growth in Albania.<sup>8</sup> In the case of land, we find that overlapping titles stand in the way of investments in tourism and land fragmentation makes it difficult to reach economies of scale in agriculture. Beyond these two sectors, gaining access to land is very problematic, but much less of a constraint for investment as compared to the absence of productive knowhow. Crime and seizure of land are not widespread problems but do become relevant in some high profile cases of attempts to acquire land for large tourism projects.

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<sup>8</sup> For instance, the U.S. Department of State (2016) states that “Albania is not and never has been on the Special 301 Watch List, Priority Watch List, or Notorious Markets report. However, IPR infringement and theft are common due to weak legal structures and poor enforcement.”



## 4. Access to Land

Albania faces major problems with incomplete land titling and ineffective land administration. The two problems are interrelated, and both issues are exacerbated by weak rule of law. Albania is experiencing a slow and incomplete transition to reestablish property rights after decades of state ownership of all land, followed by 25 years of unclear regulation of private and state property. Ownership of private property is commonly disputed between multiple parties and land plots tend to be fragmented. Incapability, or lack of interest, of successive governments to design proper land use policy has resulted in ambiguous land rights. This creates uncertainty and delays during land sales and difficulties in accessing finance through banks, which often require land titles as collateral for loans. Land administration further exhibits acute weaknesses in coordinating across ministries and levels of government to facilitate the use of public land. In addition, state property has been often used as a bargaining power by politicians over the votes of those in need of land. Weak rule of law exacerbates land issues in multiple ways. First, the ineffectiveness of the court system incentivizes parties to compete for land ownership. Second, illegal land use (including the cultivation of cannabis) and a high degree of corruption complicate the administration of public lands. Finally, weak state authority is evident over many municipalities and individual owners, including in the northern mountainous areas among traditional kinship groups.

Despite these significant issues, access to land does not appear to be binding for most private sector investment decisions. In particular, the evidence summarized below shows that access to industrial land is not a binding constraint for investment in manufacturing. Access to land is more problematic for two important sectors of the Albanian economy: agriculture and tourism. However, for agriculture, evidence presented earlier shows that the binding constraint is very limited productive knowhow. For tourism, the binding constraint is not clear, but there are several indications that land issues are critical.

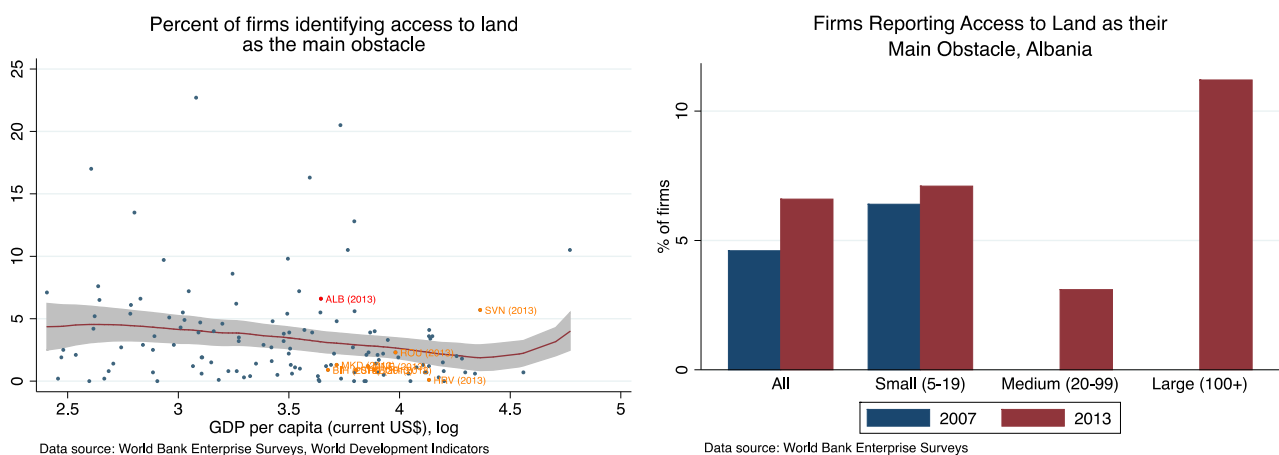
### International Benchmarking and Local Survey Evidence

Firms report that access to land is a significant constraint in Albania. Almost 7 percent of firms surveyed in the latest World Bank Enterprise Survey (2013) reported access to land as their main obstacle. Because the Enterprise Survey only covers existing firms, which by definition have managed to secure some land already, 7 percent of firms reporting access to land as their main obstacle is actually unusually high. This is roughly double what would be expected based on Albania's level of income and far above other countries in the region with the exception of Slovenia. For Albania, access to land was reported as the main obstacle at a higher rate in 2013 than it was 2007 on the Enterprise Survey, especially by medium and larger firms, suggesting that the constraint became more problematic over this time period. An annual business survey by the American Chamber of Commerce in Albania also shows a slow decline in the perception of property rights by firms over the years 2012 to 2015. However, this survey also shows an overall mixed picture of perceptions by firms, with 26.9% of those surveyed rating property rights as "good" or "very good" and 30.6% of firms rating property rights as "bad" or "very bad."

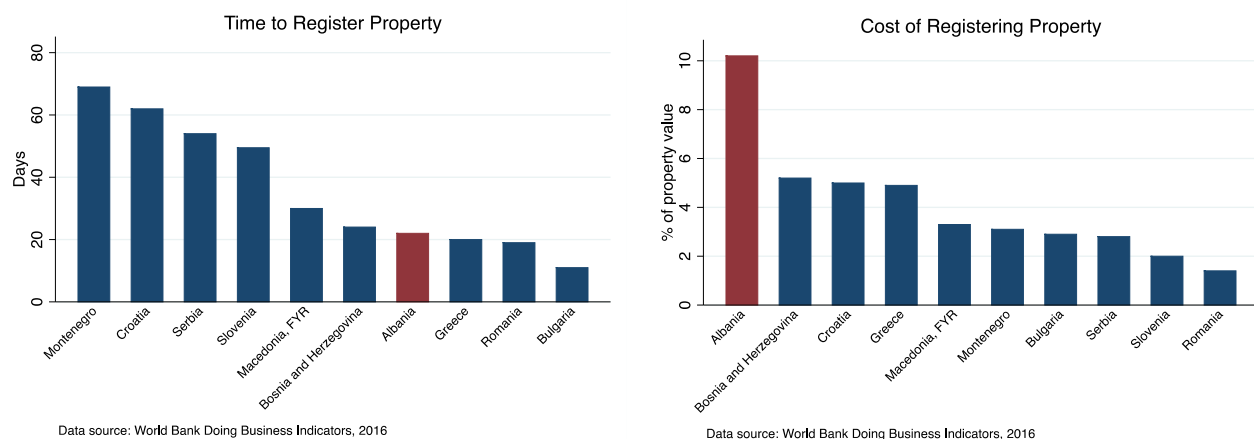


When it comes to registering property, World Bank Doing Business measures show that the time to register property is not high compared to other countries in the region but that the costs to register property are high. These measures only capture the time and cost if registration processes work as they should, and are thus a lower bound. This calculated cost of registering property has been steadily falling from around 18% of the property value in 2005 to roughly 10% in 2016. When the Doing Business methodology is used to calculate a “quality of land administration index,” Albania’s institutional quality looks fine overall, but scores a zero on geographical coverage. This reflects Albania’s lack of a land registry and mapping system covering privately held land in the country.

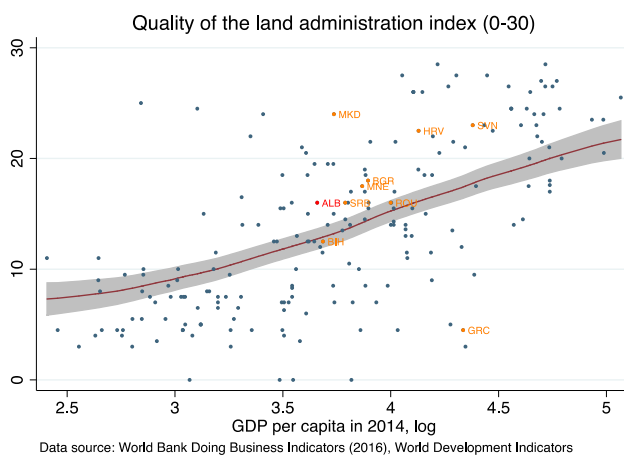
**Figure 20:** Enterprise Survey data show that access to land is a significant constraint reported by firms



**Figure 21:** Doing Business indicators on the cost to register property show high official costs



**Figure 22: Land administration institutions are lacking in geographic coverage**



Breaking down this index for Albania shows the following scores:

- Reliability of Infrastructure: 5 out of 8
- Transparency of Information: 4 out of 6
- Geographic Coverage: 0 out of 8
- Land Dispute Resolution: 7 out of 8

Note: The Doing Business Indicators only look at the largest business city; in this case, Tirana.

Source: World Bank Doing Business

## Firm Surveys and Land Prices

Therefore, international benchmarking and surveys over time paint a mixed picture. There are indications that access to land in Albania is a more significant constraint than in other countries, but there is also evidence that around a quarter of firms view property rights as good or very good. When CID interviewed a small sample of fifteen firms in a cross-section of sectors, a consistent message emerged. Many interviewed firms reported that they have run into issues acquiring land due to a lack of land titles and competing land claims. However, all of these firms expressed that these problems created delays but not existential threats to businesses. They reported that the processes for resolving these disputes work but require patience and thus the willingness to incur the costs of the delay. When these firms were asked if access to land is the biggest problem preventing them from making new investments, none responded that it was.

Among manufacturing firms in particular, the private market for industrial land, including prime land along the Tirana-Durrës highway, was described as liquid and prices were described as competitive with other countries in the region. Firms located in Durrës and Shkodër also reported paying competitive rental prices for centrally located factory space and not facing significant difficulties in expanding into new factories through leasing land. Rent for small factories, including land, in good locations in each city was €600-700 per month. Across manufacturing firms surveyed, the cost of renting or buying private land was low relative to other business costs. International data suggest that the situation may be worse for other sectors. Data from Colliers International show that office rents in Tirana are high for Balkans capitals, at €17 per square meter per month, but not high by European standards.<sup>9</sup> As of 2005, agricultural land in Albania was found to be very expensive, at €7,000/ha. This was 40% higher than agricultural land for Serbia and more than double

<sup>9</sup> Slightly higher rents than Belgrade (€15.5) and much higher than Zagreb (€12), Athens (€11) or Sofia (€9).

Bosnia and Herzegovina and Macedonia, but still below wealthier countries like Greece, Italy and Spain.<sup>10</sup> This is consistent with agricultural land being especially difficult to buy and sell in Albania. However, some large agricultural companies in Albania reported being able to acquire public land for agricultural use at low prices.

The Albanian Investment Development Agency (AIDA) has collected information from foreign companies that expressed interest in investing in Albania but did not end up doing so. AIDA's data from 2015 show that 37% of expressed interest was in manufacturing, 32% in agriculture, 14% in energy and mining, 7% in tourism, and 10% in other activities. A breakdown of the major constraints reported to AIDA by potential investors is given in Table 3. Land issues were found to be important constraints across sectors, but most especially for agriculture and tourism.

**Table 3:** AIDA's Assessment of Major Constraints of Potential Foreign Investors in 2015

Sector	Share of expressed interest	Major constraints related to land access	Major constraints <u>not</u> related to land access
Agriculture	37%	<ul style="list-style-type: none"> <li>- Land fragmentation</li> <li>- Lack of clear land ownership</li> </ul>	
Energy and Mining	32%	<ul style="list-style-type: none"> <li>- Overlapping mining permits</li> </ul>	<ul style="list-style-type: none"> <li>- Difficulties communicating with responsible institutions</li> <li>- Purchase price of alternative energy</li> </ul>
Manufacturing	14%	<ul style="list-style-type: none"> <li>- Difficulties in identifying state assets</li> </ul>	<ul style="list-style-type: none"> <li>- Difficulties in finding qualified staff</li> </ul>
Tourism	7%	<ul style="list-style-type: none"> <li>- Lack of defined tourism areas</li> <li>- Difficulties and delays with obtaining building permits</li> </ul>	<ul style="list-style-type: none"> <li>- High VAT compared with other countries in the region</li> </ul>

Note: AIDA also noted that a lack of coordination across ministries to make relevant information available to investors is a constraint that cuts across sectors.

## Other Evidence

### *Bypassing the Constraint*

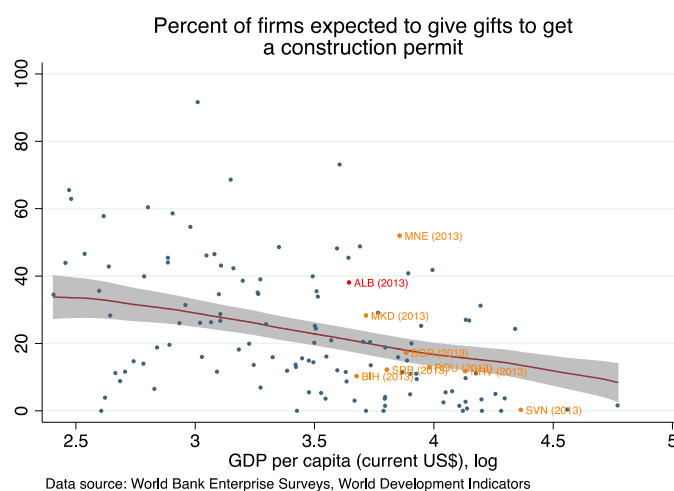
Aggregators are a natural response to the constraint of small landholdings. This approach has had noteworthy success in increasing agricultural output and exports, although further improvements are needed. Fruits and vegetable exports almost doubled between 2012 and

<sup>10</sup> Petroska Angelovska et al. *Agricultural Land Markets and Land Leasing in the Former Yugoslav Republic of Macedonia*. No. 120176. Factor Markets, Centre for European Policy Studies, 2012.

2014 (from \$36 to \$66 million, in constant USD), led by growth in tomatoes and apples, as well as nuts.

Outside of agriculture, bribery of officials to secure a construction permit has been common in Albania. In 2013, the World Bank Enterprise Survey found that almost 40% of firms were expected to give gifts to obtain a construction permit. This may have been the result of firms bypassing high official costs for registering property, but the prevalence of bribery is also linked to poor overall rule of law. In response to an acute problem of illegal construction throughout the country, the government has since made changes to its procedures for awarding construction permits.

**Figure 23: Bribery in obtaining construction permits**



This has, in turn, created new constraints for firms. Numerous firms cited a *de facto* ban on construction permits as a particular problem for them. In agriculture, building greenhouses and storage facilities is reportedly constrained by a lack of easily navigable processes to obtain construction permits, which are necessary to obtain loans. In tourism, AIDA's communications with potential investors also point to this as a significant problem. Tourism investors also note "a lack of defined tourism areas," which is linked to the same underlying challenge. The government has undertaken numerous layers of territorial planning (again, in response to its experience with widespread illegal and unplanned construction), but these plans remain incomplete and leave interested investors with a lack of clarity on where tourism-related investment will be allowed.

### *Camels and Hippos*

In a country where access to land is a binding constraint to growth, one would expect to see an absence of land-intensive industries. This is not the case in Albania, where much of production is concentrated in land-intensive and resource-intensive industries. Some of the largest sources of foreign direct investment in Albania have been in oil, mining of minerals, cement and hydropower, and mineral products made up 35% of Albania's goods exports in 2014 (20% from crude oil and 15% from other minerals and electrical energy). Each of these industries requires a lot of land, but each also has its own unique set of supporting institutions. These institutions are not perfect, as can be seen in tax disputes between the government and concessionaires of oil fields and the constraints reported to AIDA, but it is clear that the government has been able to facilitate the use of state-owned land for certain kinds of production. This is alongside other major sources of FDI in financial intermediation, telecommunications and wholesale trade, which are low land-intensity industries.

## *Changes vs. Changes*

With an understanding that investors face difficulties in accessing land for investment in Albania, two targeted actions were taken by the government of Albania, with CID's assistance, over the last two years. One action was to identify large pieces of state-owned land and put them out to bid for private developers to develop economic zones ([www.teda.gov.al](http://www.teda.gov.al)). Albania's first attempt at this took place in 2015, when a request for tender was initiated for clearly defined public land in the port city of Durrës. This did not elicit high demand from serious international developers. Although there might be other reasons why the tenders were not successful (there was little marketing and the expected costs remain high to recover the land to acceptable environmental standards and protect the land from flooding), the lack of overall investor interest can be seen as additional evidence that access to industrial land is not the binding constraint for manufacturing investment.

The second action was the compilation of a property registry by the AIDA: [www.aida.gov.al/pronat](http://www.aida.gov.al/pronat). The aim of the property registry was to identify at least 100 commercial and industrial properties that are unburdened by overlapping or disputed titles. The project was launched online in September 2016 with over 120 registered properties. According to AIDA, it is already being widely used by aspiring investors. As of now, one investment in electronic products by an Italian firm was realized directly as a result of the portal. A more systematic assessment of the impact of the property register has not been done yet.

## **Differential severity of the constraint by sector**

The severity of this constraint varies by sector, depending on the land-intensity of the sector, whether it requires state-owned land, and whether specific institutions exist to meet the land needs of the sector. For manufacturing firms, land is available to acquire on the private market. Delays are still common due to unclear ownership and competing property titles, but there is a process by which disputes can be settled for firms that are willing to work through delays. For mining and hydropower, state institutions exist that make land available for investment. Land is a major constraint in the agricultural sector in Albania, but aggregators are providing a fairly effective means of bypassing this constraint (see Box 7). For tourism, land access is a major problem but may not fully explain the low investor interest in the sector. The possibility remains that larger, "anchor" tourism projects are constrained by land access (see Box 8). This is an area where the land needs are large enough that property rights can become a binding issue, but where the government has not created a functional set of institutions. Finally, other services tend to not be land-intensive, and are not as exposed to this constraint. Office rents in Tirana are somewhat high, but not at a level that would suggest a binding constraint for services.

**Box 7: Agricultural Land**

According to Albania's FAO profile, last updated in 2006, agricultural land in Albania is highly fragmented and plot sizes average around 1.2 hectare per household, with more than 70 percent of farms being smaller than 1.5 hectares. There has been a movement over the last several years toward an aggregator model, which has become a somewhat effective means of bypassing parts of this constraint. Aggregators are able to provide economy of scale benefits by combining the production of multiple small firms, which lowers transportation and transaction costs, increases information available to small farmers on prices and demand, and facilitates some technological improvements. However, aggregators in Albania also run into some problems and Albanian fruits and vegetables still fail to reach the European market. Aggregators have non-uniform products and the system has not resolved issues in laboratory testing or a lack of internationally recognized farm-level accreditations. According to firm interviews, aggregators of herbs and spices have more fully internalized these problems. In addition to the somewhat successful way that aggregation allows for the land constraint to be bypassed, there are strong indications that agricultural output is more constrained by limited productive knowhow than by the small size of land parcels. Re-migration from Greece led to measurable increases in agricultural productivity without resolving land issues.

**Box 8: Land for Tourism**

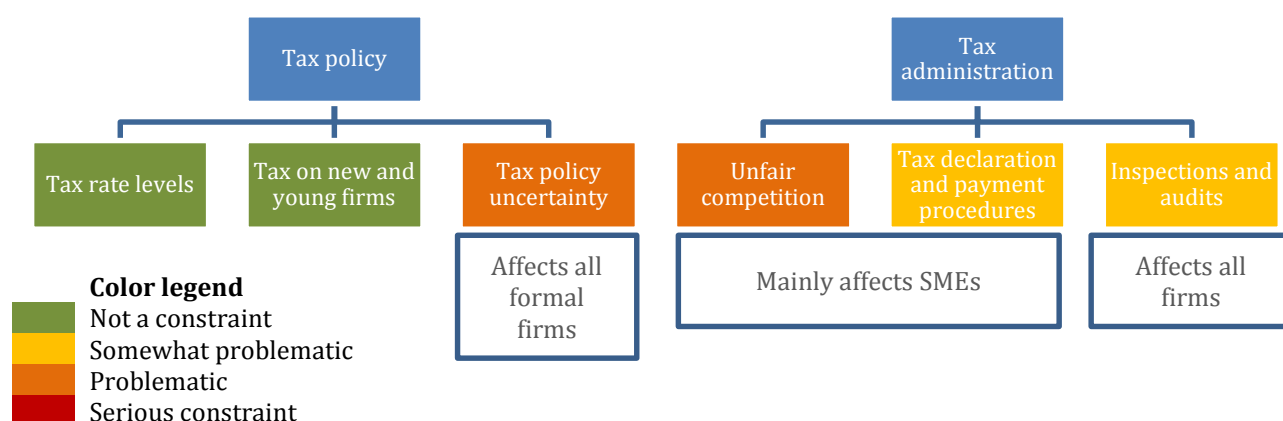
Tourism is a sector that is acutely affected by land issues. Proposed projects for resorts on the coast have repeatedly faced difficulties in obtaining high value land. Land on the coast that is suited for large investments tends to be fragmented across both state and private ownership, as with land throughout the country, while also being of especially high value. This exacerbates the dynamics of contestation between individuals, municipalities and the central government. In past instances, when faced with unfavorable state policies regarding property, individuals and groups have taken the law into their own hands. Thus, the land-related constraints in tourism are deeply related to problems of rule of law. The lack of successful, large-scale investments only serves as a deterrent to potential future investors and prevents the development of wider and more integrated tourism service networks, supply chains, and tourism-related agglomerations. The Government of Albania has recently undertaken efforts in regional, local and sectoral planning in response to a history of issues with informal construction and contestation over land rights. However, these efforts have stalled and investors that were expecting defined "tourism areas" remain with a lack of clarity on their options for investment.

## 5. Tax Policy and Tax Administration

Taxes are a direct burden on company's profits, but all countries impose various tax schemes on businesses. Hence, taxes can be a constraint to business only in specific circumstances: (a) if tax rates are excessive, and in particular, if they are high relative to the region, hurting country's competitiveness, (b) if they are imposed on new or young businesses, discouraging start-ups and preventing the expansion of young firms, and/or (c) if tax policy changes too often such that it seriously affects businesses' plans and forecasts. In Albania, tax rates are not particularly high and they are not high in a regional comparison. Young (and small businesses) are exempt from direct taxes, although they pay social security contributions. New foreign companies typically manage to negotiate tax breaks and obtain lower profit tax rates. Fiscal policy, however, has been changing very frequently in the last decade. The changes result in confusion about the interpretation of the new rules, both among the taxpayers and within the administration. In some cases, these changes might have interfered with the firms' investment plans. However, there is no definitive evidence that these changes discouraged investment.

Perhaps more relevant than the tax policy, is the effectiveness, fairness and the level of professionalism of the tax administration in Albania. The practices of the tax administration determine if certain groups of businesses face unfair competition. This is the case when only a subset of firms in a given industry is subject to taxation. Moreover, a large share of the interaction between the government and the private sector happens through taxation, meaning that the tax administration plays an important role in shaping the businesses' trust in the public administration as a whole. In Albania, the level of professionalism of the tax administration leaves much to be desired. Large firms are primarily affected by a lack of professionalism among the tax auditors and inspectors, while small and medium-sized enterprises (SMEs) are primarily affected by unequal tax treatment. In spite of positive developments on this front, tax procedures in Albania are still complex and inconvenient, and this disproportionately affects smaller firms. While all of these aspects are costly for businesses, the evidence in total shows that tax administration issues do not rise to the level of a binding constraint to growth.

**Figure 24:** Illustration of the issues analyzed under Tax Policy and Administration



## Tax Policy Overview

Like in other countries with large informal economies, most of Albania's tax comes from indirect taxation, taxes levied on consumption (59%), and less from direct taxation of income and profits (41%). The overall level of taxation is not high by European and regional standards. Albania collects less than 25% of GDP in tax revenues annually, while most East-European post-socialist countries collect over 30% of GDP in tax and most West-European ones collect close to 45% of GDP in tax.

**Table 4:** Tax revenues in Albania by major taxes

	Revenues, 2016 (expected)	As % of GDP	In total tax
<b>Tax Revenue</b>	371,330	24.7%	
<b><i>From tax offices and customs</i></b>	277,727	18.5%	74.8%
<i>V. A. T</i>	132,663	8.8%	35.7%
<i>Profit Tax</i>	27,100	1.8%	7.3%
<i>Excise Tax</i>	43,039	2.9%	11.6%
<i>Personal Income Tax</i>	32,700	2.2%	8.8%
<i>National Taxes and others</i>	35,972	2.4%	9.7%
<i>Custom Duties</i>	6,253	0.4%	1.7%
<b><i>Revenues from Local Gov.</i></b>	14,502	1.0%	3.9%
<b><i>Social Ins. Contributions</i></b>	79,101	5.3%	21.3%
<b>Indirect tax</b>	217,927	14.5%	58.7%
<b>Direct tax</b>	153,403	10.2%	41.3%

Source: Ministry of Finance, Budget 2017-2020, as of Nov. 23, 2016

Albania's main direct taxes are the personal income tax (PIT) and the corporate income tax (CIT), the largest component of which is profit tax. Albania also receives revenues from social and health insurance taxes (social contributions). PIT is paid by only about 45% of declared employees, because the lowest paying category of employees (up to ALL 30,000 or USD 240 a month) is tax-exempt. Two recent tax policy reforms are important to note: First, in 2014, the Government of Albania (GoA) changed two main tax schemes/rates:

- PIT was changed from flat 10% tax to a progressive schedule, peaking at 23% in the highest income bracket.
- The CIT rate was changed from 10% to 15%.

Second, starting in September 2015, GoA started a major campaign to reduce informality, initially through systematic visits to businesses and increased fines, and later by developing a risk assessment system that uses detailed firm-level tax data. This system uses algorithms to assess the risk of tax evasion for each individual company. The tax rate

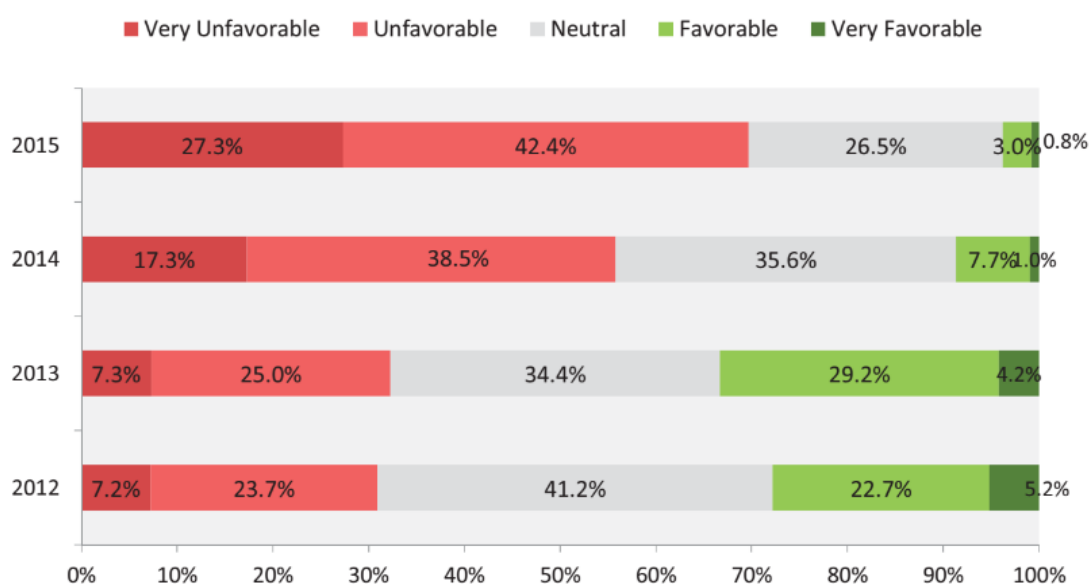


changes have had a net positive effect on CIT, but a net negative effect on PIT. The anti-informality campaign mainly increased the number of registered employees, and with that, the level of social security contributions. There was also a smaller positive effect on VAT and PIT. Overall, the level of tax collected increased from 22% of GDP in 2013 to almost 25% of GDP in 2016, and the share of direct taxes in total tax revenues increased from 39% to 41%.

### ***Are Taxes too High?***

If one would ask businesses, they will certainly say yes. Figure 25 clearly shows that the business community reacted strongly to the increase in taxation in 2014. However, the periods in which businesses found the tax rates significantly more favorable (2012-2013) were characterized by low growth, low investment and low exports, suggesting that low tax rates did not encourage more investment. Growth has been picking up only more recently despite the higher tax burden.

**Figure 25:** How do you consider the overall tax level applied in the last year for your business?



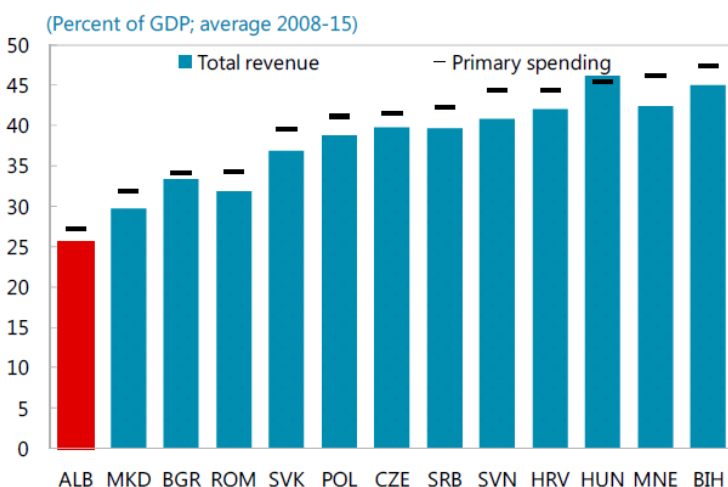
Source: AmCham 2016 Business Index 2015-2016.

Moreover, total revenue as a percentage of GDP is low by regional standards (Figure 26). Tax rates of direct taxes (here capital income tax) are on the high end for the region, while the VAT rate is comparable to that of Albania's neighbors. The efficiency of collections is low, but this seems to be the case for almost all countries in the region. This means that at the current level of tax rates and current collection efficiency levels, Albania's tax burden does not seem to hurt the competitiveness of its firms.

Referring to Figure 25 again, what forms the perception of the taxpayer is how things changed over time. In 2012, the tax rates and collections were both low. The previous

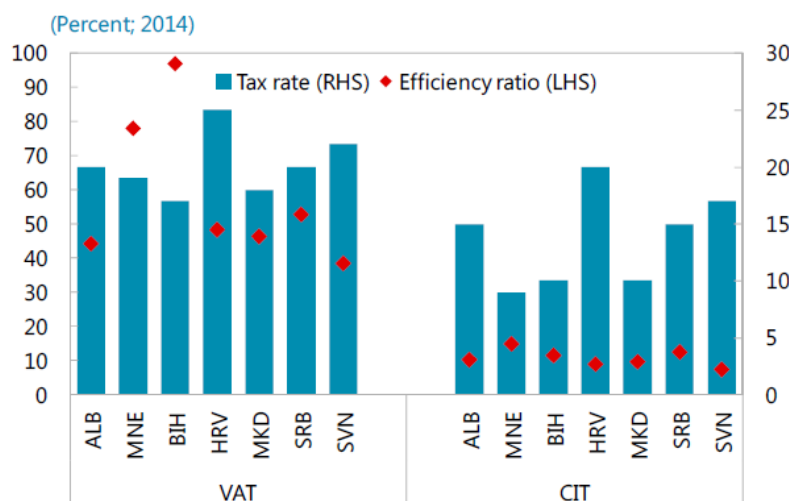
government was financing itself by building up arrears and by borrowing. In 2013, which was an electoral year, the previous government offered generous tax cuts. Hence, assessments improved. Since 2014, the current government has been increasing both the tax rates and the efficiency of collections, which evidently resulted in lower tax policy approval among businesses.

**Figure 26: CESEE, Total revenue and primary spending**



Sources: IMF, WEO database; and IMF staff calculations.

**Figure 27: Western Balkans, tax rates and efficiency ratios**



1/ Tax efficiency is the ratio of tax revenue (in percent of GDP) over the tax rate.

Source: IMF staff estimates.

## Tax Policy Uncertainty

In addition to the significant tax changes in 2014, various fiscal policy changes affecting smaller groups of businesses were also introduced, such as an increase in the excise tax on cigarettes and an increase of the carbon and circulation taxes on fuel, among others. A number of tax exemptions were also introduced, including for VAT on imported machinery and VAT paid by suppliers to the inward processing sector (fason). In November 2015, without prior consultations with the Ministry of Finance, Prime Minister Rama abolished the small businesses profit tax for the lowest profit tax group and reduced it for the second lowest group. In August of 2016, the Ministry of Finance announced a tax debt amnesty, which adversely affected VAT payments in the months following the announcement as businesses expected that they would be able to benefit from the amnesty also for the forthcoming period. In 2016, the municipality of Tirana substantially increased the property tax and the tax on the use of public space by restaurants.

The dissatisfaction with the frequent changes in fiscal policy is reflected in FIAA's 2015 survey results, where the interviewed companies list frequent changes in legislation and tax procedures as one of the most severe problems for businesses in Albania (Figure 28). In addition to planning uncertainty, frequent changes in tax policy result in confusion about the interpretation of the new policy and regulation, both on the side of the taxpayer and on the side of the tax administration (Investment Council 2015, also see Figure 28).

**Figure 28:** Business environment overall assessment



Source: FIAA Business Environment 2015 Survey

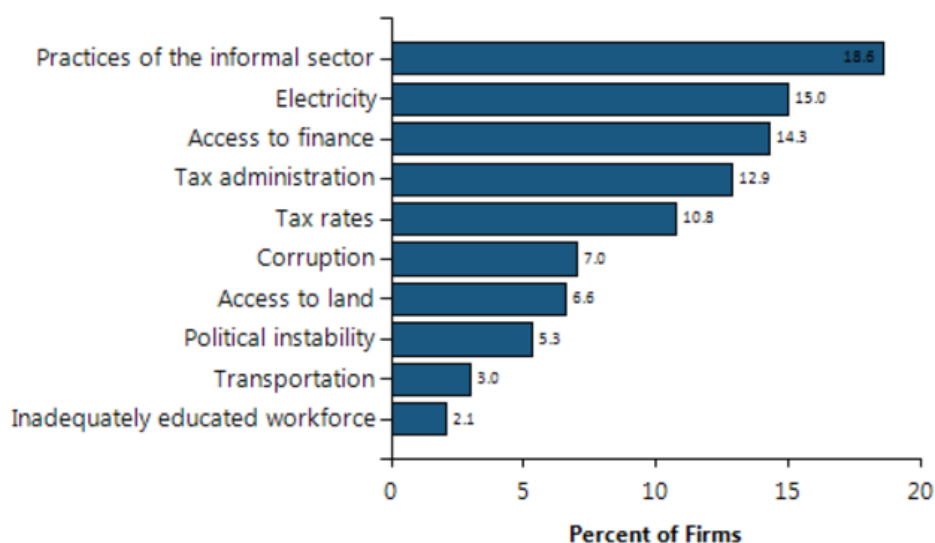
## Practices of the Tax Administration

We looked at three aspects of the practices of the tax administration: (a) discretionary application of tax policy resulting in unfair competition between firms, (b) tax declaration and payment procedures, and (c) the work of tax audits and inspections.

### *Unfair Competition Resulting from Unequal Tax Treatment*

When the tax administration imposes tax law on some businesses but not others, it distorts the playing field. This unleashes other behavioral reactions, such as resorting to bribes and corruption in order to reduce a firm's own tax burden. Taxation is replaced by rent-seeking and rent-sharing between businesses and the tax administration, but the rules (if any) are unclear and businesses do not know how their burden compares with that of their competitors. Nor do they know what kind of treatment to expect in future. According to the latest (2013) World Bank Enterprise Survey for Albania, the tax administration ranks relatively high on the list of obstacles to doing business. The most prominent way in which the work of the tax administration affects businesses is through allowing informal businesses to compete with formal ones, creating unfair tax advantages for some (Figure 29). SMEs, in particular, most often name the practices of the informal sector as their main obstacle to their work (18% among small businesses of 1-19 employees and 23% among medium-sized businesses of 20-99 employees).

**Figure 29:** Percent of firms identifying the listed problem as their main obstacle



Source: World Bank Enterprise Survey for Albania, 2013

Foreign investors too ranked illegal/informal competition among the three most severe problems to doing business in 2015 (see Figure 28). Although the tax administration has been implementing many measures to address the issue of informality since September 2015, informality is still rampant in Albania. Recent IMF estimates of tax gaps by sector

(Thackray 2016), show that many service sectors only pay a fraction of the VAT they are expected to pay (12% in the case of business support services, 18% in the accommodation and food services, and 43% in professional services). In agriculture, only 42% of the potential VAT is actually collected, and in construction this is only the case with 44% of potential VAT.

### ***Tax Declaration and Payment Procedures***

Businesses in Albania face a noteworthy burden in their need to make an average of 34 tax payments per year. This is double the number of payments for businesses in Europe and Central Asia and three times that of countries of the OECD (Table 5). The time spent on dealing with taxes is also significantly higher than in the comparison regions, although it seems that between 2015 and 2016 there was a significant progress in making the process more efficient. This was most likely the result of the introduction of electronic declarations.

**Table 5:** Procedural burden in dealing with tax declarations and payments

	Albania 2016	Albania 2015	Europe and Central Asia 2016	OECD 2016
Number of tax payments per year	34	34	17.6	10.9
Hours per year spent on dealing with taxes	261	357	221.5	163.4

Source: World Bank Doing Business 2015 and 2016

### ***Practices of the Tax Audits and Inspections***

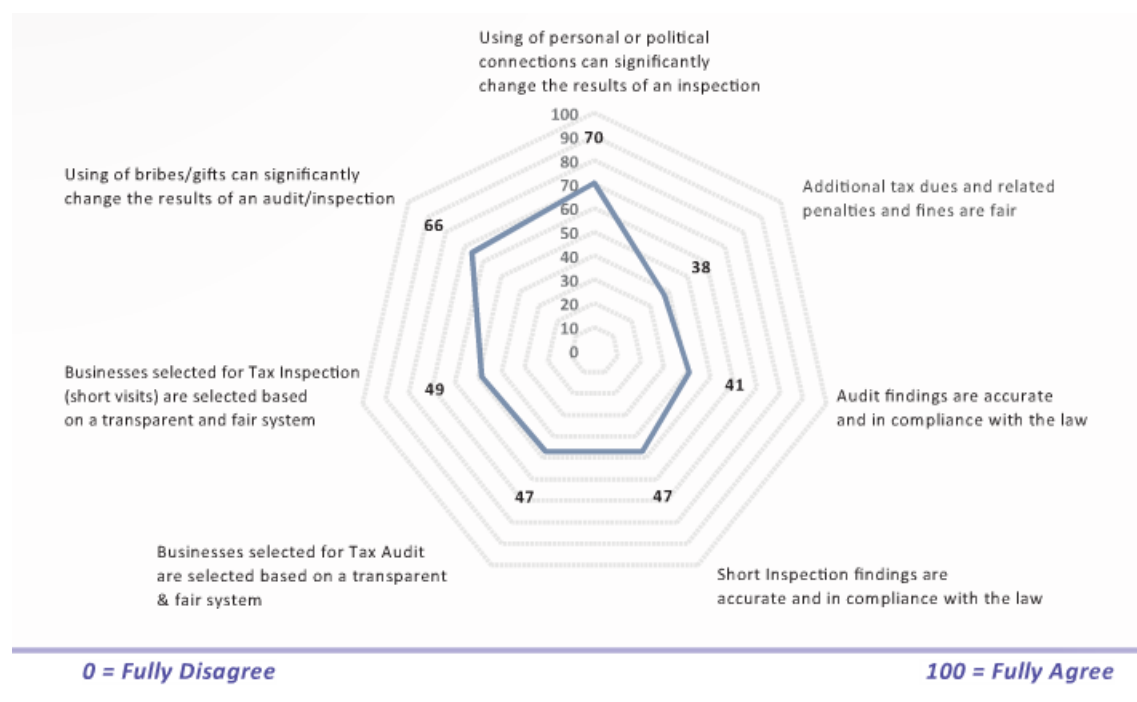
In October 2016, we asked 13 firms about their experience with the tax administration. Most of them reported that they have to spend a lot of time interacting with the tax administration and this interaction often went in tandem with bribes and corruption. However, for all of the interviewed firms, this was viewed as a manageable cost of business. The problem here is rooted in the lack of clarity of tax rules and regulations. Firms often have to communicate with tax officials to get clarifications but rarely receive the information that they desire. This benefits rent-seeking tax officials who use the lack of clarity to levy fines. Several firms that were interviewed note that this puts them in the position of not knowing whether they are paying a legitimate fine or paying a bribe.

According to a 2015 survey by the Investment Council, VIP businesses are regularly audited and their audits are unrelated to their risk assessment.<sup>11</sup> Some large businesses perceive the audits as a way for the tax administration to ensure that tax collections are according to plan (Investment Council 2015). The 2015 survey conducted by the FIAA

<sup>11</sup> The tax administration classifies around 800 businesses with turnover of over EUR 1.8 mill as VIP or large taxpayers and pays particular attention to their tax behavior. These represent less than 1% of all taxpayers, but contribute 40% of all tax revenues.

among 90 foreign businesses shows that foreign businesses perceived the tax inspections and audits as subjective, poorly targeted and prone to manipulation through contacts and bribery (Figure 30), but government inspections do not rank high among the major business environment problems listed by the firms (see Figure 28).

**Figure 30:** Perceptions about the tax inspections and audits



Source: FIAA Business Environment 2015 Survey

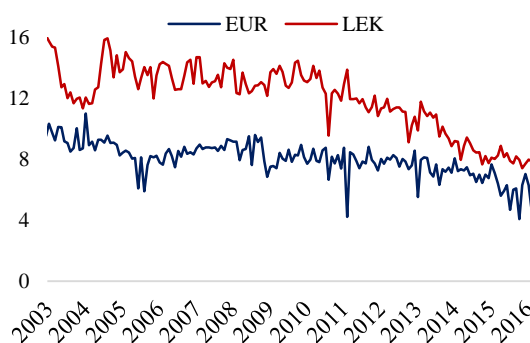
## 6. Access to Finance

While there are some weaknesses in financial intermediation in Albania, difficulty in accessing finance is not what constrains growth in Albania. Once Albania alleviates some of its more fundamental problems of low productive knowhow and poor rule of law, banks are likely to respond by relaxing credit standards and diversifying the financial products they offer. There is abundance of liquidity in the Albanian banking sector, but banks are not increasing lending activity. There are segments of the economy where capital is scarce and returns on capital could potentially be high, but firms are not borrowing more and not investing there. On the supply side of finance, firms do face a problem of low financial intermediation as evidenced by several indicators. Banking practices are unsophisticated and financial products are rigid. The non-bank financial sector is largely absent. Banks face persistently high non-performing loans (NPLs), and an unfavorable economic outlook makes banks averse to relaxing credit standards and diversifying financial products. However, demand from the private sector for lending is low as inadequate knowhow and weak rule of law, among other things, reduce the bankability of projects. Banks are willing to invest in what they perceive to be less risky projects, but such projects are rare. Moreover, the evidence shows that firms tend to successfully bypass access to finance constraints in Albania by borrowing from banks based abroad or by intra-company lending and high savings.

### Cost of finance

There has been a steady decline in interest rates over the past few years, both to households and to the private sector. Interest rates on loans in Albanian Lek (ALL) fell from 12% in 2011 to 7% in 2016, and EUR rates dropped from 8% to around 5% (Figure 31). The Bank of Albania has maintained a generally accommodative monetary policy since mid-2011, and the current policy rate is 1.25%. In an international comparison, the interest rate is in line with the regional average.

**Figure 31: Interest Rates on New Loans, %**



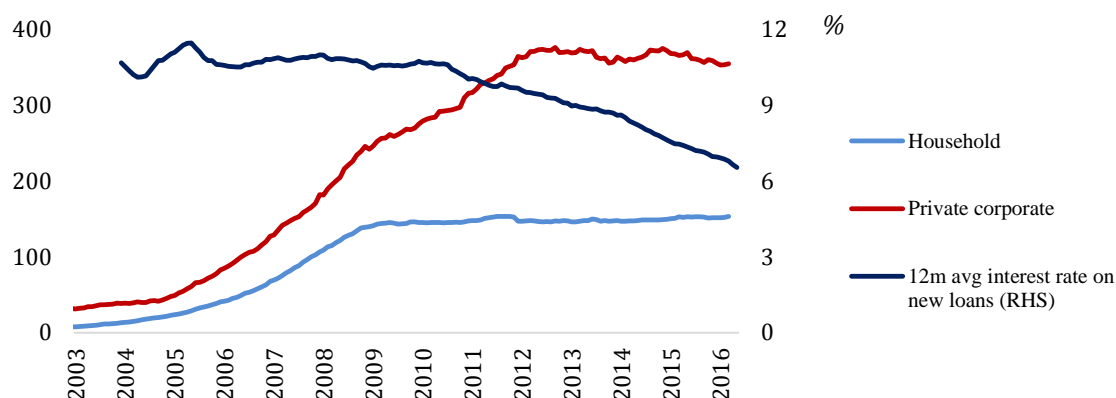
Source: AAB, Monthly Bulletin (June 2016)

### Changes vs. changes

Despite relatively low credit penetration and low interest rates, banking activity has been stagnant in recent years (Figure 32). The household loan portfolio has been stuck at around ALL 150 billion for almost seven years while the corporate loan portfolio has been stagnant for the last four years (both overall and across segments). At the same time, the assets and liabilities of the banking sector have been increasing in nominal terms since 2005. Albanian banks have had high levels of deposits for the last 15 years, and the country performs extremely well in terms of deposits/GDP ratios compared to a peer group of countries. The

increase in corporate deposits in spite of ultra-low rates suggests that the private sector as a whole enjoys ample liquidity, which can be drawn on to fund profitable investment opportunities, if these arise.

**Figure 32:** Total loans, by borrower (billion ALL)

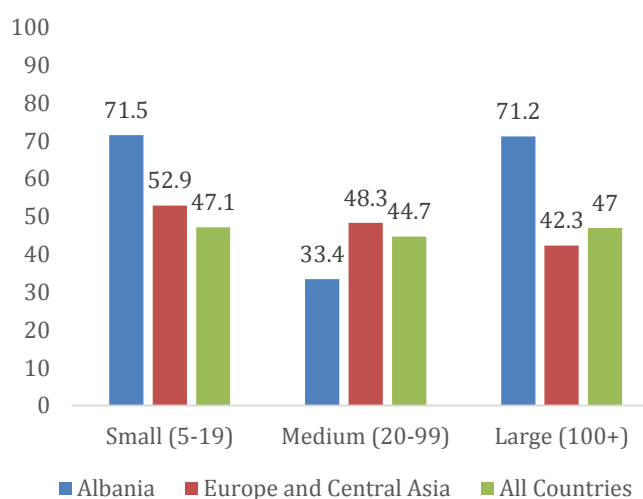


Source: AAB, Monthly Bulletin (June 2016)

The fact that lending activity is stagnant while interest rates have fallen is a strong indication that the Albanian economy is not finance constrained. However, one may still question whether this stagnation is driven by a lack of demand from firms or by rigidities in the financial system—in other words, whether firms do not need credit or because banks are rationing it. There is good reason to believe that both sides play some role but that lack of demand from firms is driving the dynamic.

On the side of the firms, 64% of all surveyed Albanian firms participating in the World Bank's Enterprise Survey in 2013 reported that they did not need a loan, while this was only the case with 51% of firms in Europe and Central Asia and 46% among all surveyed countries. The picture becomes more nuanced when breaking this down by firm size (Figure 33), with small and large firms not needing credit, but medium-sized firms showing the opposite result. However, the share of medium-sized firms with rejected loan applications was small (8.2%) and comparable to the rates in other countries (6.1% in Europe and Central Asia and 8.3% in all surveyed countries).

**Figure 33:** Firms reporting not needing a loan, %

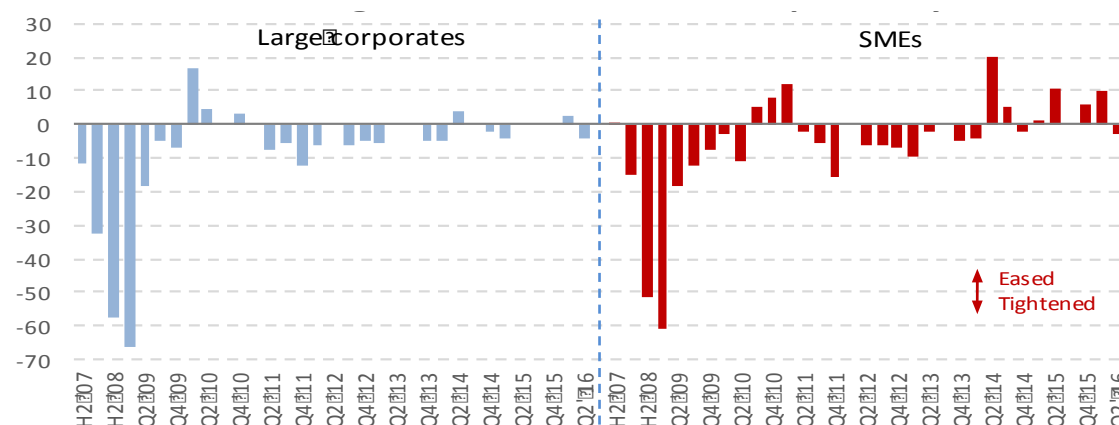


Source: World Bank Enterprise Survey, 2013



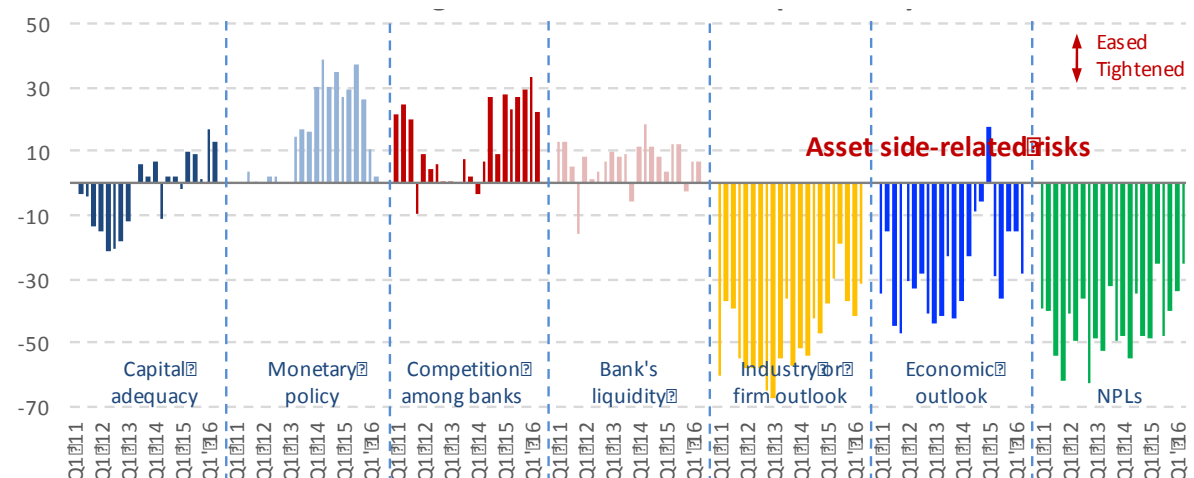
On the side of the banks, there is some reluctance to relax credit standards (Figure 34). According to the most recent Bank of Albania lending survey, credit standards were eased only few times, and primarily for SMEs rather than large corporates, during the last eight years. High NPLs, a stagnating economy, and industry-specific risks have been the main factors reported to keep credit standards tight. Expansionary monetary policies, abundant liquidity and capital, and competition among banks helped banks loosen the standards but often not enough to overcome these factors (Figure 35).

**Figure 34:** Change in credit standards, as reported by banks



Source: Bank of Albania Bank Lending Survey, 2016

**Figure 35:** Factors Affecting Credit Standards, as Reported by Banks



Source: Bank of Albania Bank Lending Survey, 2016

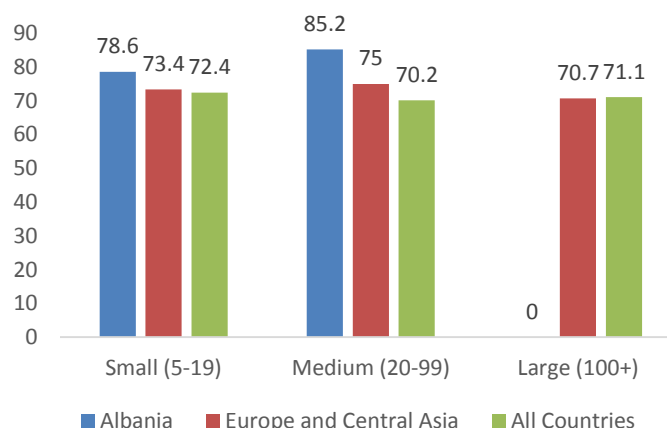
This outcome is consistent with the issues of firm productivity and knowhow discussed in other sections. Banks' hesitance to lend more freely is not being driven by issues within the financial system, but by the low quality of investment opportunities and the low demand

for loans by the private sector. Many firms in sectors where the expansion of credit is needed, such as agriculture and tourism, show little-to-no financial transparency, exhibit low quality of projects, and signal weak capacities to stay financially viable in the long run to banks.

### Bypassing the constraint

In Albania, more than in other places, it is also common to finance investments internally (Figure 36). At a first glance, this can be mistaken for evidence of bypassing a constraint. However, as elaborated above, a higher share of firms in Albania than in other countries state that they don't need a loan in the first place. Among large firms, few borrow from Albanian banks as they rely on inter-company lending, international capital markets, and borrowing from international banks.

**Figure 36:** Investments financed internally, %

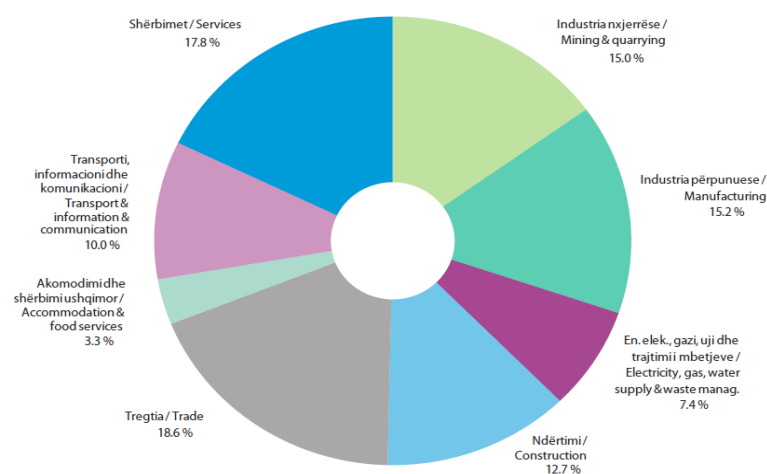


Source: World Bank Enterprise Survey, 2013

### Camels and hippos

If finance were the binding constraint, one would expect to see an absence of finance-intensive industries. But industries such as construction, utilities, and mining all have high fixed costs and are hence finance-intensive. Together these three industries make up 35% of value added in Albania, which is substantial (Figure 37). Thus, the structure of the Albanian economy itself is further evidence that access to finance is not a binding constraint to growth.

**Figure 37:** Value Added structure by economic activity



Source: INSTAT, Structural Survey of Economic Enterprises, 2014

## **What do firms say?**

In the October 2016 CID interviews with firms in Albania, we found that access to finance was not a problem any more frequently mentioned than infrastructure, education, and corruption. Several firms using banks in Albania did say that interest rates are high and collateral requirements are onerous, but these firms were still able to secure the finance they needed without too much difficulty. Foreign firms did not rely on Albanian banks, as they were often able to access finance from banks located in their countries of origin. From an interview with the Albanian Investment Development Agency, we also learned that numerous mechanisms for obtaining finance are available to farmers and SMEs, but that demand is limited. SMEs find the application procedures too complex, while the most popular AIDA programs tend to be focused on improving knowhow to access banking services, including through assistance in developing business plans and navigating bank or grant processes. Again, this is an indicator that the private sector in Albania is not finance-constrained but rather knowhow-constrained.

## 7. Electricity

Albania has made major strides in the provision of electricity since 2013. As a result of reforms centered on reducing energy theft, electricity revenues were increased by approximately 70% and electricity losses in the grid were reduced by approximately 30% between 2013 and 2015. The energy sector itself transformed from a source of severe fiscal vulnerability to a source of investment-led growth. The quality of service has also improved over this period, although system outages remain very common.

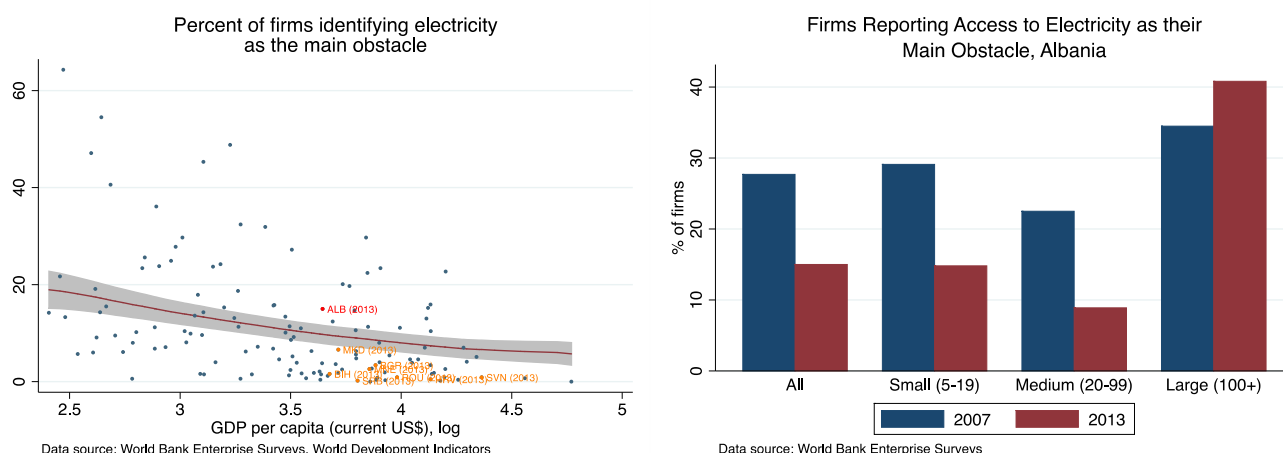
While the overall costs of electricity to firms, including the cost of outages, have decreased, Albania has not entered a new growth trajectory. Although putting the energy sector on stronger fiscal footing has led to new investments in electricity generation, Albania has not seen a significant bounce in investment in industries that are intensive in the use of electricity. This suggests that electricity is not the binding constraint to growth in the country and that continued improvements in the provision of electricity alone will be unlikely to stimulate growth. However, it remains critically important for Albania to continue to improve its electricity provision as a necessary but not sufficient condition for entering a new and higher growth trajectory. The gains made are vulnerable and electricity provision remains comparatively worse than in other countries in the region. The distribution company, OSHEE, needs to capitalize on the newly established fiscal stability in order to develop a forward-looking investment plan and improve the quality of its service to customers.

### International Benchmarking and Local Survey Evidence

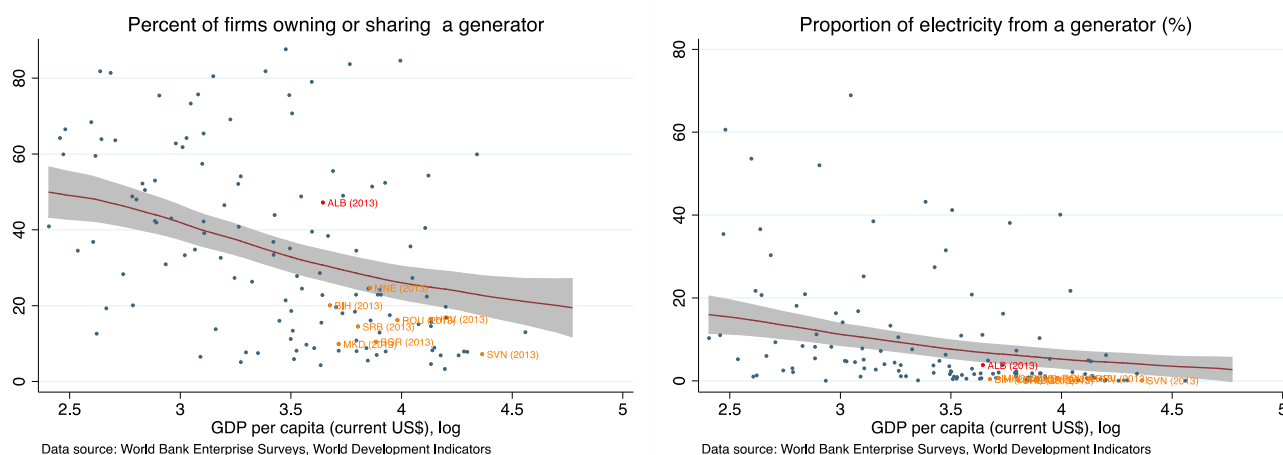
The 2013 Enterprise Survey found that 15% of firms in Albania reported electricity as their main obstacle, making it the second most often reported constraint (behind practices of the informal sector, at 18.8%). This put Albania a bit above expectation based on its level of income and far above other countries in the region, where it is very uncommon for firms to report electricity as their main constraint (Figure 38). According to the survey, the problem was the most common amongst large firms. Comparing the survey results to the previous survey year, 2007, shows that the constraint had already become less prevalent as of 2013. Consistent with an improvement in performance, the 2013 survey also found that ownership of generators by firms was high while the usage of generators by firms was fairly low. This suggests that firms tend to have back-up power sources that they no longer need due to improvements in provision of electricity (Figure 39).

Other sources of survey data suggest that access to electricity is not one of the biggest problems for the private sector in Albania. The business survey from the Foreign Investors Association of Albania in 2015 revealed that electricity is a low level concern of foreign investors in Albania, well below many issues of rule of law and taxation. Likewise, on an annual business survey conducted by the American Chamber of Commerce in Albania, firms' assessment of the "energy supply" in Albania is fairly positive. During each year between 2012 and 2015, more than 50% of firms rated the energy supply as either "good" or "very good."

**Figure 38:** Enterprise Survey data show that electricity is a major constraint reported by firms but less so in 2013 than 2007



**Figure 39:** Generator ownership by firms was high in 2013 but usage of generators was not



When CID interviewed a small sample of fifteen firms in a cross-section of sectors in late 2016, firms had mixed reports on electricity as a constraint. They painted a uniform picture of conditions, but some firms saw electricity as a constraint while others did not. Most firms agreed that electricity service has improved in recent years but some said the cost of electricity is a problem. Many reported that power cuts still happen often. Where possible, surveyed firms use back-up generators, but for firms that rely on heavy equipment it makes more sense to stop production than to switch to the use of fuel. One firm also noted that the parameters of supplied electricity are poor, which is problematic for sensitive equipment.

Available data confirms that outages continue to occur frequently. World Bank Doing Business lists the current system average interruption frequency index (SAIFI) at 49 interruptions per customer per year and the current system average interruption duration

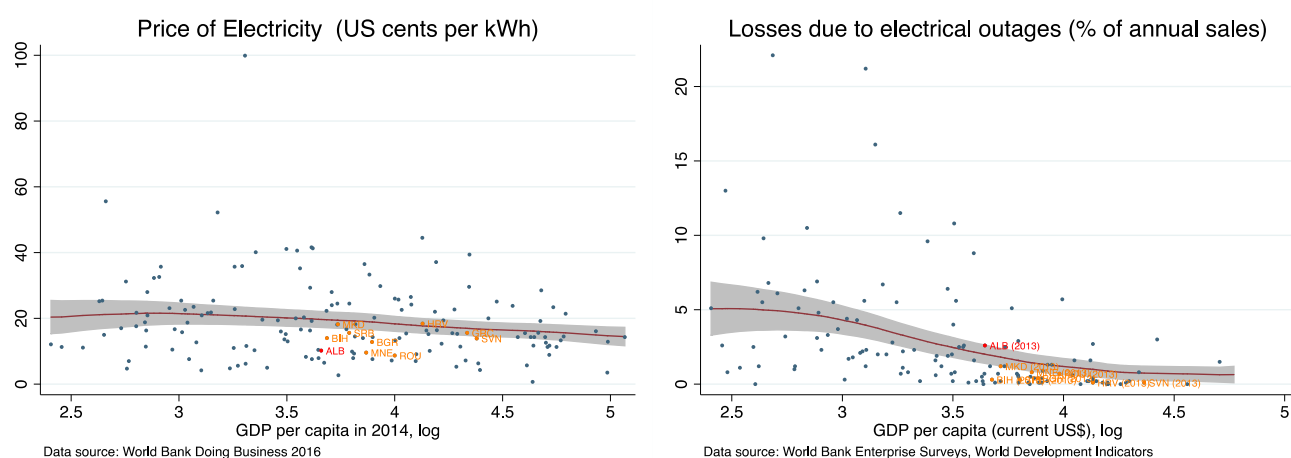
(SAIDI) index as 122 hours per customer per year. These are both very high by international standards.

## Price of Electricity

The price of electricity in Albania faced by firms is not unusually high. OSHEE lists the price of electricity for industrial users as ranging from 0.08 to 0.12 Euros per kilowatt-hour, depending on the voltage level, for peak business hours and 0.07 to 0.10 Euros per kilowatt-hour for off-peak hours.<sup>12</sup> This places the peak price for electricity (for low-voltage industrial consumers during peak business hours) at approximately the European average, with most electricity prices in the lower range of European countries. Doing Business calculates the current price of electricity at \$0.096 per kilowatt-hour, again low by international standards.

Therefore, firms in Albania do not face a high cost of electricity, but at times there is a shortage of supply that they pay the price for. The latest available information on the cost of outages to firms comes from the Enterprise Survey in 2013, which found that outages cost firms 2.6% of sales overall and 5.4% for firms experiencing outages, which is high for the region but not particularly high for Albania's level of income. As with other indicators of performance, this is a significant reduction from 2007, when the survey found that outages cost firms 8.9% of annual sales overall and 13.7% for firms experiencing outages.

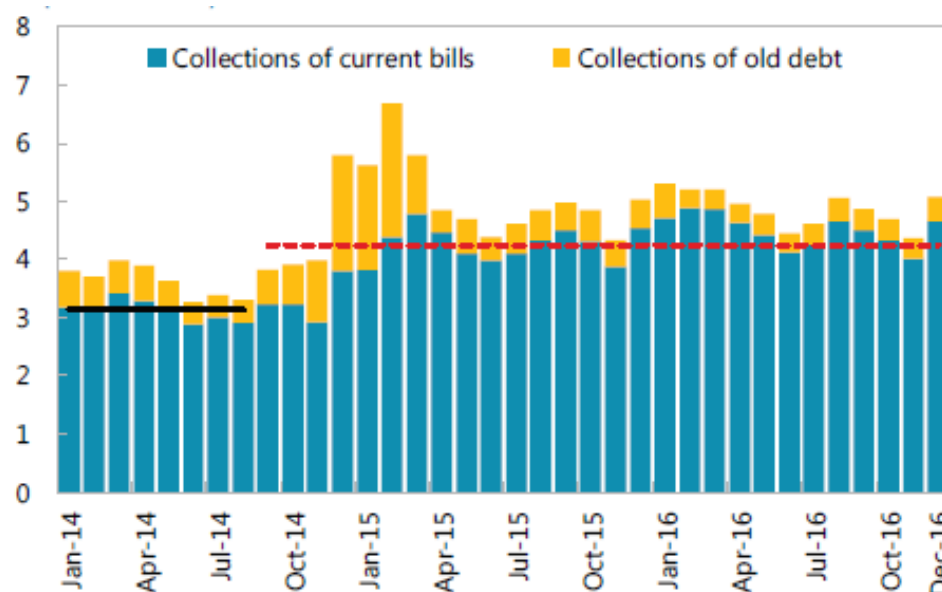
**Figure 40:** Firms do not face a high price of electricity but do face somewhat high costs from electrical outages



Finally, it is important to note that the electricity bills for some business segments probably increased since the government improved the enforcement of electricity bill payments and arrears collections towards the end of 2014 (Figure 41). The higher payment of bills and the clearance of arrears has been sustained until today.

<sup>12</sup> See OSHEE's tariff schedule: <http://oshee.al/blog/tarifat-e-energiise-elektrike/>.

**Figure 41:** Bill collections by the electricity distribution company (Billions of ALL)



Source: INSTAT and IMF calculations

## Other Evidence

### *Camels and Hippos*

Albania is home to several resource-intensive companies that require high quantities of electricity. These electricity users now buy directly from producers on an open market rather than from the utility. One such company that was interviewed described the transition in the electricity market as difficult but was satisfied with the current situation. This company reported that they currently pay 15-20% more for electricity in Albania than they would in other Balkan countries (like Bulgaria) due to limited international grid connections and high losses in the system. The presence of such large users suggests that the quantity of electricity supply is not a binding constraint. However, a general absence of manufacturing industries in Albania that use precision technology may reflect weaknesses in the supply of high quality electricity that is uninterrupted and provided with stable parameters.

### *Changes vs. Changes*

While it is clear that electricity is still a widespread problem for firms in Albania, it is also clear that conditions have improved over time. There is consistent evidence that the constraint was much reduced between 2007 and 2013, and there is further evidence of improvement since 2013. However, Albania saw its fastest (although unsustainable) growth prior to 2008. This mismatch also suggests that electricity is not the binding constraint to growth in Albania today.

## 8. Transportation Infrastructure

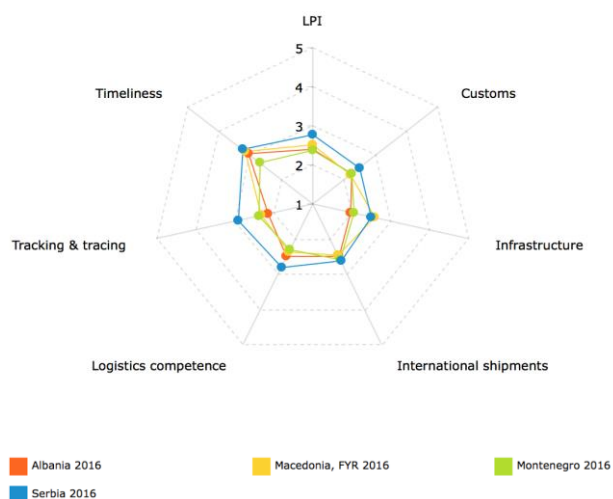
Transportation infrastructure in Albania has many weaknesses. Quality road networks are limited throughout the country, but recent public investment has improved accessibility, especially in the northern half of the country. Major road links are currently considered strong from Tirana north to Montenegro, northeast to Kosovo, and west to the main port in Durrës, but travel times on these roads is still slow. Road travel from Tirana south is more difficult, and many rural areas remain disconnected. Port and airport traffic is very concentrated in Albania. Roughly 90% of maritime trade flows through Durrës, although facilities are also present in three other cities. The port in Durrës is currently undergoing an expansion, but the shipping connectivity of Albania is extremely low given its geographic position. Albania has only one international airport, and the monopoly power of Tirana International Airport (TIA) has been a factor in the country's limited air connectivity, with relatively few direct flights and no Albanian airport near coastal tourism destinations in the south of the country. Traveling to some destinations in the south from Tirana's airport is (close to) a five-hour drive. Albania's rail network has been neglected over the years such that rail transport of people and goods is very limited.

Despite these weaknesses, transportation infrastructure is not binding Albania from transitioning to a higher growth trajectory. International benchmarking and firm surveys provide strong evidence that transportation is not among the top issues faced by existing firms or potential investors. One sector that is more constrained than others by transport infrastructure is tourism as the cost of getting to and from promising tourism destinations remains comparably high, due to weak connectivity in both road and air networks.

### International Benchmarking

On the World Bank's Logistics Performance Index (LPI), which is based on a worldwide survey of logistics operators (global freight forwarders and express carriers), Albania's performance is poor but in line with that of other countries in the Western Balkans. But on the infrastructure indicator, where respondents are asked to assess "the quality of trade and transport infrastructure" from very low (score of 1) to very high (score of 5) Albania performs very poorly. Along with Montenegro, Albania averaged a score of 2 on this question in 2016. According to this survey, Albania has shown mixed improvement in aspects of its logistics performance over the last ten years, but no improvement in its trade and transport infrastructure.

Figure 42: World Bank LPI versus comparators



Source: World Bank Logistics Performance Index, 2016



This survey result indicating a lack of improvement over time is surprising given recent public investments to modernize road, port and airport infrastructure. By contrast, the World Economic Forum's Global Competitiveness Report, which is based on executive opinion surveys, shows a steady improvement in infrastructure quality over the last decade, especially the quality of roads. On this index, Albania moved from an overall quality of infrastructure ranking of 118 in 2006-2007 to 75 in 2015-2016, and a quality of roads rank of 112 in 2006-2007 to 52 in 2015-2016. On these indicators Albania moved ahead of most regional comparators over time.

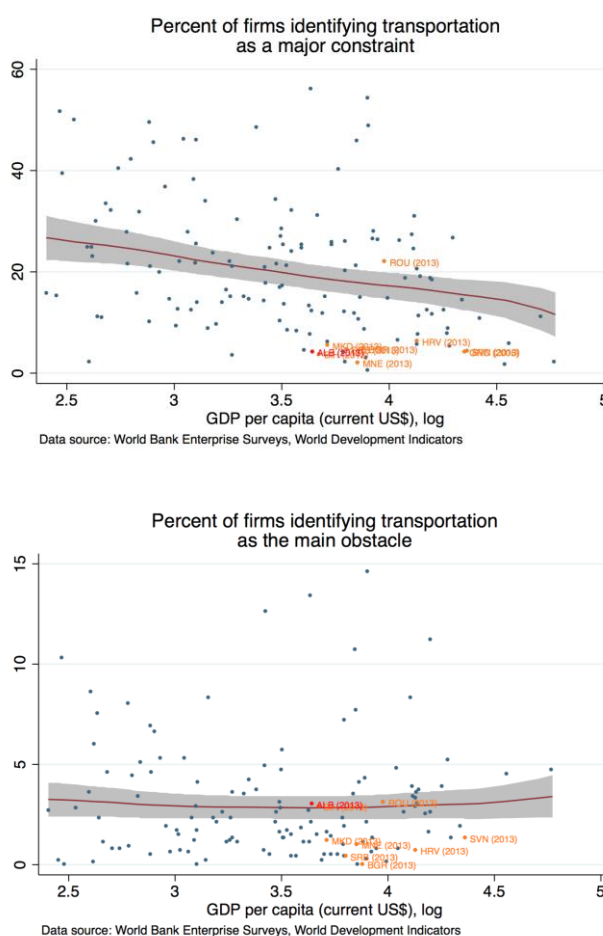
While Albania's port infrastructure does not score badly on available opinion surveys, it is weakly connected to global markets. On the United Nations Conference on Trade and Development (UNCTAD) index for liner shipping connectivity, Albania scores very poorly (a score of 3.4/100 in 2016), on par with Latvia, Eritrea and Tonga, as well as Montenegro. This is noteworthy given Albania's extensive coastline and position in Europe. However, this indicator is a measure of port usage rather than port capabilities, so it may be more reflective of Albania's lack of supply capacity than its infrastructure's capabilities.

### What do firms say?

The mixed benchmarking evidence above is, however, less informative than surveys and interviews that force firms to compare across constraints. On the latest World Bank Enterprise Survey (2013), very few firms reported that transportation was a major constraint. This was also true for most other countries in the region. Unlike the other countries in the region, most of the firms in Albania who viewed transportation as a major constraint also saw it as their main obstacle. But Albania still does not stand out as being transportation-constrained based on a cross-country comparison (Figure 43, bottom).

The American Chamber of Commerce in Albania's business survey for 2015 asked business leaders to rate infrastructure as a factor for their business activity. The responses were mixed with more respondents answering "bad" and "very bad" (39%) than "good" (25%). Respondents in this survey were also given the opportunity to provide open-ended comments. Out of over 100 comments, no

**Figure 43:** Enterprise Survey results



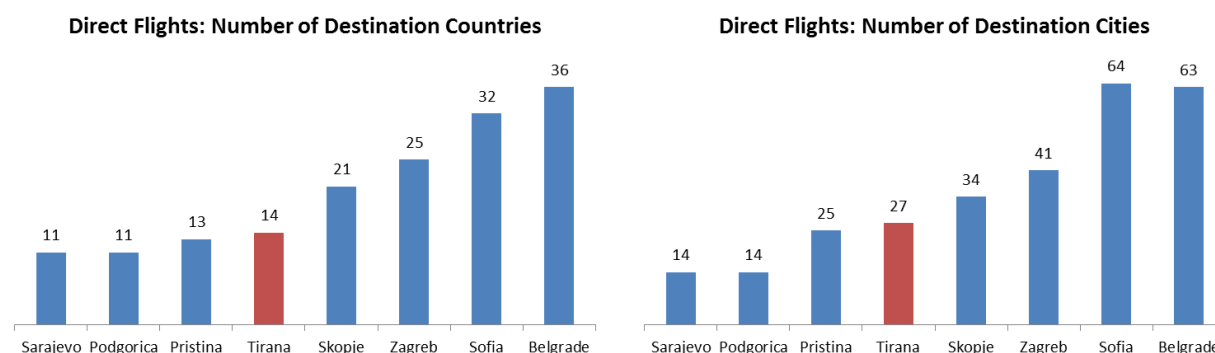
respondent commented on transportation, ports, rail, or air travel, suggesting that transportation is not among the biggest concerns of businesses. The Albanian Investment Development Agency also did not note transportation issues among the top concerns of potential investors in 2015.

In CID's own interviews of firms in October 2016, a pattern emerged. For firms that weren't very big and where materials are not very heavy (most of the firms interviewed), transport infrastructure was not a major constraint. Those located between Tirana and Durrës had very few problems with roads and northern companies did not complain either. Costs related to transport were reported as higher for locations in the southern half of the country than the northern half. Many companies contracted out their logistics/transport/shipping to other companies and none had any issues with contracting these services. Several small firms did point to shipping as being expensive, which seemed to be a problem of scale. To serve markets beyond Europe, firms often need to connect to larger shipping lanes from Italy or elsewhere. This was consistent with Albania's weak connectivity in shipping. For heavier industries such as cement, firms reported that the size and depth of the port are a constraint, as are the absence of highways that bypass cities.

## Air Travel in Detail

Air travel to Albania is limited. There are relatively few direct flights to Albania (Figure 44). Although cheap flights to Tirana are available, they often have multiple stops, layovers in distant cities, and long layovers. Tirana has more direct flights than Sarajevo (Bosnia and Herzegovina), Podgorica (Montenegro) and Pristina (Kosovo), but it is less connected than neighboring Skopje (Macedonia) and significantly less connected than Zagreb (Croatia), Sofia (Bulgaria), and Belgrade (Serbia). In addition, Tirana's flight connections are concentrated in connections to Italy. Tirana has direct flights to 12 different cities in Italy, leaving only 15 flights to cities in other countries. A map of direct flights that serve Tirana and other comparator cities is illustrative (Figure 45). Without the flights to Italy, Albania seems poorly connected to Europe in terms of direct flights. Pristina, is almost as connected as Tirana, even though it has about half the population.

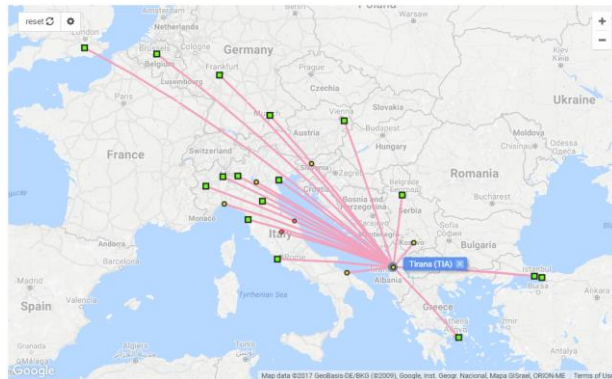
**Figure 44:** Direct flights from Tirana versus comparator cities



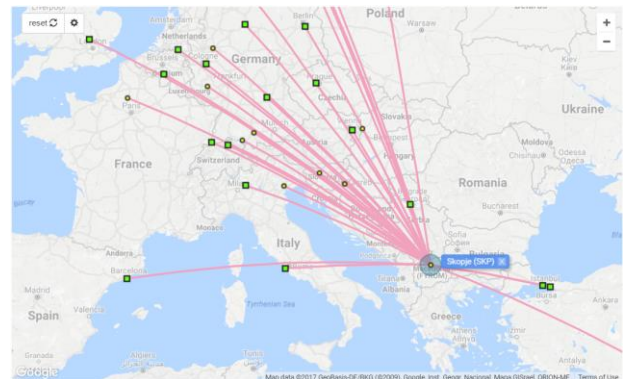
Source: <http://info.flightmapper.net>, own calculations

**Figure 45: Maps of direct flights from Tirana versus comparator cities**

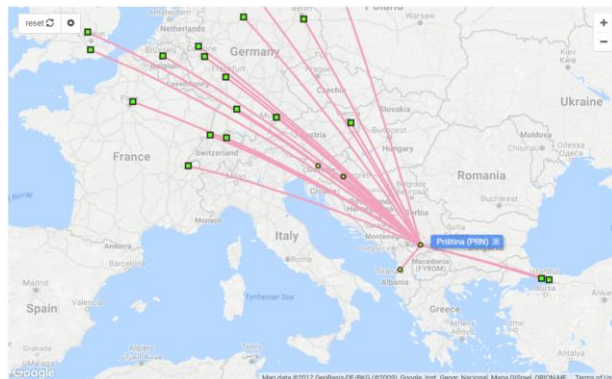
### Tirana



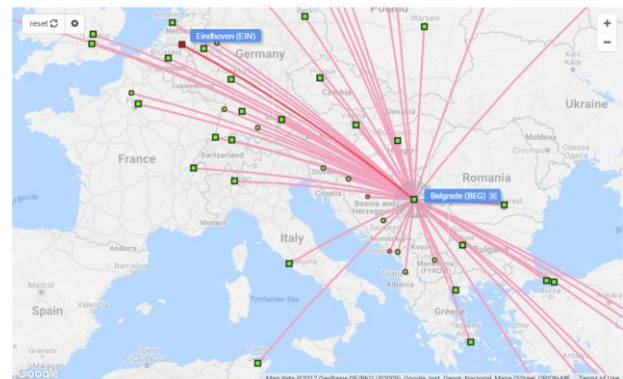
### Skopje



### Pristina



### Belgrade



Source: <http://www.flightconnections.com/>

To assess the cost of flying to Albania, we compared one-way flight prices from Tirana and comparator cities to various destinations cities (with zero, one or two stops). Table 6 summarizes the comparison. It lists the difference in price with respect to the average airfare to the destination city in the sample.

We examined flights from Tirana in the three time windows. The least expensive flight from Tirana to any of the 10 destination cities was, on average, \$11 cheaper than the least expensive flight from other comparator cities. Therefore, airfare to Albania is competitive in terms of price alone. However, this price comparison exercise did not control for flight quality (e.g. flight duration and quality of the flight carrier), which turns out to be important.<sup>13</sup>

<sup>13</sup> This is important considering that the least expensive flights from Tirana to the destination cities often included multiple stops, connecting flights in distant cities, and/or long layovers. For example, to fly Tirana-Copenhagen, the cheapest flight on May 1 is \$99, but connected through Athens and with a 20-hour layover. The next cheapest flight connected through Belgrade with a 1 hour, 45 minute layover, but cost over twice as much (\$211). Similarly, the cheapest Tirana-Madrid flight on May 1st was \$98 but had a 16-hour flight time and two stops. The next most reasonable flight to Madrid connected through Milan and had a 2-hour layover for \$145.

**Table 6:** Comparison of cheapest flights to destination cities in Europe

Week of May 1st: Low Price	Origin							
	Podgorica	Pristina	Sarajevo	Skopje	Tirana	Belgrade	Sofia	Zagreb
Amsterdam	-23	21	30	-4	-3	-22	-29	28
Copenhagen	101	2	11	-47	-11	14	-51	-18
Frankfurt	-51	6	14	-7	-19	19	17	21
Istanbul	49	-20	-22	-34	-21	-4	0	53
London	-33	10	31	58	1	0	-58	-9
Madrid	95	6	22	-36	-20	11	-75	-5
Munich	16	-7	19	-16	-7	0	-34	26
Paris	-10	-32	43	1	-8	37	-30	-1
Rome	49	-1	55	-12	-16	1	-74	-3
Vienna	1	-14	1	-21	-11	49	-28	22
Average	19	-3	20	-12	-11	11	-36	12

Note: Positive numbers indicate more expensive flights to the destination cities and negative numbers indicate cheaper flights. Prices were observed over three periods.  
Source: kayak.com, own calculations

## Road Travel in Detail

Land travel in Albania is slow. Table 7 shows estimated travel times and road distances to various destinations within Albania from Tirana. The data assumes a 10am weekday departure. Travel to all destinations is generally slow. As can be seen in the table, the average speed to the nine destinations is 55 kmph (34 mph). The highway north to Shkodër and onwards to Montenegro is considered effective, but travel in that direction is still slow. The same is true of the highway to Kosovo. Travel south beyond Vlore to the typically tourist beaches such as Dhermi, Himara and Borsh is also slow.

**Table 7:** Estimated travel times and speeds from Tirana

Travel Times in Albania from Tirana				
Destination	Distance (km)	Location	Avg. Time	Avg. Speed (kmph)
Sarande	282	South	4:50	58
Dhermi	202	South	3:30	58
Vlora	150	South	2:50	53
Korce	168	Southeast	3:10	53
Berat	122	South Central	1:50	67
Durres	36	West Central	0:35	62
Elbasan	44	Central	1:10	38
Pogradec	128	East Central	2:30	51
Skodra	94	North	1:50	51
Kosovo Border	159	Northeast	2:50	56
Average				55

Source: maps.google.com data, own calculations

Comparing internationally, land travel in Albania is somewhat slower than in Macedonia, and considerably slower than in Italy (Table 8).

**Table 8:** Estimated travel times and speeds from the capitals of Macedonia and Italy

Travel Times in Macedonia from Skopje			Travel times in Italy from Rome		
Destination	Distance (km)	Avg. Speed (kmph)	Destination	Distance (km)	Avg. Speed (kmph)
Ohrid	172	65	Milan	572	93
Bitola	174	75	Genoa	496	96
Kumanovo	40	61	Venice	525	103
Prilep	165	66	Naples	225	87
Tetovo	43	57	Bari	484	87
Veles	55	66	Bologna	375	90
Stip	95	67	Palermo	920	90
Strumista	158	73	Bolzano	639	96
<b>Average</b>		<b>66</b>	<b>Average</b>		<b>93</b>

Source: maps.google.com data, own calculations

## **9. Education Summary**

The supply of education is not binding economic growth in Albania. While both the supply of and the demand for college graduates have grown in recent years, the supply exceeded demand. Returns to schooling in Albania remain low and firms tend not to report that the education of workers is not one of their biggest challenges. We also find no signs of skill shortages in specific fields of education. A brief summary is given below and the detailed evidence is provided as an appendix.

### **Demand and Supply Conditions**

The demand for highly educated workers has increased over the last few years in Albania, but the increase was not sufficient to absorb all those graduating from a vastly expanding higher education system. Between 2012 and 2015, the share of tertiary educated employees in the Albanian workforce increased from 12% to 17%. Two sectors accounted for this up-skilling: knowledge-intensive business services and the public sector.

Meanwhile, this demand was met by an even larger supply of tertiary educated Albanians. Albania has seen a long-term transformation in its education system with expanding enrollment and mixed results in education quality. As a result, Albania developed a growing stock of jobseekers with upper secondary and tertiary education. But this transformation has not been adequately met with new opportunities for private sector employment. Based on the most recent data available, over a quarter of all highly-educated Albanians currently live outside Albania. These dynamics of supply, demand and quality are discussed at length below.

### **Returns to Education**

The returns to a year of education in Albania are lower than the international average (8% vs. 10%), but are growing. One reason for this is the growing share of highly educated employees. A year of college education has higher returns (14%) than a year of upper secondary education (6%). Tellingly, returns to education are significantly lower in the private sector (7%) than in the public sector (11%). This is consistent with the binding constraint of limited productive knowhow in the private sector.

### **Bypassing the Constraint**

If skills or qualifications would be in short supply, firms would adopt one or more of the following strategies: deplete the pool of candidates on the market, pay high wages, train workers and/or employ foreign workers. However, no single field of education has particularly low unemployment rates and very high field-specific wage premiums at the same time, and the numbers of work permits issued to foreigners is very low. In comparison to other countries, Albanian firms are less likely to offer job training. The reasons behind this become evident once one analyses the quality of firms in Albania. The typical Albanian company is unsophisticated, has relatively little sector-specific experience

and foresight, and interacts little with the financial sector. Hence, the overall demand for human capital is low and concentrated in few sophisticated service sectors.

### **What do firms say?**

The World Bank Enterprise Survey conducted in Albania in 2013 found that less than 10% of firms viewed an inadequately educated workforce as a major constraint, and only around 2% of firms surveyed reported that this was their biggest constraint. On both of these measures, Albanian firms are less concerned about finding educated workers than other countries in the region and other countries at a similar level of income per capita. A survey conducted by the Foreign Investors Association of Albania on the business environment in 2015 also found that this is a low level concern of investors in the country. However, during CID's own interviews, several firms emphasized difficulties in finding specific skilled workers, including engineers, chemists, electricians, mid-level managers, marketing and sales professionals, and service workers to meet the expectations of tourists. Overall, labor market data shows that these cases are exceptions rather than the rule. During interviews, many of these firms reported that they train workers where possible, but very few firms hired foreign workers to fill skill gaps.

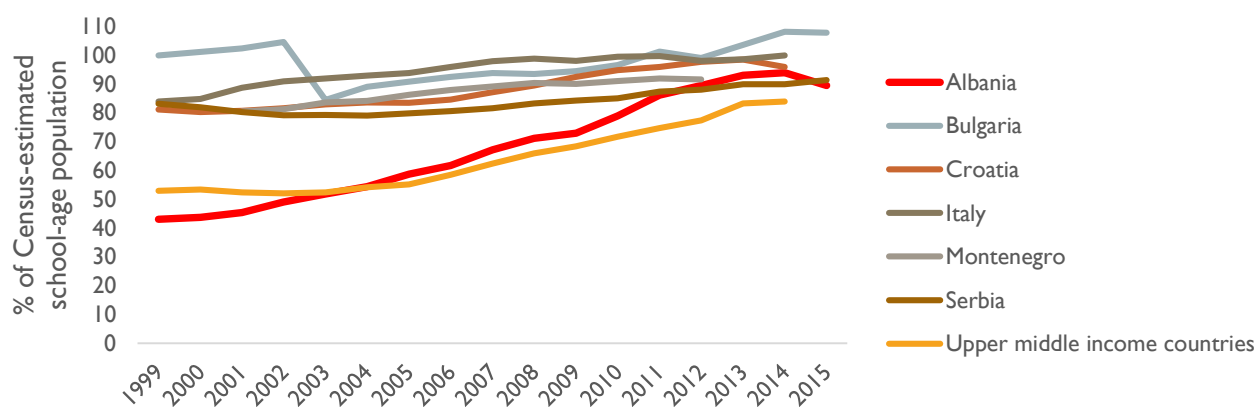


## Appendix: Education Analysis

### The Supply of Education

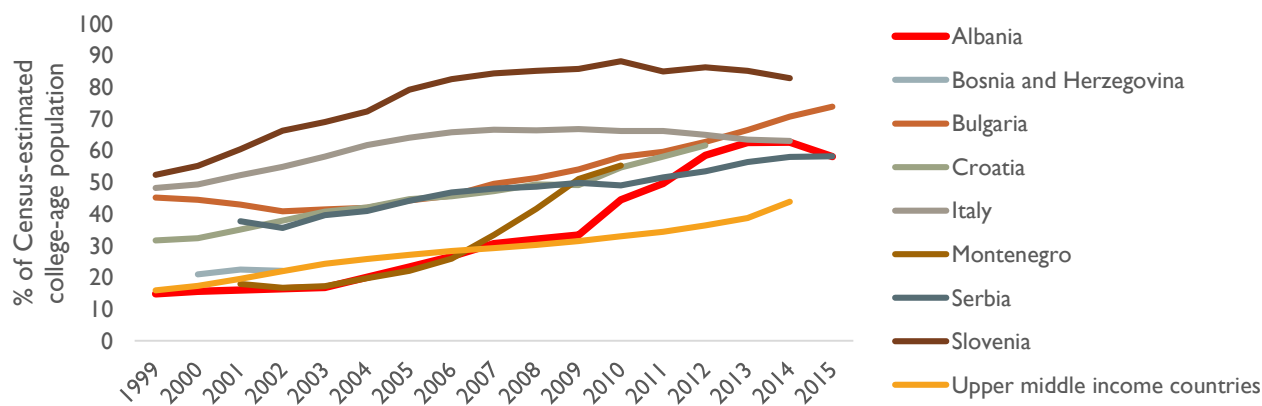
After the fall of communism in the early 1990s, Albania found itself at the bottom of the educational achievement in Europe. Since then, Albania invested heavily in improving the access to upper secondary and tertiary education, achieving remarkable progress. Gross enrollment in upper secondary education increased from 43% in 1999 to over 90% in 2015 (Figure A1), while the gross enrollment in tertiary education increased from 16% in 1999 to 58% in 2015 (Figure A2). In spite of this progress, Albania still lags behind many of its neighbors and other countries in Europe. Only 18% of Albanians in the labor force have a tertiary degree, compared to 31% in the countries of the European Union, 21% in Macedonia and Serbia, and 26% in Montenegro. Only Bosnia and Herzegovina appears to have lower educational attainment than Albania (15% in 2012), although this estimate is somewhat outdated (Figure A3).

**Figure A1:** Gross enrolment ratio, upper secondary



Source: OECD Stats 2016

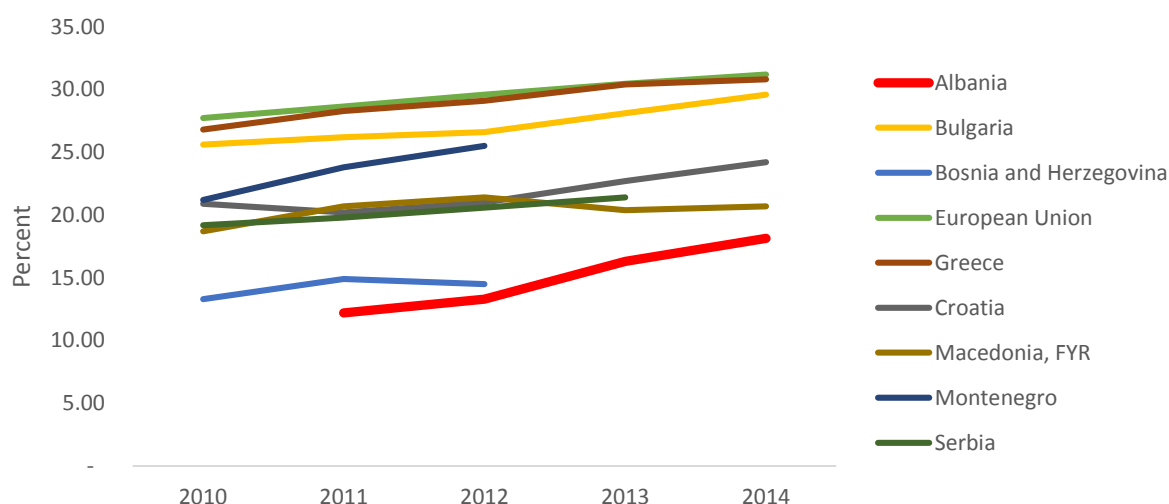
**Figure A2:** Gross enrollment ratio, tertiary education



Source: OECD Stats 2016



**Figure A3: Share of tertiary educated in the labor force**

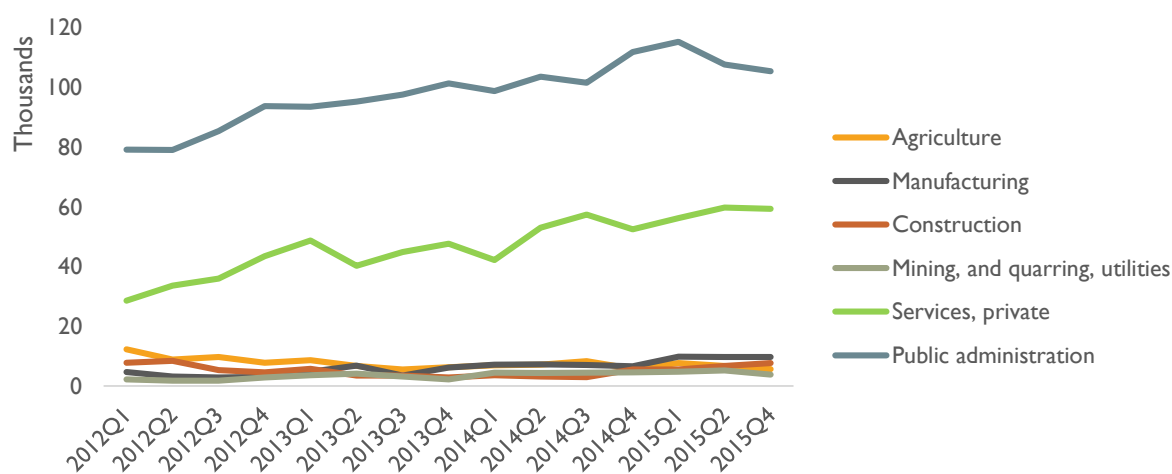


Source: World Development Indicators, 2016; Albania 2014, own calculations using the QLFS 2014

## Demand for Education/Qualifications

The demand for education has been growing, but not at the rate of the supply. Two sectors fully accounted for the up-skilling we observe in the last 4-5 years, as the share of tertiary educated employees increased from 12% to 17%: knowledge-intensive business services and the public sector. Professional services (knowledge-intensive business services) created significant demand for highly educated Albanians, adding about 100,000 new jobs for tertiary educated individuals between 2012 and 2015 alone. Additional demand was created by the public sector (another 26,000 jobs). See Figure A4 and Table A1 for more details.

**Figure A4: Employment of tertiary educated individuals by sector**



Source: QLFS 2012 – 2015

Note: Due to changes in the classification in the survey, it is difficult to disaggregate the industries further.

**Table A1:** The most education intensive economic sectors

Sector	% college grads in total
Legal and accounting activities	92.9%
Architectural and engineering activities; technical	82.4%
Financial service activities	78.2%
Education	77.0%
Human health	64.3%
Office administrative, office support, business support	62.5%
Public admin and defense; social security	58.7%
Telecommunications	44.4%
Activities of membership organizations	42.4%
Postal and courier activities	41.5%
Creative, arts and entertainment activities	35.9%
Manufacture of beverages	30.3%
Warehousing and transportation support	29.3%
Extraction of crude petroleum and natural gas	26.0%
Wholesale trade, except of motor vehicles	21.3%

Source: QLFS 2015

Note: Sector-specific shares of college graduates in 2015. NACE rev. 2, 2-digit industry classification.

Finally, over a quarter of all highly educated Albanians decided to leave Albania since the early 1990s (Table A2). When job opportunities are limited at home, emigration provides the clearest path to good employment for highly educated individuals.

**Table A2:** Emigration rates among European countries

Country and region of origin	Total population			
	Emigrant population (thousands)	Highly educated emigrant population	Emigration rate	Emigration rate of the highly educated
<b>EUROPE</b>	<b>32,759</b>	<b>9,270</b>	<b>5.0</b>	<b>5.3</b>
United Kingdom of Great Britain and Northern Ireland	3,505	1,384	6.5	10.8
Poland	3,195	884	8.9	15.5
Germany	3,162	1,168	4.2	8.4
Romania	2,643	483	12.7	18.4
Italy	2,309	401	4.4	7.9
Russian Federation	1,953	660	1.6	1.0
Portugal	1,492	147	14.2	12.9
France	1,291	573	2.5	5.3
Ukraine	1,136	433	2.9	2.8
Albania	977	82	28.7	26.7
Spain	738	212	1.9	2.3
Netherlands	728	284	5.0	8.3
Ireland	679	227	16.1	17.4
Greece	655	143	6.4	5.8
Serbia	562	61	6.1	6.1

Source: OECD 2013 - World Migration in Figures

### Box A1: Quality of Education

Albania's catch-up in the supply of upper secondary schooling has been matched by commendable improvements in quality, as measured by pupils' performance on international PISA tests. Typically, the expansion of access to education coincides with lower average performance as more disadvantaged kids join school. Albania started with the lowest quality in Europe in reading, math and science performance in 2000. But as of the latest test in 2015, Albanian students managed to significantly outperform neighboring countries such as Macedonia and Kosovo. In spite of these positive developments, Albanian kids have a lot of catching up to do. The average 15-year old student in Albania still lags behind the average OECD student by about two years of education.

#### Results in various PISA tests for Albania

	2000	2009	Diff to previous test	2012	Diff to previous test	2015	Diff to previous test	OECD 2015 average
Reading	349	385	(+36*)	394	(+9)	405	(+11*)	493
Math	381	377	(-4)	394	(+17*)	413	(+19*)	490
Science	376	391	(+15*)	397	(+6)	427	(+30*)	493

Source: OECD, various PISA test results

Note: All tested subjects are for 15-year olds. One year of schooling corresponds with about 40 test points.

Meanwhile, the quality dynamics for tertiary education in Albania have been quite different. Although we are missing direct measures of student performance for this level (Albania has not taken part in the PIAAC tests), the developments in the business of higher education institutions (HEI) are informative. The number of HEIs grew from four during the Communist regime to 59 in 2014, and the number of HEI enrollments grew from 20,000 per year in 1990/91 to over 120,000 in recent years. Suspecting serious problems with the quality of the awarded degrees, the Ministry of Education and Sports inspected all HEIs in 2014, checking whether they adhere to the educational standards and regulations set by the Ministry. Through this process, 18 out of 44 private HEIs lost their licenses, while another 13 licenses were suspended. Some of these HEIs were found to blatantly produce higher education diplomas without providing educational services. In line with these findings on the low level of quality standards in some of these institutions, the data also show that the employability of graduates with a 3-year bachelor degree is extremely low, lower than the employability of those with upper secondary education. However, a fraction of them (presumably those graduating from better quality HEIs) find employment and experience significant returns to their college education.

## The Quality of Demand

The quality of demand for labor was discussed in the section on Albania's lack of productive knowhow. As elaborated there, the typical Albanian company is unsophisticated, has relatively little sector-specific experience and foresight and interacts little with the financial sector. Hence, the overall demand for human capital is low. It is worth mentioning that poor educational achievement goes hand-in-hand with poor demand for qualified workforce, as the quality of education also affects the quality of entrepreneurs, managers, engineers and other key personnel in firms. However, the quality of these does not only depend on education, but also (and probably more so) on industry-

specific knowhow and skills that are typically not gained through the system of general education.

## Equilibrium Outcomes

The oversupply of qualified workers is reflected in two outcomes: low employability and low returns to education. Table A3 shows that the employment rate<sup>14</sup> of Albanians increases with education, except for those with 3-year Bachelor's degree, where the employability is similar or worse to that of lower secondary and upper secondary general education. The employment rates at all levels of education, however, are relatively low.

**Table A3:** Employment and rates by level of educational achievement

	Employment rate*			
	2012	2013	2014	2015
No school	20%	9%	9%	11%
Primary	24%	16%	16%	18%
8/9-years school (classes V-IX)	49%	42%	48%	48%
Upper Secondary - general	46%	40%	44%	46%
Upper secondary - vocational 2-3 yrs	63%	55%	54%	57%
Upper secondary - vocational 4-5 yrs	69%	62%	56%	57%
Tertiary (BA)	39%	35%	41%	34%
Tertiary (BAMA)	69%	64%	62%	64%
Tertiary (old system before Bologna)	70%	73%	67%	64%
Post university / Master	66%	72%	65%	79%

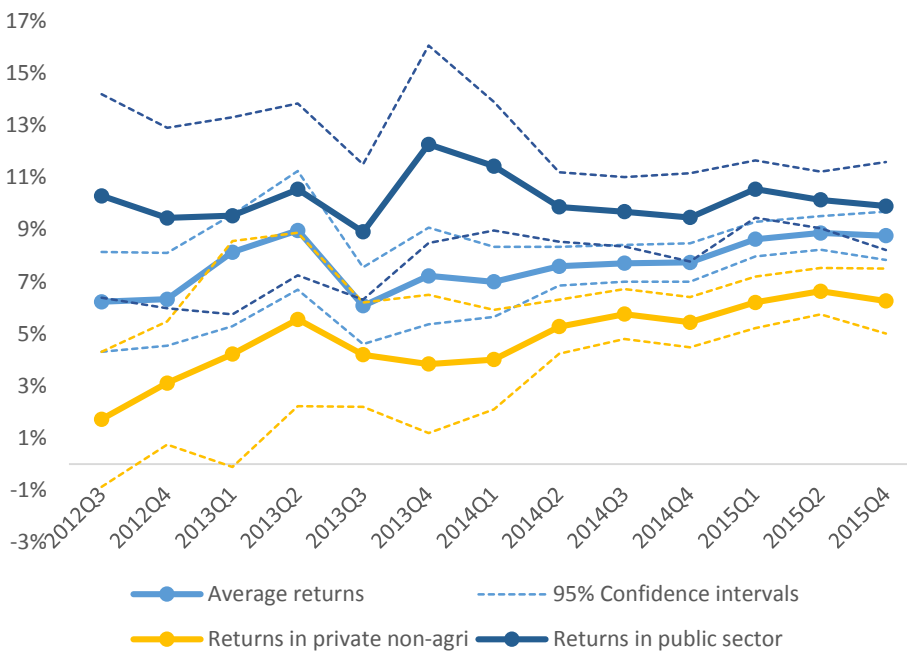
\*No. employed as % of working age population

The average return to a year of education in Albania between 2014 and 2015 was 8.2%, while international studies show an average of about 10% (Psacharopoulos and Patrinos, 2004; Montenegro and Patrinos, 2014). This premium is higher for higher levels of education: upper secondary results in 5-6% premium for a year of schooling, and a year of undergraduate education results in 14% premium (except for the 3-year BA where the premium is 12%).

There are significant differences between the returns to education in the private and in the public sector. The public sector pays an 11% premium to a year of education, while, in the most recent year we observe, the private sector pays only 6-7% (Figure A5). These differences are largely (but not entirely) explained by the educational composition in the two sectors: 13% of all employees in the non-agricultural private sector have at least a college degree, while this is the case with 57% of the employees in the public sector.

<sup>14</sup> This is the share of employed in the total working age population. This is a more stable indicator of the employment situation than the unemployment rate because it does not depend on the participation rate, which increases in times of better employment chances.

**Figure A5: Returns to a year of education by sector**



Source: QLFS 2012-2015

## Skill Mismatch

Shortages of certain qualifications can occur in spite of general abundance of educated workforce. They can be recognized by some or all of the following symptoms:

- Groups with these qualifications/in these educational or vocational fields experience full employment.
- Their pay is significantly higher than the pay of others with similar levels of education.
- Firms employ foreign workers to fill these positions.
- Firms provide training in these fields.

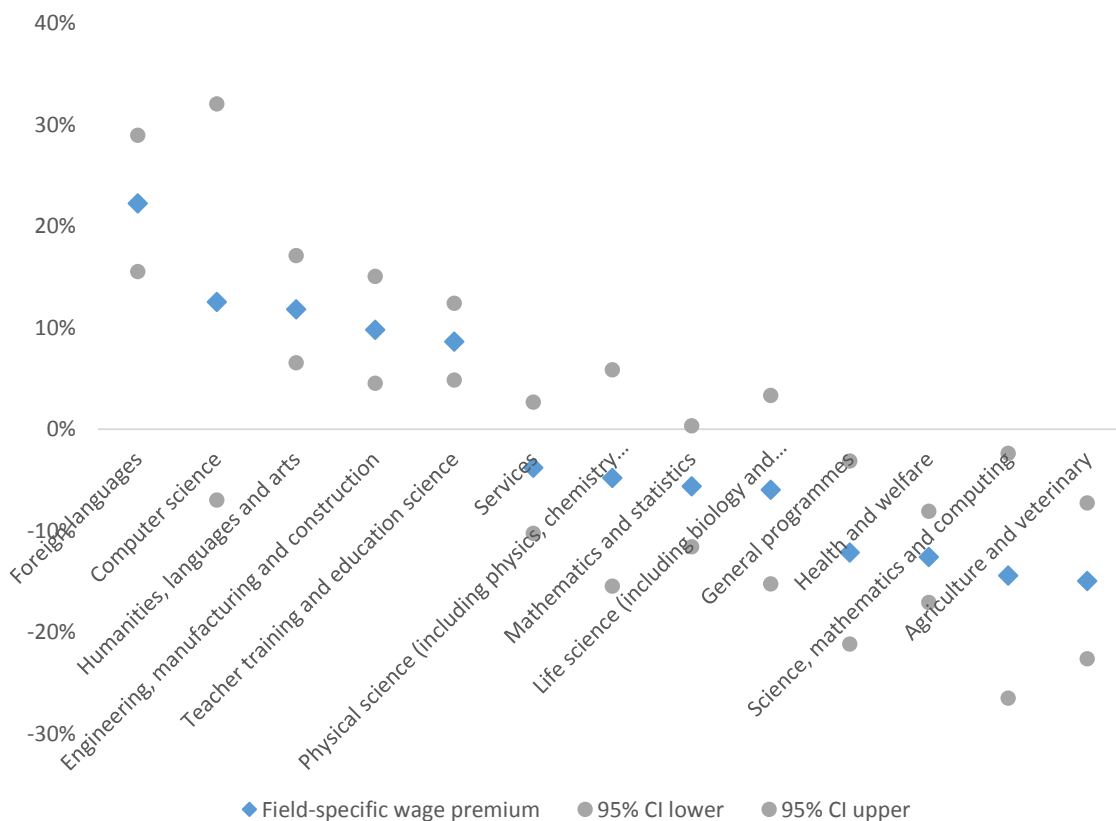
We don't find evidence for skill shortages in any of the observed educational fields. The employment rates by educational field show that no group approaches full employment (Table A4). Among employed college graduates, a number of fields of study do earn significantly more than the largest category of college graduates (social sciences, business and law). These fields of study include foreign languages; humanities, languages and arts; engineering, manufacturing and construction; and teacher training and education science (Figure A6). However, no single educational field is characterized by both very high wages and very high employability.

**Table A4:** Employment rates by educational field

	Employment rate			
	2012	2013	2014	2015
General programs	47%	41%	45%	47%
Teacher training, education science	52%	68%	62%	55%
Humanities, languages, arts	56%	71%	56%	44%
Foreign languages	47%	35%	48%	59%
Social sciences, business, law	65%	58%	55%	56%
Science, mathematics, computing	82%	69%	56%	59%
Life science (incl. biology, environmental science)	70%	57%	60%	60%
Physical science (incl. physics, chemistry)	72%	58%	52%	57%
Mathematics and statistics	81%	71%	61%	49%
Computer science	51%	54%	49%	65%
Engineering, manufacturing, construction	62%	62%	56%	61%
Agriculture and veterinary	75%	65%	63%	64%
Health and welfare	67%	61%	61%	55%
Services	66%	48%	44%	49%

Source: QLFS 2012-2015

**Figure A6:** Educational field premiums



Source: QLFS 2014 and 2015

Moreover, according to the Ministry of Welfare and Sports (2013), only 2,189 work permits were issued in 2013. The total number of work permit holders is also low. For instance, for all of the EU, there were only 2,712 work permits as of 2013. To our knowledge, Albania does not have legal barriers that would prevent firms from employing foreign workers. With this in mind, the low number of such workers suggests that firms do not demand them.<sup>15</sup> Finally, the overall incidence of firm training in Albania is small (World Bank Enterprise Survey 2013).

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<sup>15</sup> One exception is oil production, where only in 2013, over 150 work permits were issued to Canadian citizens.