



ALBANIA

SELECTED ISSUES

June 2016

This Selected Issues paper on Albania was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on May 12, 2016.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: <http://www.imf.org>
Price: \$18.00 per printed copy

International Monetary Fund
Washington, D.C.



ALBANIA

SELECTED ISSUES

May 12, 2016

Approved By
European Department

Prepared By Ezequiel Cabezon, Nicolas End, Kareem Ismail,
and Mick Thackray

CONTENTS

POTENTIAL GROWTH AND OUTPUT IN ALBANIA	4
A. Background and Growth Accounting	4
B. Medium-Term Growth Outlook	7
C. Potential Output and Output Gap Estimations	8
D. Conclusions	11
References	17
BOXES	
1. Growth Accounting Assumptions	12
2. Simple Multivariate Filter	13
3. Credit Cycles and "Sustainable" Output	15
ANNEX	
I. The Determinants of TFP	16
FIGURES	
1. Western Balkans: Real GDP Growth	4
2. Real GDP Growth	4
3. Growth Accounting	5
4. Western Balkans: Real GDP Growth Contributions	5
5. Average Years of Schooling	6
6. Population	6
7. Labor Force Participation and Employment Rate	6
8. Selected CESEE Countries: Expected Convergence	7
9. Real GDP Growth	9
10. Output Gap	9

11. Average Output Gap _____	10
12. Housing Prices and Credit to Private Sector _____	10
13. Output Gap and Credit Cycles _____	11
14. Real Potential GDP Growth and Credit Cycles _____	11

TABLES

1. Growth Accounting _____	5
2. Medium Term Growth _____	7
3. Potential Growth and Output Gap 2016 _____	10
4. Real GDP Growth _____	10

EXTERNAL COMPETITIVENESS _____ 19

A. What Do Indicators Say? _____	19
B. Export Trends _____	21
C. Labor Productivity and Wages _____	23
D. Conclusion and Policy Recommendations _____	25

FIGURES

1. Doing Business _____	19
2. Global Competitiveness Report _____	19
3. Share in World Export Markets _____	22
4. Textile and Footwear Exports and Income, 2010–14 _____	22
5. Western Balkans: Structure of Goods Exports _____	22
6. Unit Labor Cost _____	23
7. CESEE: Average Wages and Productivity, 2014 _____	23
8. Real Unit Labor Cost, Real Wages, and Productivity _____	23
9. Wages _____	24
10. Minimum Wage _____	24
11. How Much of an Obstacle is an Inadequately Educated Workforce? _____	24

TABLES

1. Market Share of Albanian Exports _____	22
2. Labor Market Statistics, 2014 _____	25

TAX POLICY, EVASION, AND INFORMALITY IN ALBANIA _____ 26

A. The Tax System in Albania: A Cross-Country Comparison _____	26
B. Recent Developments _____	31
C. Revenue Management and Forecasting Errors _____	32
D. Revenue Performance in 2015 _____	33

E. Compliance and Evasion	35
F. Policy Recommendations	36
References	39

FIGURES

1. General Government Revenue in Balkan Countries	26
2. Tax Revenue in Balkan Countries	27
3. Tax Efficiency in Balkan Countries, 2014	28
4. Average C-Efficiency Ratio in Selected European Countries, 2011–13	28
5. Tax Revenues	31
6. VAT C-Efficiency Ratio	32
7. CIT Efficiency	32
8. Errors in Budget Revenue Forecasts	33
9. Administrative Efficiency in Paying Taxes	37

TABLES

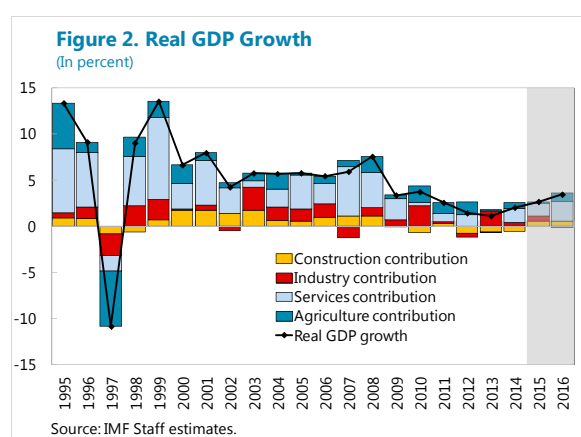
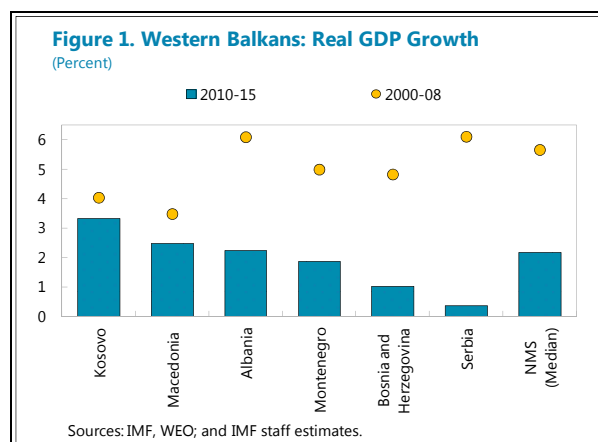
1. Tax Rates for Selected European Countries	29
2. 2015 Revenue Projections: Breakdowns of Errors	34
References	39

POTENTIAL GROWTH AND OUTPUT IN ALBANIA¹

Growth in Albania has slowed since the global financial crisis. This note aims to determine how much of the slowdown is due to cyclical conditions and how much to a reduction in potential growth. The analysis below shows that average growth in 2009–14 dropped by 3.2 percentage points relative to 1997–2008, of which 2.8 percentage points are due to lower potential growth. The first section of this note focuses on growth accounting to understand the drivers of growth. The second section looks at the medium term outlook. Finally, the third section estimates and discusses potential output.

A. Background and Growth Accounting

1. Albania's real GDP growth² has weakened since the global financial crisis. The average growth rate fell from 5.5 percent in 1997–2008 to 2.4 percent in 2009–14. Whereas Albania's pre-crisis growth was among the highest in the Western Balkan region, post-crisis growth has decelerated to around the regional average (Figure 1). During the 2000s, the Albanian economy underwent a transformation which included large-scale privatization and massive reallocation of resources across sectors, mainly from agriculture and large SOEs to construction, retail trade, and the financial sector. Non-tradable sectors, in particular construction, expanded considerably thanks in part to rapid credit growth (see section C). Since 2008, the contributions of construction and services have declined significantly (Figure 2).



¹ Prepared by Ezequiel Cabezon.

² In this paper, "real GDP" and "output" are used interchangeably.

2. A growth accounting exercise shows declining contributions of total factor productivity (TFP) and capital (both physical and human). During 2009–14, their contributions halved compared to 1997–2008 (see Table 1 and Box 1 for details), in line with regional trends (Figures 3 and 4). Lower contribution from human capital also explains the relatively low growth during 2010–15 compared to other countries in the region.

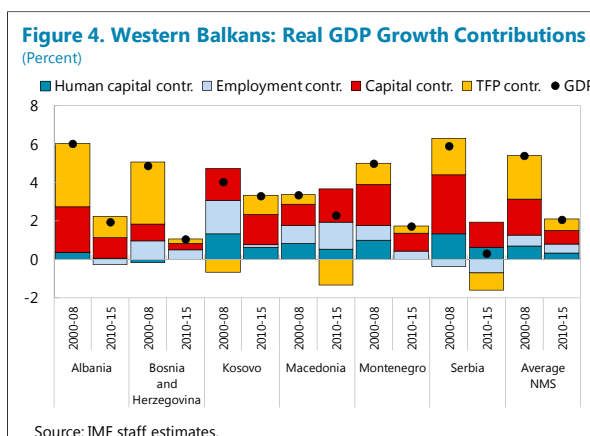
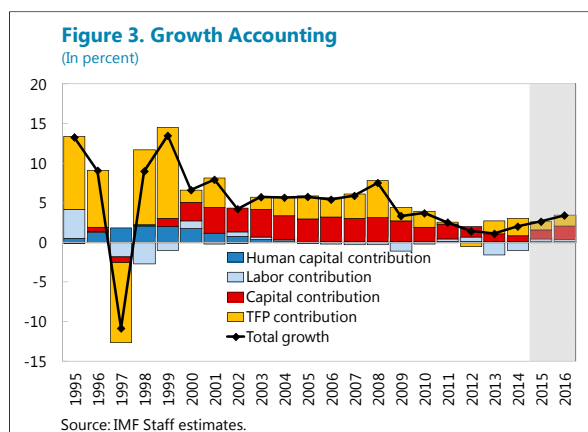


Table 1. Albania: Growth Accounting

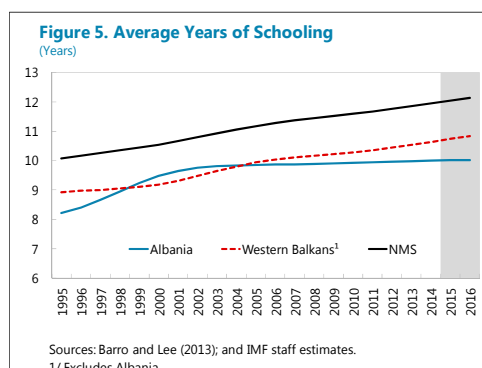
	1993-1996 (Early transition)	1997-2008 (Boom)	2009-2014 (Post-crisis)	2015	2016
Real GDP growth	10.1	5.5	2.4	2.6	3.4
Capital contribution	-0.4	2.3	1.5	1.1	1.7
Labor contribution	2.4	-0.4	-0.5	0.3	0.2
Human capital contribution	0.3	0.9	0.1	0.1	0.1
TFP contribution	7.7	2.8	1.2	1.1	1.4

Source: IMF staff estimates.

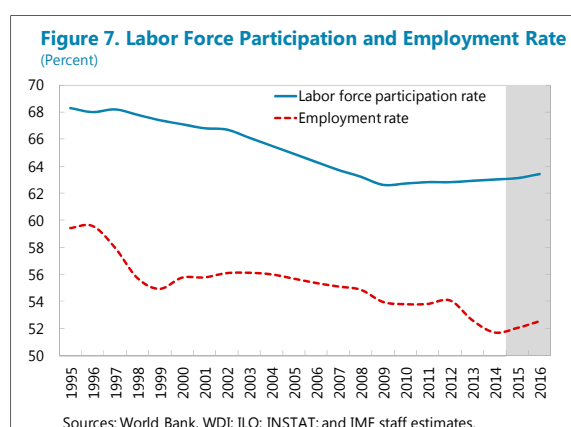
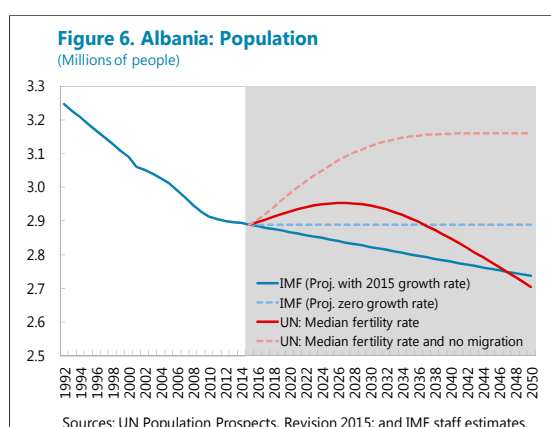
- The slowdown in TFP reflects trends observed in other transition economies, as well as delays in key structural reforms.** During the 2000s, Albania's TFP increased due to four factors: fast convergence to the technological frontier, as in other emerging economies (WEO April 2015); the domestic reallocation of resources from low productivity to high productivity sectors (Kota 2009); large-scale privatization; and the expansion of financial intermediation. The slowdown in TFP since 2009 is explained by decelerating technological convergence after the fast catch-up, the end of the privatization program, and decreasing returns from resource reallocation. The sluggish growth in TFP is further attributed to a slower reform implementation relative to new EU member states, particularly in the areas of property rights, rule of law, and governance (Murgasova and others, 2015).

- **The deceleration in physical capital accumulation is attributed to the global financial crisis and the end of the construction boom.** During the 2000s, easy credit conditions fed a construction boom which accelerated capital accumulation. By 2009–10, a housing glut in Albania and increased risk aversion as a result of the global financial crisis halted credit growth and the construction boom. A drop in remittances contributed to the decline in construction. The crisis also increased uncertainty which reduced the firms' incentives to invest.

- **In the 2000s, human capital accumulation—approximated by average years of schooling—decelerated relative to the 1990s as well as regional peers (Figure 5).** Average years of education increased from 9.5 in 2000 to 9.8 in 2005 and reached to 9.9 in 2010.

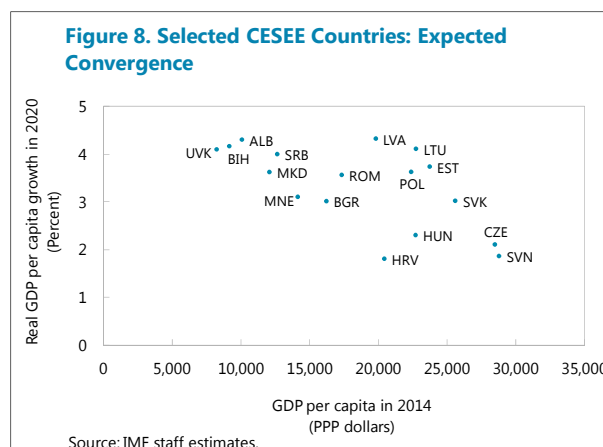


- **Labor contribution remains negative mainly reflecting Albania's demographic trends.** Population fell by more than 10 percent since the end of the communist regime in the early 1990s, mainly due to mass emigration (Figure 6). Emigration continues but its pace has declined significantly. In 1995–99, net emigration accounted for 2 percent of the population per year, while in 2010–14 it shrank to ¼ percent per year. Labor force participation decreased during the last three decades (Figure 7), in part due to the steady inflow of remittances. Employment rates fell gradually until 2013, when construction activity collapsed in Albania. Labor force participation rate has improved in the post-crisis period, boosted by the opening of government employment offices in villages, to facilitate job searches.



B. Medium-Term Growth Outlook

3. Albania’s medium-term growth is expected to recover to around 4 percent of GDP, broadly in line with regional peers with similar per-capita income levels. The medium-term growth projections for the Western Balkans are generally higher than those for other Central and Southeastern European peers reflecting convergence dynamics (Figure 8). The key assumption behind these projections is that technologies and institutions converge and that international capital flows fuel this catch-up process. However, the weak growth observed during 2010–15 indicates that the speed of convergence may have slowed down compared to the pre-crisis period.



4. Growth is expected to accelerate in the medium-term supported by ongoing FDI and continued reforms towards EU accession. FDI projects will boost the capital stock, but reforms to increase TFP as well as labor utilization will be needed as well (Table 2). TFP gains will be driven by increased financial development, the clarification of property rights over land, improvements in the rule of law, and judiciary reform.³ This scenario also assumes that labor’s contribution increases as a result of three factors: a more stable population as migration decelerates, a small improvement in the labor force participation rate, and a gradual reduction in unemployment.

	2016-19 Reform 1/	2016-19 No reform 2/
Real GDP growth	3.9	2.4
Capital contribution	1.8	1.5
Labor contribution	0.2	-0.5
Human capital contribution	0.1	0.1
TFP contribution	1.7	1.2

Source: IMF staff estimates.
 1/ Reform scenario is consistent with the IMF program.
 2/ Assumes labor and TFP contributions consistent with historical averages for 2009-14, and the capital stock growing at a rate 85 percent lower than the reform scenario.

5. A reduction of migration outflows can help output growth. The reform scenario above assumes that for the next 10 years population continues decreasing at 0.2 percent per year (INSTAT’s estimate for 2015). This is a conservative assumption considering that the UN Population Prospects Report projects population growing for Albania—even assuming emigration—over the next 10 years. If net migration is reduced to zero, real GDP growth will accelerate by an additional

³ Cross country estimations (see Annex I) show that TFP’s contribution should be around 1.2–1.7 percentage points on average during 2016–20.

0.2 percentage points. The effect on real GDP per capita growth will depend on the level of human capital of the emigrants and the effect of that additional human capital on productivity. A higher human capital stock will increase productivity (through learning effects) and accelerate real GDP per capita growth (Lucas, 1988).

C. Potential Output and Output Gap Estimations

Challenges of Potential Output Estimation

6. Measuring potential output is a complex task in developing economies. Potential output is defined in Okun (1962) as the maximum production level that avoids inflationary pressures. Potential output is unobservable and therefore it needs to be estimated. Each of the three standard approaches—univariate filters, production function, and multivariate filters—has advantages and disadvantages. No approach is free from controversy. The task is more complex in emerging economies where structural breaks and supply shocks are larger and more frequent. Short time series and limited data availability also constrain the estimations.

7. Univariate filters are simple but lack economic structure. These statistical filters, such as the Hodrick-Prescott filter, require a single input (only GDP series) and are easy to implement. Potential output is computed as a smoothed sequence over the actual output data. This implies that the average output gap is zero, by definition. However, these filters are sensitive to the smoothing parameters used and subject to the endpoint problem (the substantial revision to the end values of the series as the sample is expanded or forecast uncertainty is reduced). Another limitation of these filters is the lack of economic structure which hampers their ability to capture structural changes in the economy (Kuttner, 1994). While these filters can produce sensible results for large and advanced economies where aggregate supply shocks are smaller, they are less appropriate for developing economies where structural changes are important.

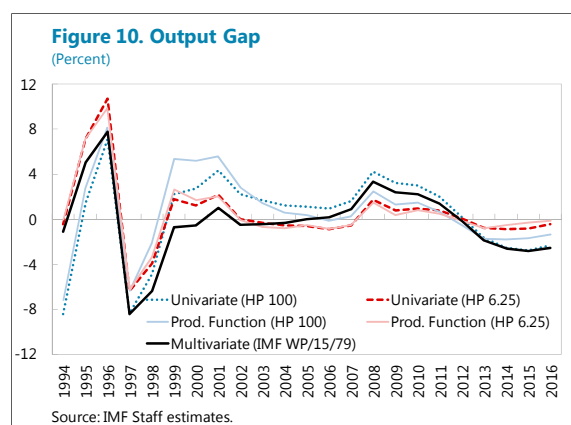
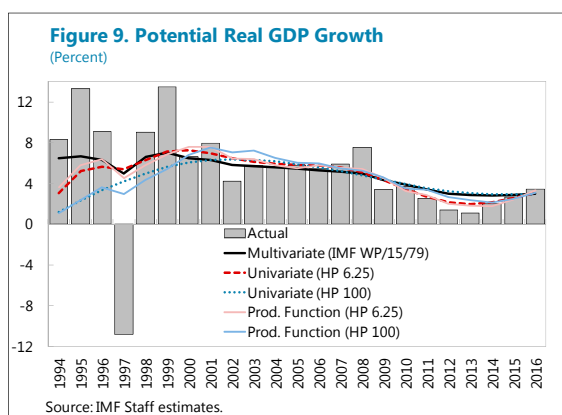
8. The production function approach identifies the drivers of growth, but is vulnerable to parameter mis-specification. A production function is assumed and potential output derives from combining the actual stock of capital with filtered series of employment and TFP. The main issue here is that it requires additional information such as employment, estimates of the capital stock, and an assumption regarding capital's income share. The estimation is sensitive to the parameters assumed—in particular, the depreciation rate used to construct the capital stock series and the filtering method applied to employment and TFP.

9. Multivariate filters add economic structure, including indicators such as the unemployment rate or the capacity utilization rate; however, their estimation is complex. The method combines a univariate filter with a Phillips Curve and Okun's Law to incorporate information from inflation and unemployment data to estimate potential output. These filters produce real-time estimates that are less sensitive to the endpoint problem when they are complemented with expectations of growth and inflation, but they are still subject to uncertainty from model or parameter mis-specification.

Measuring Potential Growth and the Output Gap

10. We estimate potential output using five models: two Hodrick-Prescott filters, two versions of the production function, and a multivariate filter. The estimations have been computed using annual data because the quarterly output series are short—starting only in 2005—and problematic, due to the high shares and volatility of agriculture and hydropower generation.

- **Hodrick-Prescott (HP) filter:** Two cases are considered for which the smoothing parameter is set at 100 and 6.25, respectively. These values reflect discussions in the literature—see Ravn and Uhlig (2002), for example. The real GDP series have been forecasted until 2020 to mitigate the endpoint problem. Only the HP filter is considered because at annual frequencies other filters deliver similar results.
- **Production function:** This method breaks down output growth into contributions from TFP, capital, and labor. The actual capital stock is combined with the filtered labor and TFP series to obtain potential output. The parameters of the production function are detailed in Box 1 and the filtering technique is HP with smoothing parameters 6.25 and 100.
- **Simple multivariable filter (IMF, 2015):** This method considers additional variables such as unemployment, expectations of output growth and inflation, and relationships among variables such as the Phillips Curve and Okun’s Law. Details of the filter are provided in Box 2. The method is a general case of an extended Kalman filter model.



11. These estimations show similar patterns for potential output growth but higher dispersion in terms of the output gap (Figure 9–11). In 2016, all the methods show potential growth around 3 percent. Estimates of output gap, however, range between -0.2 to -2.6 percent of GDP (Table 3). To mitigate the specification errors of the different approaches, the results are aggregated using the mean across estimation techniques—as in Medina (2010).

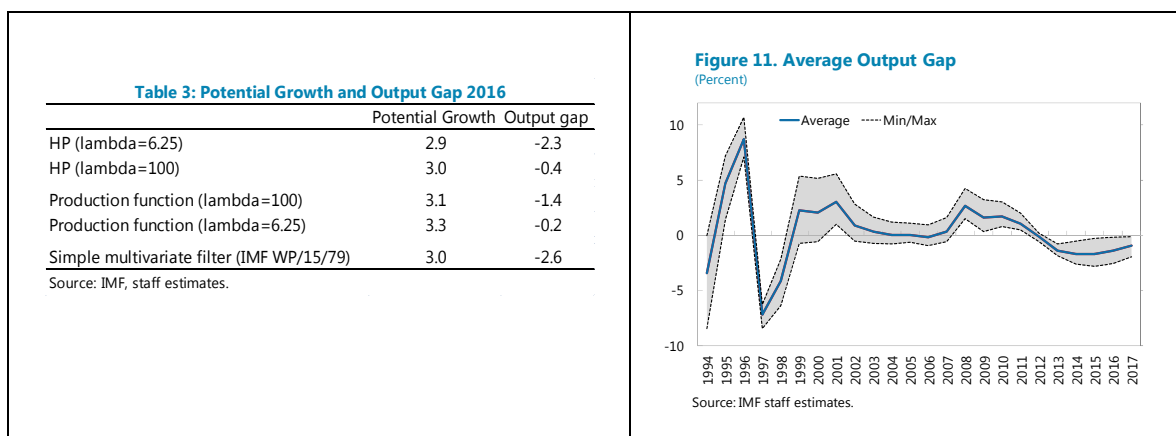
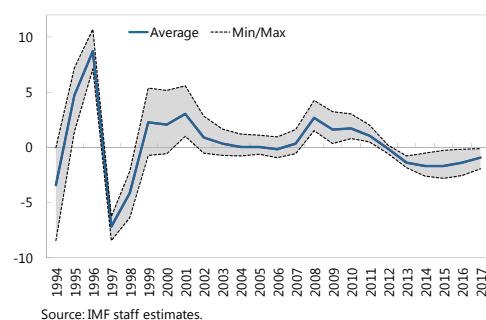


Figure 11. Average Output Gap (Percent)



12. Estimation results suggest that potential growth has declined since 2007–08. Average potential growth fell from around 6 percent during 1997–2008 to around 3 percent during 2009–14 (Table 4). The estimates also point to an increase in potential growth during 2015 and 2016. In addition, the range of estimates of potential growth across the different methodologies has narrowed compared to 1994–97, likely reflecting the stabilization of the economy relative to that period. Below, we present actual real GDP growth (Δy_t) as function of potential growth (Δy_t^*) and the change in the output gap:

$$\Delta y_t = \Delta y_t^* + \Delta \text{output gap}_t$$

	1997-2008 (Boom)	2009-14 (Post-crisis)	2010	2011	2012	2013	2014	2015	2016
a) Actual GDP growth	5.5	2.4	3.7	2.5	1.4	1.1	2.0	2.6	3.4
b) Potential GDP growth (average)	5.9	3.1	3.6	3.2	2.6	2.4	2.3	2.6	3.1
c) Change in output gap (a - b)	-0.4	-0.7	0.1	-0.6	-1.2	-1.3	-0.3	0.0	0.4

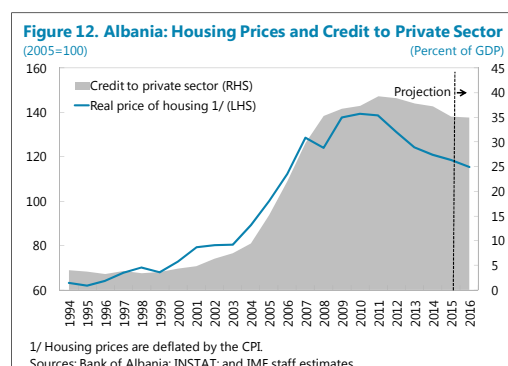
Source: IMF staff estimates.

13. Despite the wide dispersion in output gap estimates, they all indicate that since 2013 the economy has been below its potential. The different estimates all point to the conclusion that the output gap is now gradually closing.

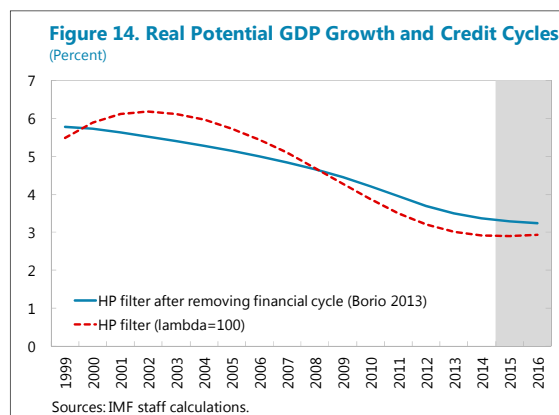
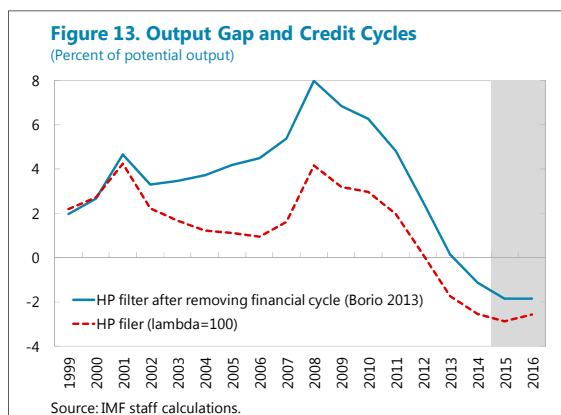
The Impact of Credit Cycles

14. Estimates of potential GDP growth are likely impacted by the credit boom in the 2000s.

The credit expansion caused real estate prices to grow much faster than the general price level. Between 2002 and 2010 property prices increased by more than 70 percent (in real terms) and credit to the private sector expanded from 6 to 36 percent of GDP (Figure 12). Such large credit booms can lift estimates of potential output temporarily, and vice versa (Berger and others, 2015).



15. The estimate of potential output is therefore adjusted to take into account credit cycles. The impact of the credit cycle on potential output is estimated by considering the HP filter as the baseline potential output and using a simplified version of Borio and others (2013). See Box 3 for details. The HP filter is augmented to consider the effect of private sector credit and property prices. The estimation results show that output gaps have been larger than those estimated by the simple HP filter during the credit boom (Figure 13). The results also imply that the average increase in potential growth due to the credit cycle was around 0.5 percentage point during 2002–08 (Figure 14).



D. Conclusions

16. We conclude that average growth in 2009–14 dropped around 3.2 percentage points relative to 1997–2008, of which 2.8 percentage points are due to lower potential growth. The main policy implication is that countercyclical policy should be centered on a potential growth of 2.9–3.2 percent and not the historical values of 5–6 percent. The second policy implication is that enhancing potential growth through structural reforms should be a top priority. Key growth-enhancing reforms should cover land property rights, the rule of law, fighting corruption, and the judiciary system. Improvements in land property rights will facilitate the reallocation of resources towards more productive sectors (such as tourism and agriculture). The rule of law and judicial reform will enhance growth across sectors by improving the return on investment.

Box 1. Growth Accounting Assumptions

The calculations assume a Cobb-Douglas production function. Output (Y) depends on physical capital (K), labor (L), human capital (H), and total factor productivity (A). Capital's income share (α) is assumed to be 0.35, as in D'Auria and others (2010).

$$Y_t = A_t K_t^\alpha (L_t H_t)^{1-\alpha}$$

The stock of physical capital (K) is computed using the permanent inventory method, using the series for real GDP and real gross fixed investment (I) since 1980. The depreciation rate (δ) is set at 8 percent, consistent with Kota (2007), and the exogenous trend growth (g) is 2.6 percent, consistent with the historical data for the 1980–2016. The initial capital stock and its dynamics are described by:¹

$$K_{1980} = \frac{I_{1980}}{\delta + g}$$

$$K_{t+1} = (1 - \delta)K_t + I_t$$

Labor (L) is defined as the employed population:

$$L = (Pop_{15-64})(Part. rate)(1 - UR)$$

The series for population between ages of 15 and 64 was constructed based on INSTAT, World Bank, and United Nations statistics. The labor force participation and unemployment rates (UR) were built by splicing series from INSTAT and ILO.

$$H_t = (avg. years of schooling) * return on education$$

H_t is the stock of human capital measured by the average years of schooling, which are computed by interpolating the Barro-Lee (2013) dataset. Finally, the return on education is assumed to be 0.11 per year consistent with the estimates of Psacharopoulos (1994).

¹ The lack of a long time series for capacity utilization constrained the analysis. Estimations using weak data on capacity utilization point to similar results for the period 2000–16.

Box 2. Simple Multivariate Filter

Potential output is estimated following Blagrove, Garcia-Saltos, Laxton, and Zhang (2015). The filter assumes that the dynamics for potential output and the non-accelerating inflation rate of unemployment (NAIRU) are subject to shocks. It also includes empirical relations, such as the Phillips Curve and Okun's Law, as well as expectations of inflation and output growth. The central parts of the model are the output and employment gaps that are inferred by the rest of the equations. The full model is detailed below.

Potential output and output gap dynamics

- 1) $y_t = Y_t - \bar{Y}_t$ (Output gap)
- 2) $y_t = \phi y_{t-1} + \varepsilon_t^y$ (Output gap law of motion)
- 3) $\bar{Y}_t = \bar{Y}_{t-1} + G_t + \varepsilon_t^{\bar{Y}}$ (Potential output law of motion)
- 4) $G_t = \theta G^{SS} + (1 - \theta)G_{t-1} + \varepsilon_t^G$ (Potential output trend growth)

Phillips Curve

$$5) \pi_t = \lambda \pi_{t+1} + (1 - \lambda)\pi_{t-1} + \beta y_t + \varepsilon_t^\pi$$

Unemployment and NAIRU Dynamics

- 6) $\bar{U}_t = \tau_4 \bar{U}^{SS} + (1 - \tau_4)\bar{U}_{t-1} + \bar{g}\bar{U}_t + \varepsilon_t^{\bar{U}}$ (NAIRU law of motion)
- 7) $\bar{g}\bar{U}_t = (1 - \tau_3)\bar{g}\bar{U}_{t-1} + \varepsilon_t^{\bar{g}\bar{U}}$ (NAIRU trend growth)
- 8) $u_t = \tau_1 y_t + \tau_2 u_{t-1} + \varepsilon_t^u$ (Okun's Law)
- 9) $u_t = \bar{U}_t - U_t$ (Unemployment gap)

Expectations

- 10) $\pi_{t+j}^E = \pi_{t+j} + \varepsilon_{t+j}^{\pi^E}$ for $j=0,1$
- 11) $Growth_{t+j}^E = Growth_{t+j} + \varepsilon_{t+j}^{Growth^E}$ for $j=0, \dots, 5,$

where Y_t is the log of real GDP, \bar{Y}_t is the log of potential output. G_t is the unobservable long term potential growth, with a steady state at G^{SS} . y_t is the output gap and π_t is the inflation rate. U_t is the unemployment rate, and \bar{U}_t is the NAIRU with a steady state at \bar{U}^{SS} . $\bar{g}\bar{U}_t$ is the unobservable long-term change in the NAIRU and u_t is the unemployment gap. Finally $Growth_{t+j}^E$ and π_{t+j}^E denote GDP growth and inflation forecasts from WEO (and measure expectations). Finally the ε 's are shocks to the different variables. The filter is applied to data for the period 1994-2020.

The methodology requires some assumptions. The NAIRU steady state is assumed at 13 percent, close to the minimum unemployment observed during 2003-2014, and the steady state of potential growth is assumed at 3.5, close to the values observed in other Balkan countries. The model was estimated using Bayesian estimation techniques, with the priors for the parameters displayed below.

Box 2. Simple Multivariate Filter (concluded)

Priors used in the estimation

Parameter	Prior
β	0.25
λ	0.25
Θ	0.10
Φ	0.60
τ_1	0.30
τ_2	0.30
τ_3	0.10
τ_4	0.10
$\text{std}(\varepsilon_t^{\bar{y}})$	0.50
$\text{std}(\varepsilon_t^G)$	0.50
$\text{std}(\varepsilon_t^y)$	1.00
$\text{std}(\varepsilon_t^\pi)$	0.25

The main results are summarized in the equations below:

$$y_t = 0.70y_{t-1} + \varepsilon_t^y$$

$$\pi_t = 0.5\pi_{t+1} + 0.5\pi_{t-1} + 0.05y_t + \varepsilon_t^\pi$$

$$u_t = 0.24y_t + 0.44u_{t-1} + \varepsilon_t^u$$

$$G_t = 0.05G^{ss} + 0.95G_{t-1} + \varepsilon_t^G$$

Box 3. Credit Cycles and “Sustainable” Output

“Sustainable” output is the output that an economy can produce in the absence of imbalances. This concept differs from potential output, which refers to the capacity to produce without accelerating inflation. During a credit boom, an economy may be producing at the potential level, but that level may not be sustainable as the financial cycle lifts potential output temporarily.

To estimate sustainable output, we start out by expressing the HP filter as a state space model and then expand the model to include financial cycle variables. The idea is to compute sustainable output which is potential output adjusted for the effect of the credit cycle. The left column below presents the HP model, while the right column presents the expanded model and details how the filter removes the financial cycle effects from potential output to arrive at sustainable output.

HP Filter	Expanded model
$\Delta y_t^* = \Delta y_{t-1}^* + \varepsilon_t^{y^*}$	$\Delta y_t^* = \Delta y_{t-1}^* + \varepsilon_t^{y^*}$
$y_t = y_t^* + \varepsilon_t^C$	$y_t = y_t^* + \gamma_1 \Delta Credit + \gamma_2 \Delta HousePrice + \varepsilon_t^C,$

where y is the log of output and y^* is the log of potential output. The expanded model includes *Credit* which is the natural log of real credit to the private sector and *HousePrice* which is the natural log of real housing prices. Both variables have been deflated with the CPI. ε_t^C and $\varepsilon_t^{y^*}$ represent cycle and trend shocks respectively.

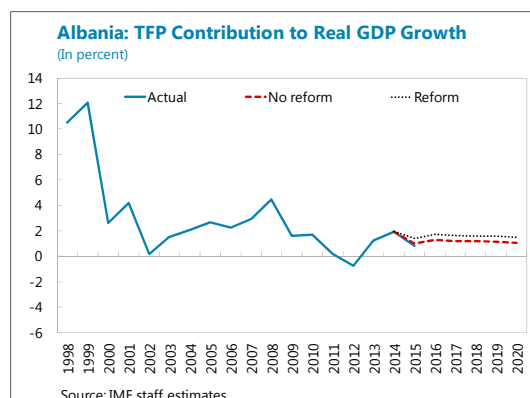
The smoothing parameters of the HP filter and the expanded model are set at 100.¹

^{1/} Given the limited space, we focus on a smoothing parameter of 100, but results using 6.25 instead do not change the main results.

Annex I. The Determinants of TFP

1. TFP is difficult to predict as it is a mix of structural features, such as technology and institutional quality, but also includes measurement errors from labor and capital. This

appendix aims to estimate TFP as a function of the current level of institutions. This would allow us to estimate the path of TFP in the near future. Using a panel of 17 CESEE¹ economies, a model is estimated for the period 2000–14. The explanatory variables include World Bank Governance indicators, political risk from ICRG, EU-3 potential growth, a time trend, and a dummy to account for the 2009 global financial crisis.



2. The estimations imply that TFP's contribution to growth will be 1.2–1.7

percentage points on average for the period 2016–20, depending on the institutional improvements. At the current institutional level, reflecting the current indicators of regulatory

quality, rule of law and political risk, the TFP will contribute 1.2 percentage points, and assuming a 25 percent improvement in the institutional level, the TFP will contribute around 1.7. Although the results show statistically significant coefficients, they should be interpreted with caution as they are sensitive to model specification.

	Dependent variable: TFP contribution ¹	
	Coefficient	Standard errors
Lag TFP contribution	0.107*	(0.058)
Change in regulatory quality	3.612	(2.537)
Change in rule of law	2.197	(3.206)
Change in political risk	-0.226**	(0.112)
EU-3 potential growth	3.578**	(1.801)
2009 crisis dummy	-5.854***	(1.334)
Trend	-3.469	(2.142)
Constant	8.462	(7.842)
Observations	200	
Countries	17	
R-squared	0.536	R-squared

*** p<0.01, ** p<0.05, * p<0.1

1/ Albania, Armenia, Belarus, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Moldova, Poland, Romania, Serbia, Slovak Republic, Slovenia, and Ukraine.

References

- Barro, R., and J. Lee, 2013, "A New Data Set of Educational Attainment in the World, 1950–2010," *Journal of Development Economics*, Vol. 104, pp. 184–198.
- Borio, C., F. Disyatat, and M. Juselius, 2013, "Rethinking Potential Output: Embedding Information About the Financial Cycle," BIS Working Papers 404, Bank for International Settlements (Basel).
- Blagrove, P., R. Garcia-Saltos, D. Laxton, and F. Zhang, 2015, "A Simple Multivariate Filter for Estimating Potential Output," IMF Working Papers 15/79 (Washington: International Monetary Fund).
- Feenstra, R., R. Inklaar, and M. Timmer, 2015, "The Next Generation of the Penn World Table," forthcoming, *American Economic Review*.
- D'Auria, F., C. Denis, K. Havik, K. McMorrow, C. Planas, R. Raciborski, W. Roger, and A. Rossi, 2010, "The Production Function Methodology for Calculating Potential Growth Rates and Output Gaps," *Economic Papers* 420, DG ECFIN, European Commission.
- Berger, H., T. Dowling, S. Lanau, W. Lian, M. Mrkaic, P. Rabanal, and M. Sanjani, 2015, "Steady as She Goes—Estimating Potential Output During Financial 'Booms and Busts,'" IMF Working Papers 15/233 (Washington: International Monetary Fund).
- Hodrick, R., and E. Prescott, 1997, "Postwar U.S. Business Cycles: An Empirical Investigation," *Journal of Money, Credit and Banking*, Vol. 29(1), pp. 1–16 (February).
- International Monetary Fund, 2006, "The Evolution and Determinants of Growth in the Baltic and Central European Countries – Lessons for Albania," Selected Issues Paper.
- Kota V., 2007, "Alternative Methods of Estimating Potential Output in Albania," Bank of Albania.
- , 2009, "Determinants of Economic Growth," *Economic Bulletin*, Vol. 12, No. 4, Bank of Albania (December).
- Kuttner, K., 1994, "Estimating Potential Output as a Latent Variable," *Journal of Business & Economic Statistics*, American Statistical Association, Vol. 12 (3), pp. 361–68.
- Lucas, R., 1988, "On the Mechanics of Economic Development," *Journal of Monetary Economics*, 22, pp. 3–42.

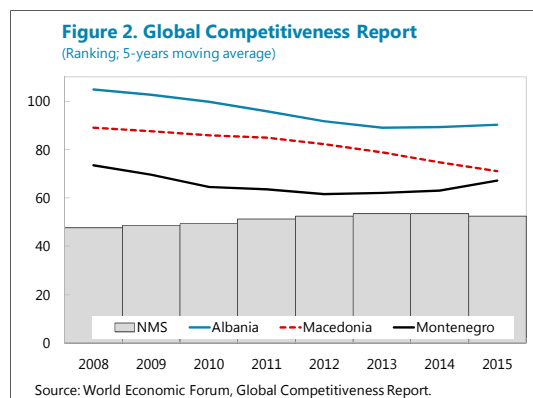
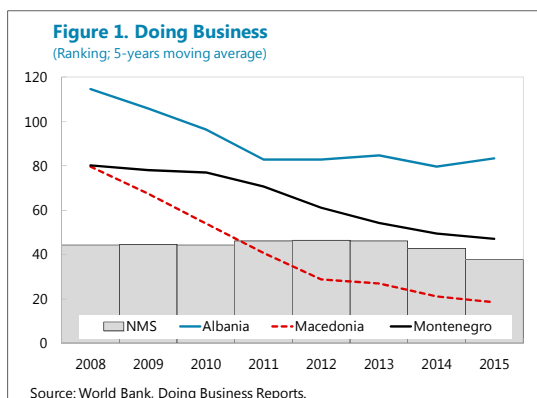
- Medina, L., 2010, "Potential Growth and Output Gap in Peru," Staff Report for the 2010 Article IV Consultation, IMF Country Report No. 10/99, page. 57 (Washington: International Monetary Fund).
- Murgasova, Z., N. Ilahi, J. Miniane, A. Scott, I. Vladkova-Hollar, and an IMF Staff Team, 2015, "The Western Balkans: 15 Years of Economic Transition," IMF Regional Economic Issues Special Report (Washington: International Monetary Fund).
- Okun, A., 1962, "Potential GNP: Its Measurement and Significance," Cowles Foundation Paper 190.
- Psacharopoulos, G., 1993, "Returns to Investment in Education: A Global Update," Policy Research Working Paper Series 1067 (Washington: World Bank).
- Ravn, M., and H. Uhlig, 2002, "On Adjusting the Hodrick-Prescott Filter for the Frequency of Observations," *The Review of Economics and Statistics*, Vol. 84(2), pp. 371–375.

EXTERNAL COMPETITIVENESS¹

Albania has significant potential to improve its export competitiveness. It has proximity to both European and emerging markets, access to the Mediterranean, a young population relative to the rest of Europe, and natural resources that remain to be fully tapped. However, Albania's competitiveness has shown narrow improvements over the past 5 years, with weak productivity growth and continued concentration in low-skilled labor-intensive sectors with limited value added. Recently, the authorities have taken steps forward but need to accelerate efforts to encourage investment in higher value-added products by implementing further structural reforms to enhance the business environment, address infrastructure gaps, and improve labor skills. Increased exchange rate flexibility would also help support external re-alignment (see External Sector Assessment), which may further boost export growth.

A. What Do Indicators Say?

1. Several broad-based cross-country indicators are commonly used to measure competitiveness. Two such indicators are the World Bank's Doing Business Report and the World Economic Forum (WEF) Global Competitiveness Report. The WB's Doing Business indicators cover various areas ranging from the legal regime for contract enforcement to regulatory processes for registering businesses, paying taxes, getting credit, and trading across borders. The WEF competitiveness indicators cover a wider range of criteria including infrastructure, institutions, education, labor market efficiency, as well as innovation, business sophistication, and technological readiness. Rankings in such reports are a proxy for countries' competitiveness with higher rankings signaling better competitiveness.



¹ Prepared by Ezequiel Cabezon and Kareem Ismail.

2. These rankings show that Albania has been closing the gap with EU new member states (NMS), but also that competitiveness convergence has slowed down in the last few years. While Albania improved its rankings during 2008–11, the pace of improvement has decelerated more recently (see Figure 1 and 2). Regional peers such as Macedonia and Montenegro were able to converge faster towards NMS rankings. There remains a significant gap between Albania and the NMS and therefore there is scope for significant gains from reforms to improve the business environment.

3. These indicators suggest that Albania needs to address governance and infrastructure weaknesses. In particular, the country's competitiveness has been limited by the following constraints:

- **Infrastructure gaps constrain trade.** Insufficient road maintenance is a key challenge. Several road projects aiming to reduce transportation costs and connect neighboring countries are pending (e.g., Arberi Road connecting Albania and Macedonia). Albania also has infrastructure gaps in telecommunications, ports, railroads, and airports relative to new EU members.
- **Unreliable energy supply hampers efficiency.** While Albania is rich in hydropower, electricity supply is prone to blackouts. This is a key constraint as electricity is an important input for many industries. Power outages averaged 112 hours per consumer in 2014, far above the CESEE average of 3 hours. There has been improvement recently as a result of the government's energy sector recovery plan, although its implementation remains at an early stage. Propane is a key input to develop chemical and plastics industries. The lack of a transport network and of low-cost supplies has blocked the development of such industries until now. The Trans-Adriatic Pipeline is expected to be completed by 2019 and should overcome these bottlenecks.
- **High informality contributes to low productivity.** More than 40 percent of firms report facing informal competition. The large informal sector is a constraint to investment, has a short-term perspective, and lacks access to credit. Low levels of physical and human capital keep productivity low.
- **Weak institutions hamper the rule of law.** The judiciary system is unable to protect property rights and enforce contracts, and undermines the business environment fostering myopic business strategies and high profit margins to insure against legal risks.
- **Corruption undermines competitiveness.** The WB-EBRD Enterprise Survey 2013 highlights corruption as one of the main obstacles for business. This issue combined with weak protection for property rights reduce the incentives for business activity. Fighting corruption is a long term process and the Albanian government is taking steps forward as it is a precondition for EU accession.

- **The complexity of the tax system places a substantial burden on business.** The number of tax payments and hours needed to pay taxes are 19 and 43 percent, respectively, higher than the Western Balkan average.
- 4. To address these weaknesses, the Albanian government has undertaken some recent initiatives which include:**
- The Law on Strategic Investments sets up a one-stop window to facilitate large investments. It accelerates licensing and the resolution of operational issues such as land consolidation, use of state-owned land, and infrastructure coordination.
 - The Law on Tourism aims to standardize the sector, reduce red tape, and coordinate tourism activities with local governments. It also allows the leasing of state-owned land for 99 years.
 - The Law on the National Business Center merged the National Registration Center and the National Licensing Center. This reduces the administrative burden by creating a single entity for registration and the issuance of special licenses.
 - The ongoing campaign against tax evasion, non-compliance, and informality is trying to level the playing field for law-abiding businesses.

B. Export Trends

- 5. Over the past decade, Albania has increased its market share in global export markets, mainly due to oil and minerals.** However, oil production is expected to be subdued in the near future, given lower oil prices.² In the non-oil sector, gains in export market share over the past decade have been modest (Figure 3). In the textiles and footwear sector, which represents the largest export sector after fuel and minerals, there have been no significant gains over the past decade (Table 1).

²Due to its geological specifics, Albania is a high-cost oil producer. This implies that oil price shocks have a bigger impact on Albania's oil production than on production in other regions.

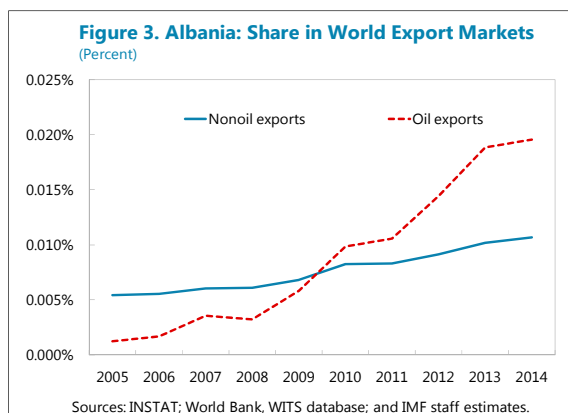


Table 1. Market Share of Albanian Exports
(In percent of World exports of each sector)

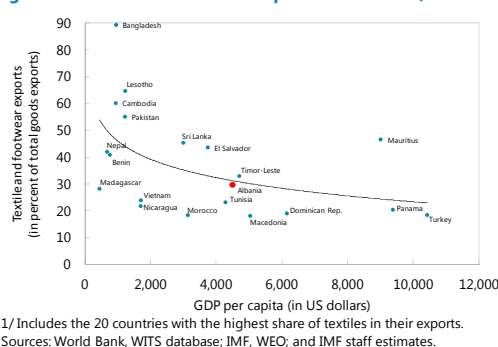
	2005-09 (a)	2010-14 (b)	(c)=(b)-(a)
Food, beverages, and tobacco	0.006%	0.007%	0.0007%
Minerals and metals	0.011%	0.019%	0.0078%
Fuels	0.003%	0.015%	0.0115%
Chemicals and plastic prod.	0.000%	0.001%	0.0003%
Wood and paper	0.007%	0.012%	0.0047%
Textiles and footwear	0.055%	0.055%	-0.0004%
Machinery	0.001%	0.001%	0.0003%
Others	0.002%	0.002%	0.0003%

Sources: INSTAT; World Bank, WITS database; and IMF staff estimates.

6. Albania's exports are concentrated in low value-added sectors, which may face

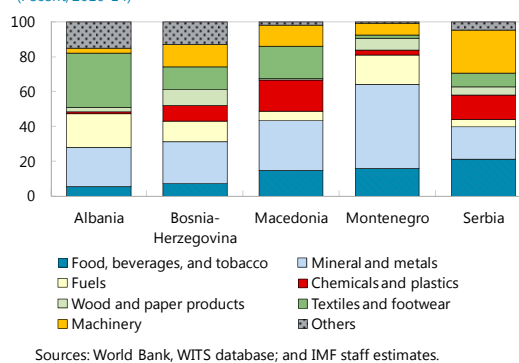
headwinds over the medium term. Albania's non-oil exports continue to concentrate in low-skilled labor-intensive sectors (such as textiles and footwear), where Albania's proximity to European markets has encouraged growth in the in-sourcing industry. However, Albania could be facing headwinds from the growth slowdown in Europe and the decline in transport costs, which places it in competition with countries that have large textile sectors with lower labor costs such as Bangladesh, Cambodia, and Vietnam (Figure 4).

Figure 4. Textile and Footwear Exports and Income, 2010-14



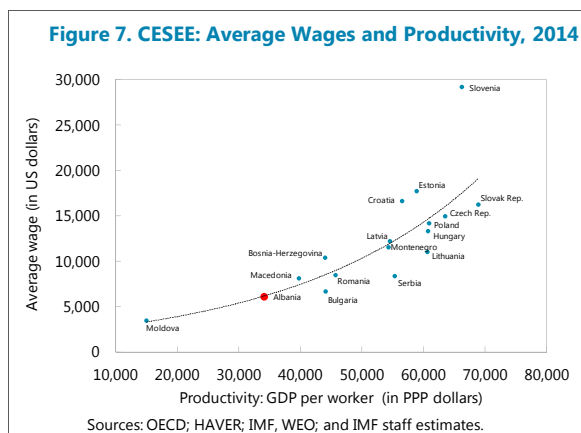
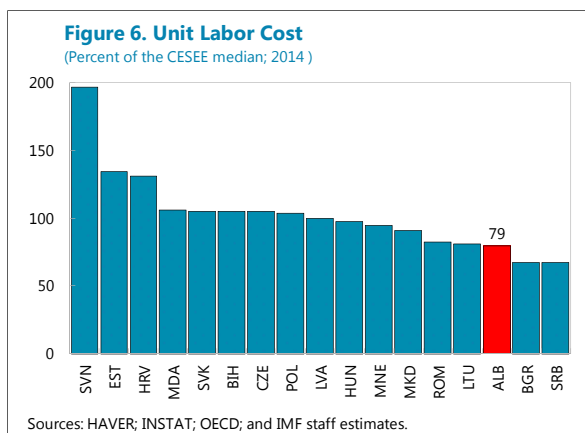
7. In order to achieve faster growth, a more rapid transition to higher value-added exports will be necessary. Albania's export sector is narrowly focused on oil, minerals, and textiles and footwear (Figure 5). In contrast with some of its regional peers such as Macedonia and Serbia, it has yet to diversify its export base into higher value-added products such as chemicals, plastics, or machinery. In Macedonia, export diversification was led by FDI in the tradable sector and a favorable business climate which helped integrate exports into the supply chains of Western European manufacturers. Given the challenges ahead in the oil sector and the significant headwinds in textiles, Albania will need to step up reforms to improve investment prospects and attract FDI that allows it to diversify into higher value-added products.

Figure 5. Western Balkans: Structure of Goods Exports (Percent; 2010-14)

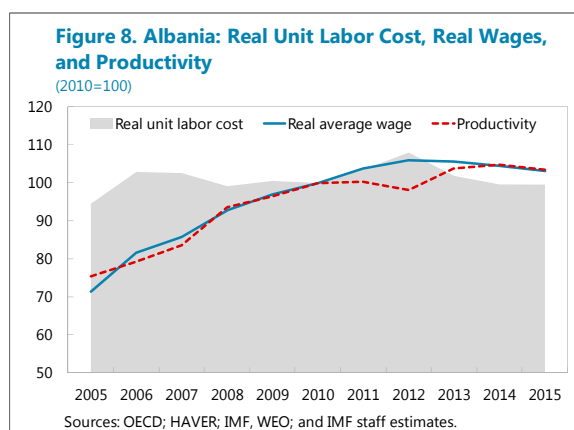


C. Labor Productivity and Wages

8. Unit labor costs remain low by CESEE standards. Average unit labor cost was 79 percent of the CESEE median (Figure 6). While at €380 per month in 2014, Albania's average wage is around 50 percent of the CESEE median³, productivity is also low compared with the rest of the region (Figure 7). Output per worker in Albania is around 62 percent of the CESEE median.

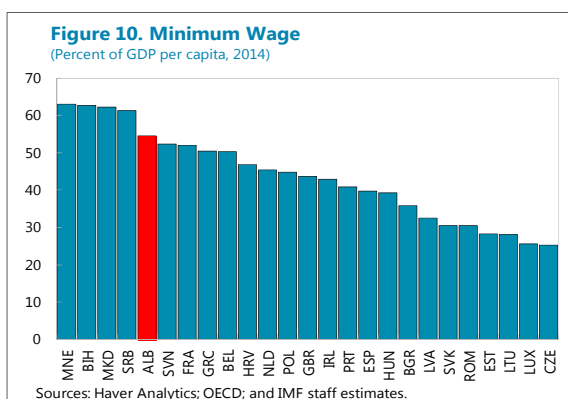
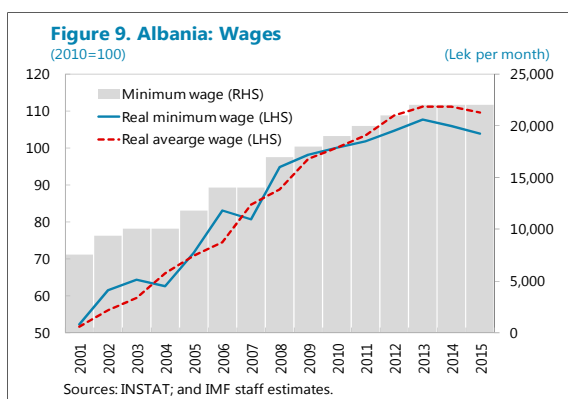


9. Albania's unit labor cost has fallen marginally in recent years, mainly reflecting a decline in real wages. The decline in real wages has offset the slowdown in labor productivity growth (Figure 8). The decline in wages partly reflected the weakening of labor demand following the slowdown in activity triggered by the Greek crisis in 2010. At the same time, labor supply has been expanding and exerting downward pressure on wages. The increase in labor supply is driven by migration from rural to urban areas and a drop in remittances which incentivizes people to join the labor force. New government employment offices in rural areas have also contributed to expanding labor supply by facilitating job searches.

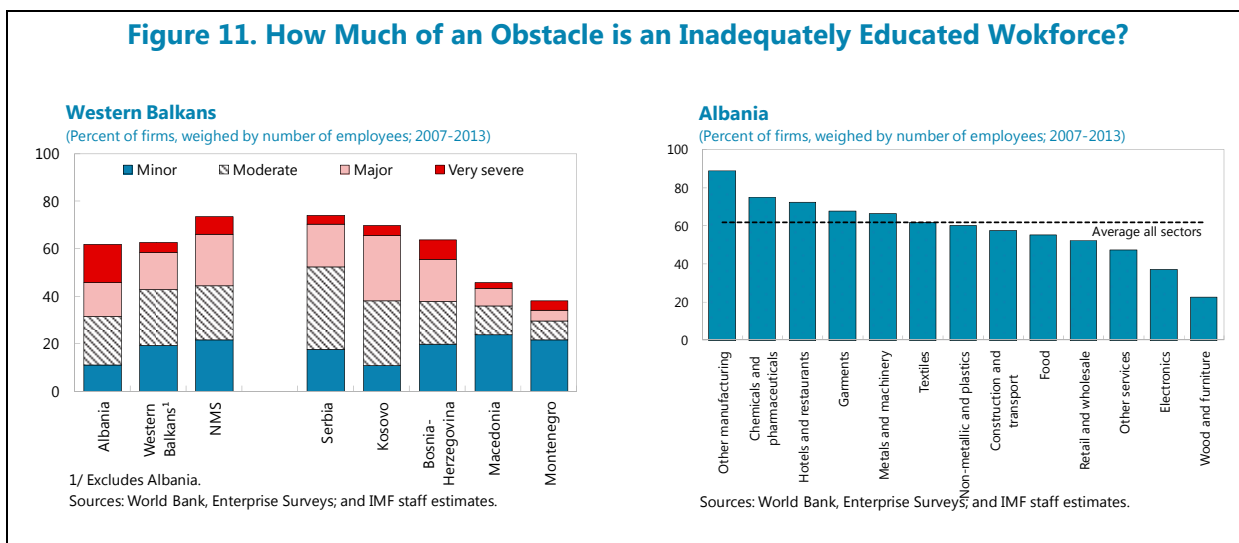


³ The average wage is proxied by the average public sector wage, because measures of private sector wages are unreliable given the large informal payments over the formal wages.

10. Holding the minimum wage steady for the past three years has also helped contain wage growth (Figure 9). The minimum wage has fluctuated within a band of 40–50 percent of the average wage over the past 10 years, which is relatively high by regional standards. In 2014, the ratio of the minimum wage to per-capita GDP was one of the highest in Europe (Figure 10). Hence, although the low growth in minimum wage has limited the spillover to the wage-scale, it may be adversely affecting competitiveness in labor-intensive exports and undermining youth employment.



11. Skill shortages remain a key structural challenge. According to the World Bank’s Enterprise Survey, around 60 percent of Albanian firms during 2007–13 reported that lack of properly educated workers was an obstacle (Figure 11). This percentage is higher than in Macedonia and Montenegro. The severity of the shortage of skilled labor has declined since 2007, in part due to cyclical factors. Nevertheless, this has created a bottleneck for growth. The lack of skilled workers is more severe in the tradable sectors—manufacturing and tourism—than in nontradable sectors, such as construction and retail trade.



12. The high youth unemployment rate is another symptom of skill shortages. The gap between the youth and headline unemployment rate increased from 6 percentage points in 2007 to 15 percentage points in 2014 (Table 2). This implies that the educational system is not providing the appropriate skills needed to join the labor market. A relatively high minimum wage is an entry barrier for young people entering the labor market. The long-term unemployed account for more than half of unemployment, which points to structural problems in the labor market.

Table 2. Labor Market Statistics, 2014

	Albania	Western Balkans ¹	EU New Member States ²
Unemployment rate	17.9	25.7	10.0
Long-term unemployment rate ³	11.2	20.1	5.2
Youth unemployment rate ⁴	32.5	52.1	23.4

1/ Includes Bosnia-Herzegovina, Kosovo, Macedonia, Montenegro, and Serbia.

2/ Includes Bulgaria, the Czech Republic, Croatia, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.

3/ Unemployed for more than 12 months.

4/ Unemployment rate among people aged 15-29.

Sources: National statistics offices; Eurostat; and IMF staff estimates.

13. Policies to improve competitiveness should focus on improving the quality of education and developing entrepreneurial skills. The 2012 PISA survey ranks Albania at the bottom of the distribution—20 percent below the CESEE median. The Global Entrepreneur Index ranks Albania 39th out of 40 European countries. Aversion to risk and innovation is the main obstacle to an entrepreneurial culture.

D. Conclusion and Policy Recommendations

14. Albania's exports may face headwinds in the near future. Albania's textile and footwear sectors will find it difficult to expand, given competition from large low-cost Asian producers. In recent years, export growth was driven by the oil sector, but lower oil prices represent an important challenge given Albania's high costs of oil production.

15. Structural challenges limit the potential for investment and diversification into new sectors. Policies to address these issues include:

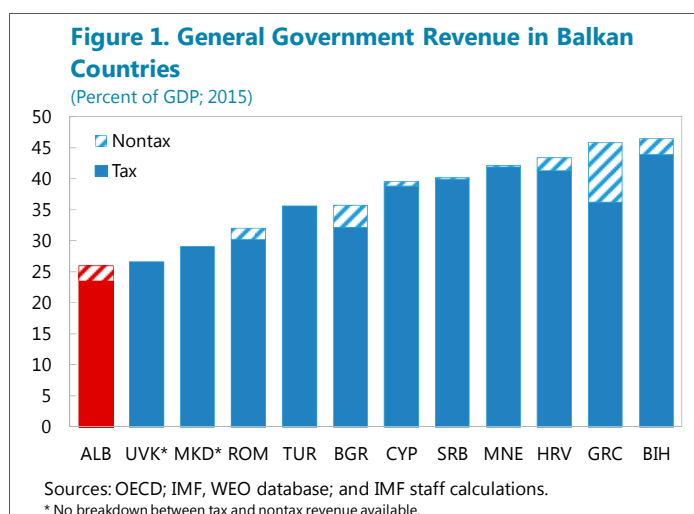
- Complete key infrastructure projects to reduce transportation costs and improve the energy supply.
- Improve institutions to strengthen the rule of law. Reform of the judiciary system and of land property rights should be the top priorities.
- Broaden the tax base to make the tax system more efficient, encourage compliance, and reduce informality.
- Improve labor market efficiency by containing the minimum wage and implementing policies to reduce skill shortages.

TAX POLICY, EVASION, AND INFORMALITY IN ALBANIA¹

This note explores the factors underpinning Albania's relatively low level of general government revenues. The analysis finds that while tax rates and tax expenditures are comparable to regional standards, tax efficiency is low and declining, perhaps due to relatively high levels of noncompliance and informality. Past revenue underperformance in Albania also reflects overly optimistic projections. To address the compliance and evasion issues, policies need to focus on strengthening the cooperation between the tax and customs departments, enhancing performance monitoring and governance of tax administration and improving policy design to improve tax compliance.

A. The Tax System in Albania: A Cross-Country Comparison

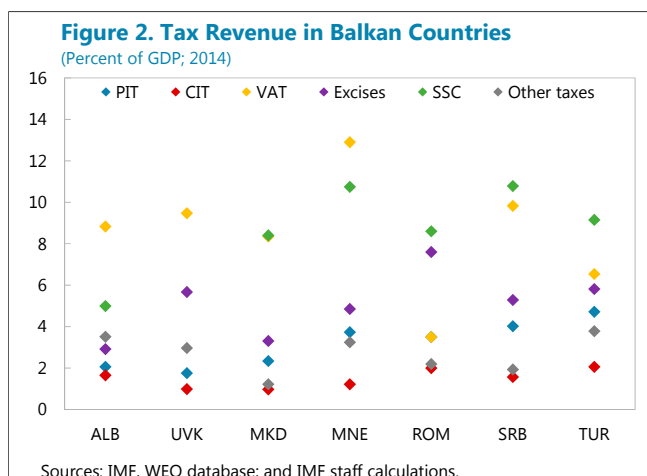
1. The size of the Albanian government is relatively small. General government revenues, both tax and non-tax, are lower in Albania than in its neighbors (Figure 1). Consequently, public spending is rather parsimonious.



2. The tax burden is lower in Albania than in most other Balkan economies (Figure 2). Compared with most neighboring countries, the Albanian tax collections are modest for most of the main tax sources. In particular, income taxes, property taxes, and above all social security contributions are substantially lower in Albania. Only revenues raised by VAT and CIT approach levels that are in line with those of comparator countries. Therefore, Albania relies as much on

¹ Prepared by Nicolas End and Mick Thackray.

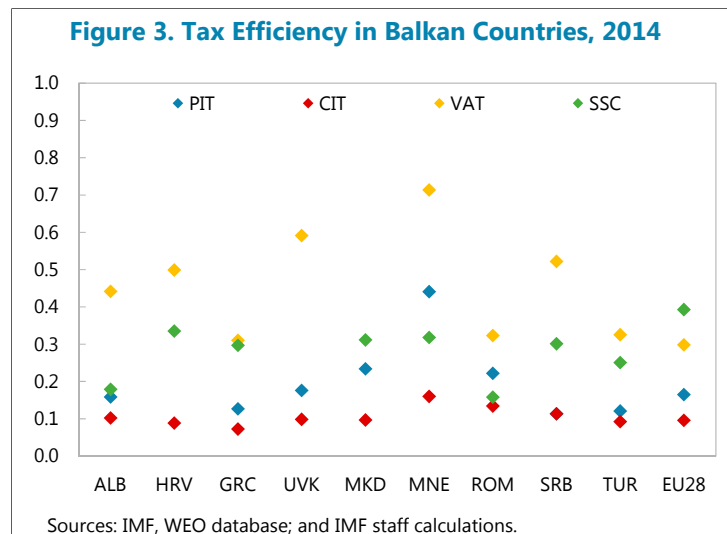
indirect taxes as on direct taxes: the share of VAT and excise tax revenues in total tax revenues is about 49 percent.



3. The main headline tax rates in Albania are above the Balkan average, but the tax thresholds are also comparatively higher (Table 1). Relative to EU member states, Albania's top rates for personal and corporate income taxes and social security contributions are lower than the EU average. On the other hand, relative to neighboring Balkan states, Albanian rates are rather high. However, zero-tax thresholds are higher in Albania than in its neighbors, on average. Also, because income tax efficiency measures are based on top rates rather than average, progressive tax regimes inherently measure as less efficient than flat rate regimes.

4. Albania's lower tax revenues are partly a consequence of the lower efficiency of taxes on wages (Figure 3). Tax efficiency is the ratio between each tax revenues for each tax (in percent of GDP) and the top tax rate.² Tax efficiency for social security contributions and personal income tax appears to be lower in Albania than in other Balkan countries. For corporate income and value added taxes, tax efficiency in Albania is roughly in line with neighbors' performance, but there is a broad range of results.

² This measure provides a broad indicator of the efficiency of each tax as being the amount of additional revenue produced per percentage point of the top rate. Its value is a function of (i) the coverage of the tax base by tax policy and degree of progressivity, (ii) the composition of GDP and distribution of incomes/expenditure; and (iii) the level of taxpayer compliance.



5. Albania's VAT efficiency appears lower on average than other Balkan non-EU countries but above the EU performance. However, the variability of the share of domestic consumption relative to GDP biases this measure. In particular, in Albania, remittances to households by the large number of Albanian émigrés working abroad boosts consumer spending, which is the VAT base, as a proportion of total economic activity as measured by GDP. This boosts artificially the observed efficiency of VAT relative to GDP.

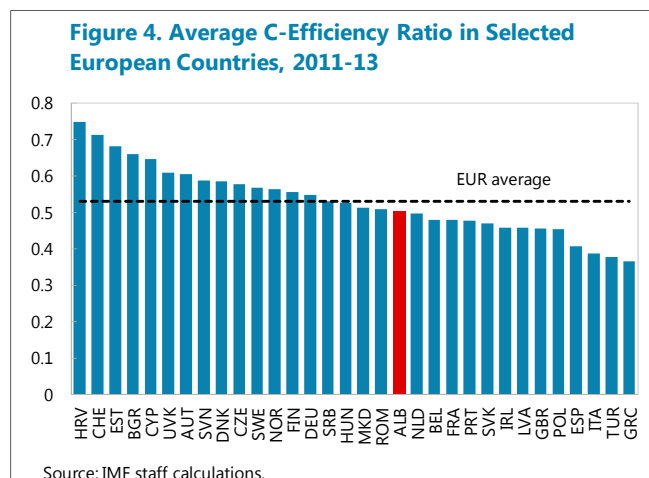


Table 1. Tax Rates for Selected European Countries (2013 for social contributions, 2015 for everything else)							
Country	VAT		Top Corporate Income Tax Rate	Top Individual Income Tax Rate	Social Security Contributions		
	Threshold (euro)	Current Standard Rate			Employer Rate	Employee Rate	Total Rate
Albania	35,672	20	15	23	16.7	11.2	27.9
Bosnia & Herzegovina	25,524	17	10	10	10.5	31.0	41.5
Rep. of Kosovo	30,007	18	10	10	5.0	5.0	10.0
FYR Macedonia	32,462	18	10	10	13.5	13.5	27.0
Montenegro	18,000	19	9	15	9.8	24.0	33.8
Rep. of Serbia	68,099	20	15	15	17.9	17.9	35.8
Turkey	0	18	20	35	21.5	15.0	36.5
Unweighted Average Neighbors	29,015	18	12	16	13.0	17.7	30.8
Austria	0	10	25	50	21.7	17.6	39.3
Croatia	30,077	25	20	40	15.2	20.0	35.2
Cyprus	15,600	19	12.5	35	10.5	6.8	17.3
Germany	17,500	19	15	45	19.3	20.2	39.5
Greece	0	23	26	42	28.6	16.5	45.1
Italy	0	22	27.5	43	30.0	10.0	40.0
Slovenia	50,000	22	17	50	16.1	22.1	38.2
Total Unweighted Average	22,098	19	17	31	16.6	16.6	33.2
<i>Sources: IMF Staff; Eurostat.</i>							

6. Albania’s VAT efficiency as a percent of final consumption indicates sizable revenue losses. Albania’s VAT efficiency, as measured by C-efficiency, is slightly below the European average, which is dominated by EU member states (Figure 4).³ Multiple sources have reported widespread problems with VAT fraud within the EU; these imply significantly reduced VAT collections and efficiency. In addition, most European countries have a number of material VAT exemptions and other tax expenditures, which also decrease C-efficiency ratios. Therefore, the average for Europe reflects material levels of noncompliance and tax expenditures. It follows that Albania’s C-efficiency, which is slightly below the European average, also indicates likely material losses from tax expenditures and/or noncompliance.

7. The overall impact of tax expenditures in Albania is not high by European standards, except for having higher zero-income-tax thresholds. The design of Albania’s VAT follows the EU standard, with a small number of additional statutory exemptions—the main one being the exemption for sales of newspapers and magazines and media advertising. Furthermore, the Albanian VAT applies exemptions where many EU member states apply zero-rating (for example, to food). This is more expensive, because of the mechanics and timing of input tax credits.⁴ The personal and corporate income taxes are relatively straightforward, albeit with relatively high zero-rate thresholds. There are a number of exemptions on imports from both VAT and excises, which seem to aim at facilitating foreign investments and correcting weaknesses in the domestic VAT refund regime. The net cost of VAT exemptions in policy terms is not high as these would otherwise be claimed as input tax credit—however, they raise compliance and administrative issues, such as increased risks of misreported imports and decreased control over the supply chain for VAT, increasing the costs through lower compliance.

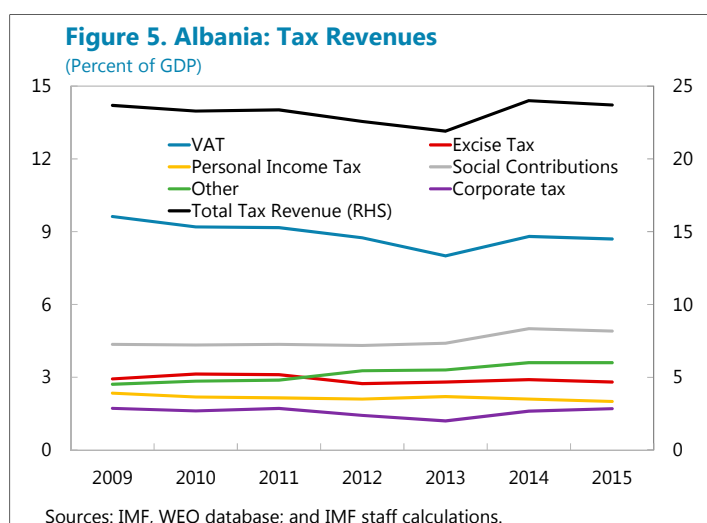
8. Overall, low tax revenues in Albania seem to be mostly imputable to a low level of compliance. Estimating definitively the relative impact of high thresholds and low compliance on income taxes and social contributions requires better knowledge of the distribution of individual and corporate incomes. However, officials and external observers report widespread failure to register for as well as pervasive excise smuggling and fraud. A preliminary decomposition of the observed VAT C-efficiency measure (Section III) indicates substantial VAT compliance losses.

³ Formally, C-efficiency is computed as follows: $C\text{-efficiency} = \frac{VAT\ revenues}{Final\ Consumption \times Standard\ VAT\ Rate}$. This measure compares actual performance to a normative VAT regime that applied the standard rate to all final consumption, with perfect taxpayer compliance.

⁴ Especially when refunds are restricted.

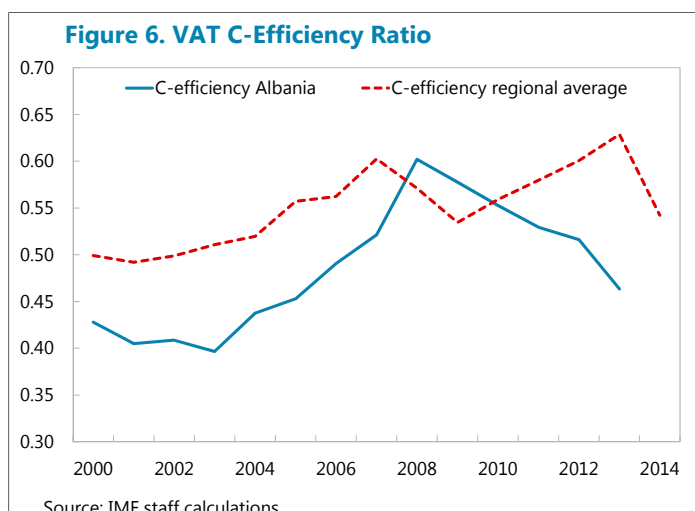
B. Recent Developments

9. **Despite several tax rate increases, tax revenues have remained broadly unchanged compared to 2009** (Figure 5). The EFF-supported program launched in 2014 helped reverse a decreasing trend in tax collections, mainly through increased social contributions and profit tax. The authorities increased tax rates across the board, in particular for corporate tax and excises. Conversely, the 2014 reform of the personal income tax—from a flat tax to a progressive system where 60 percent of the taxpayers are below the zero-rate threshold—weakens revenue collection. In the 2016 budget law, the government abrogated the small business tax and exempted small and micro businesses from any profit tax; these measures are likely to have further weakened direct taxation. The increase in excise duty rates for road fuels and tobacco also failed to increase collections in 2015, but this was mainly due to taxpayers’ pre-releasing stocks in 2014 ahead of the anticipated duty rise, thus decreasing 2015 revenues.

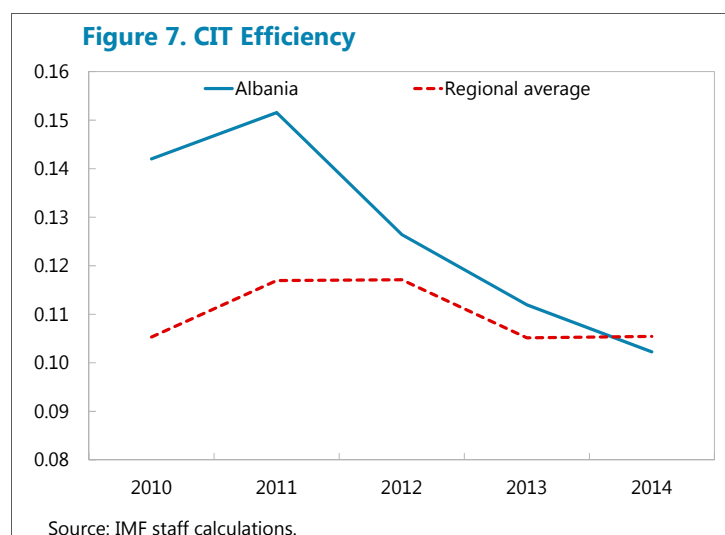


10. **The VAT C-efficiency ratio in Albania has decreased from 60 percent in 2008 to 50 percent in 2013, indicating an increase in the VAT gap** (Figure 6). While over 2000–2008 the VAT C-efficiency was on a rising trend, this reversal could result from an increase in the VAT gap, due to changes in either policy, behaviors, or compliance.⁵

⁵ An alternative explanation is a change in the composition of GDP in Albania, for example increasing consumption of exempted commodities. This possibility will be covered by the upcoming RA-GAP study of the VAT gap.



11. The tax efficiency of CIT has also fallen, from 0.15 in 2011 to 0.10 in 2014 (Figure 7). The observed tax efficiency relative to GDP has fallen consistently throughout 2011–2014. In terms of revenue collected, this partially offset the effect of the increase of the top rate of CIT to 15 percent in 2014.

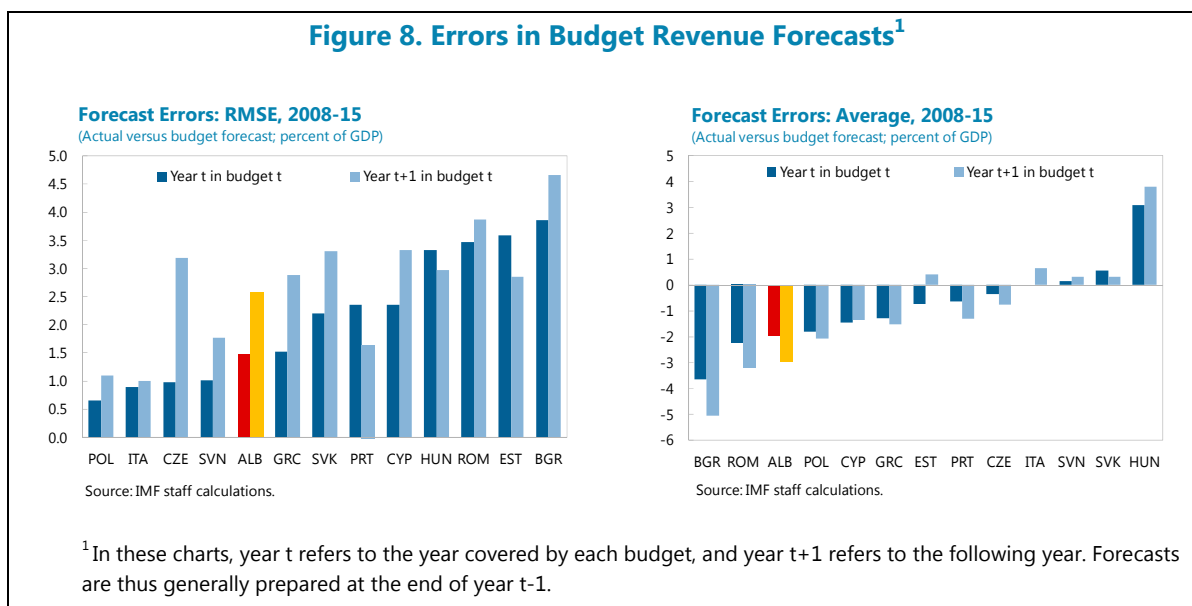


C. Revenue Management and Forecasting Errors

12. Forecasting revenue is a difficult exercise in a small open economy like Albania. The economy is subject to numerous external shocks, which are large relative to the size of the economy. For instance, foreign direct investments generally have a high import content. Hence, large foreign-financed projects routinely produce a lumpy profile of imports of goods and services and customs revenues.

13. Revenue forecasts in Albania are characterized by significant errors (Figure 8, left panel). The root-mean-square error (RMSE) of the revenue projection on which budgets are based is close to 1.5 percent of GDP. This represents a substantial forecast dispersion, which poses risks for the budget.

14. Moreover, the forecasts have a systematic and sizable upward bias (Figure 8, right panel). On average over the last eight years, budget revenue projections have been consistently too optimistic by almost 2 percent of GDP. While such an upward forecasting bias is not uncommon, it is higher in Albania than in neighbors and peers.



D. Revenue Performance in 2015

15. In 2015, the government's revenues missed their budget projection by 2½ percent of GDP. The 2015 forecast error exceeds the recent average. The underperformance was in almost all the main taxes, with the exception of corporate income tax and social security contributions.

16. Revenue forecasts were overly optimistic. Tax revenue forecasting used a "top down" methodology. Nominal GDP growth was applied across the board to expected collection outcomes for the base year, with adjustments for the estimated impact of policy changes and anticipated increases in collection efficiency. There was no regard for microeconomic factors particular to different tax headings and limited consideration for one-off and other distorting factors known to the revenue administrations. Jensen and others (2015) identified the following contributing factors:

- The estimated 2014 base for the 2015 revenue forecast was too optimistic. Some significant base adjustment and one-off factors were not taken into account in preparing the 2015 budget, in particular the early release of excise goods in 2014, in anticipation of tax increases taking effect in early 2015.
- The growth rates applied were also too optimistic. In addition, exogenous surprises contributed to the underperformance: namely, plummeting oil prices and declining deposit interest rates.
- Forecast estimates for tax collection efficiency were unrealistically high. These coefficients were intended to set revenue administration targets rather than provide a realistic forecast.
- Estimates for the impact of some tax policy measures were unrealistic. Behavioral responses were underestimated, such as the increased smuggling of cigarettes that contributed to a major reduction in cigarette imports.

17. Most of the underperformance of tax and customs revenues in 2015 was the consequence of overly optimistic assumptions (Table 3). A tentative decomposition of the errors shows that more than half of the overall underperformance related to unrealistic assumptions pertaining to administrative efforts and elasticities with respect to GDP—in particular, the growth of declared volumes of cigarettes and other excisable commodities. The remaining underperformance can be attributed to the decline in oil prices (26%) and the shortfall in nominal GDP growth (13 percent).

(in ALL billion)	2015 performance			Breakdown of the deviation					
	Budget	Est.	Deviations	Base effect	Nominal GDP	Admin. Effort	Oil	Elasticity	Other 1/
Tax revenues	377.1	341.6	-35.5	-1.0	-4.6	-7.5	-9.4	-11.0	-2.1
VAT	135.3	124.8	-10.4	-2.2	-1.7	-3.5	-1.2	-2.2	0.3
CIT	23.5	24.2	0.7	-0.4	-0.4	-0.4			1.9
Excises	51.7	39.0	-12.7	-3.8	-0.5	-1.2	-1.6	-5.1	-0.4
PIT	35.3	29.5	-5.8	0.7	-0.3	-0.6		-3.4	-2.3
National taxes	42.7	33.5	-9.2	-1.6	-0.4	-0.6	-6.5		-0.1
<i>royalties</i>	5.4	3.2	-2.2			0.0	-2.2		0.0
<i>others</i>	37.3	30.4	-7.0	-1.6	-0.4	-0.6	-4.3		-0.1
Customs	6.2	5.9	-0.3	-0.1	-0.1	-0.1			0.0
Local governments	13.6	11.7	-1.9	-0.3	-0.2				-1.3
Social security contributions	68.8	72.9	4.1	6.7	-1.1	-1.0		-0.3	-0.2

Sources: Albanian authorities and IMF staff estimates.
1/ Includes increase in noncompliance (e.g., tobacco smuggling), behavioral responses, one-offs, timing effects, etc.

E. Compliance and Evasion

18. There is a consensus that Albania suffers from widespread informality, with a significant adverse impact on tax revenues. Government officials and external observers consistently portray widespread noncompliance across most taxes. Further evidence of endemic compliance issues is provided in the performance data compiled by the customs and tax administrations, which show a high percentage of compliance checks yielding additional liability (up to 100 percent in some regions). Whilst such high hit rates may be partly the result of better, risk-based case selection, they also imply that a large number of noncompliant taxpayers remain to be identified and assessed for additional liabilities.

19. High levels of noncompliance not only damage tax revenues, but can also undermine social cohesiveness and economic growth. There has been a number of empirical studies establishing causal links between tax compliance and social cohesion. In particular, taxpayers need to perceive tax policy as fair, effectively administered (so that everyone pays their fair share). There must be a clear, transparent link between tax payments and public benefits. Enterprises thrive in countries with properly funded public services and infrastructure, where revenue administrations facilitate compliance and unfair competition from noncompliant businesses is minimized.

20. While tax gaps in Albania have never been quantified, an approximate level of VAT noncompliance can be derived from C-efficiency. C-efficiency measures the efficiency of the VAT tax base (i.e., final consumption) in generating VAT collections (section I). Efficiency losses can stem from structural reliefs and tax expenditures (the *policy gap*) and noncompliance (the *compliance gap*).⁶ The approximate compliance gap can therefore be derived from C-efficiency and the likely policy gap.

21. The compliance gap for VAT is provisionally estimated to be in the region of 35 percent of potential VAT. Previous research has found that virtually all EU member states have policy gaps in the range 20–35 percent (EC, 2013). The design of the Albanian VAT is much the same as the EU standard, with limited additional tax expenditures. So, Albania's policy gap likely is in the range 25–30 percent. Given Albania's observed C-efficiency of 46 percent in 2013, we estimate the compliance gap to be around 34–39 percent of potential VAT.

⁶ Keen (2013) formally decomposes C-efficiency as: $C\text{-efficiency} = (1 - \text{policy gap}) \times (1 - \text{compliance gap})$.

22. Weakening C-efficiency over recent years may be due to increasing VAT noncompliance. C-efficiency in Albania has fallen steadily over 2008–2013. Assuming that the composition of final consumption remained largely unchanged over that period, with no substantial increases in the policy gap due to new tax expenditures, the implication is that the declining trend has been caused by worsening compliance.

23. The compliance gap in excise duties is likely significant too. Officials and external observers believe that there is substantial smuggling and fraud in excise duties in Albania, particularly in road fuels and cigarettes, based on evidence from compliance and enforcement operations. As part of the recently launched campaign against informality, measures have been implemented to counter such noncompliance, including a review of the excise stamps regime and strengthened control of trans-shipments of excise goods across Albania, to prevent diversion to untaxed domestic markets.

F. Policy Recommendations

24. Low tax revenues stem from weaknesses in tax administration and compliance, which are being addressed. The Albanian authorities embarked on a reform effort in September 2015 to improve tax compliance, fight evasion, and minimize informality—and so increase tax collections. The effort is multifaceted. The government launched a public awareness campaign, waived penalties for businesses that become fully compliant before end-2015, implemented pilot compliance campaigns based on centralized risk profiles and set up a lottery to incentivize customers to claim their tax receipts. To enhance enforcement, 500 new tax inspectors were hired. A steering committee monitors the effort on a weekly basis, and promotes closer collaboration between tax and customs administrations.

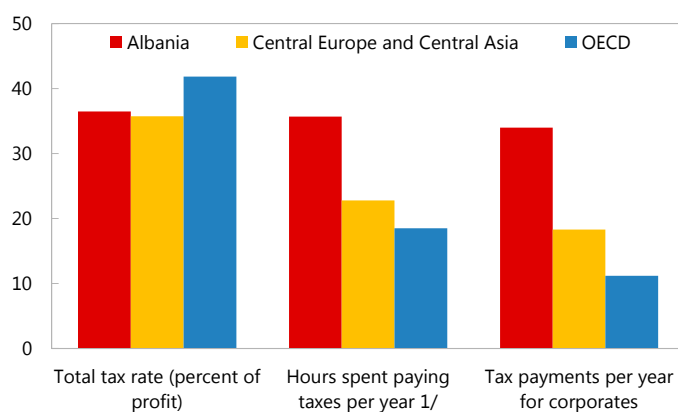
25. The compliance campaign should focus more on long-term outcomes, using expertise and new risk profiles from the joint tax and customs risk unit. The risk analysis from the newly merged tax/customs risk unit and operational intelligence has informed the compliance measures implemented in the informality campaign. These measures are having an impact in terms of increasing taxpayer registrations and early indications of improved revenue yield from compliance action. For example, verification of 1,358 VAT taxpayers by March 8, 2016, yielded an additional ALL 2,961 million, with a hit rate of 81 percent. Individual regions' results varied widely in terms of both take up of the initiative and hit rate, but the Tirana region recorded a 100 percent hit rate on 651 cases with a yield of ALL 1,585 million and the large business office recorded ALL 1,141 million from just 8 cases, out of a total of 15 checked. There is clearly a strong direction behind the campaign, and the authorities need to continue refocusing compliance interventions on high value, high risk taxpayer segments and on implementing modern compliance risk management frameworks.

26. The informality campaign should establish a robust performance-monitoring regime focusing on a relatively small number of key strategic performance indicators.

While detailed reporting of inputs, actions, and outputs is critical for operational managers, there is a need at the strategic level to monitor the overall outcomes of the informality campaign and maintain clear visibility of strategic objectives.

27. In terms of tax policy, the authorities should seek to simplify the tax system, so as to reduce administrative and compliance costs. Surveys show that such costs are relatively high (Figure 9). Implementation of a mandatory online filing of sales transactions ledgers should be viewed with caution given potential compliance costs for taxpayers, capacity risks for the tax administration and financial costs. Eliminating import tax exemptions (see ¶17) would also reduce the risks of misreporting and facilitate proper monitoring of the supply chain for VAT system. Relatively high zero-rate thresholds make it more difficult for the administration to establish taxpayers' liability to register and pay tax—because it is more plausible for taxpayers to claim that their income is not high enough to bring them into tax.

Figure 9. Administrative Efficiency in Paying Taxes



1/ Each unit in the chart corresponds to 10 hours.

Sources: Doing Business (2016); and IMF staff calculations.

28. The authorities should continue to review the campaign's governance, establishing clear and transparent lines of responsibility. High-level support was vital for the launch and early stages of the campaign. As the campaign progresses, its day-to-day governance can be delegated to senior managers in the revenue administrations and the Ministry of Finance, with continuing oversight by the Minister of Finance. Operational decisions should be insulated from political considerations and the campaign's governance become part of the new corporate strategy for tax administration.

29. Increased cooperation between customs and tax administrations in joint risk analysis and compliance operations is desirable. The merger of the tax and customs administrations remains a long-term goal, but is not currently being pursued, to avoid distraction from the informality campaign. Nevertheless, there have been initiatives to increase cooperation and joint working between the two agencies. These include the establishment of a joint risk unit, increased data sharing and pilot programs for joint audits. These initiatives are to be encouraged and maintained.

References

- Alm, J., 2013, "Expanding the Theory of Tax Compliance from Individual to Group Motivations," Working Papers 1309 (Tulane University).
- Alm, J. and B. Torgler, 2011, "Do Ethics Matter? Tax Compliance and Morality," *Journal of Business Ethics*, Springer, Vol. 101(4), pp. 635–51.
- , 2005, "Culture Differences and Tax Morale in the United States and in Europe," *Journal of Economic Psychology*, Vol. 27(2), pp. 224–46.
- Alm, J., K.M. Bloomquist, and M. McKee, 2013, "When You Know Your Neighbor Pays Taxes: Information, Peer Effects, and Tax Compliance," Working Papers 13–22 (Appalachian State University).
- Bazart, C. and M. Pickhardt, 2009, "Fighting Income Tax Evasion with Positive Rewards: Experimental Evidence," Working Papers 09-01, LAMETA (University of Montpellier).
- Barretto, R.A. and J. Alm, 2003, "Corruption, Optimal Taxation, and Growth," *Public Finance Review*, Vol. 31.
- Calvet, R. and J. Alm, 2014, "Empathy, sympathy, and tax compliance," *Journal of Economic Psychology*, Vol. 40(C), pp. 62–82.
- Daude, C., H. Gutiérrez, and Á. Melguizo, 2012, "What Drives Tax Morale", *OECD Development Centre*, Working Paper 315.
- European Commission, 2010, "Compliance Risk Management Guide for Tax Administrations," TAXUD.
- , 2013, "Study to Quantify and Analyse the VAT Gap in EU Member States," TAXUD/2013/DE/321.
- Feld, L.P., B.S. Frey, and B. Torgler, 2006, "Rewarding Honest Taxpayers? Evidence on the Impact of Rewards from Field Experiments," CREMA Working Paper Series.
- Jensen, A., S. Caner, E. Hutton, M. O'Grady, and S. Hansen, 2015, "Causes of Tax Revenue Underperformance and Options for Corrective Measures," IMF Technical Assistance Report.
- Joshi, A., W. Prichard, and C. Heady, 2014, "Taxing the Informal Economy: The Current State of Knowledge and Agendas for Future Research," *The Journal of Development Studies*, Vol. 50(10), pp. 1325–47.
- Kanbur, R. and M. Keen, 2014, "Thresholds, informality, and partitions of compliance," *International Tax and Public Finance*, Vol. 21(4), pp. 536–59.

Kastlunger, B., S. Muehlbacher, E. Kirchler, and L. Mittone, 2011, "What Goes Around Comes Around? Experimental Evidence of the Effect of Rewards on Tax Compliance," *Public Finance Review*, Vol. 39, pp. 150–167.

Keen, M., 2008, "VAT, tariffs, and withholding: Border taxes and informality in developing countries," *Journal of Public Economics*, Vol. 92(10–11), pp. 1892–1906.

Keen, M., 2013, "The Anatomy of the VAT," IMF Working Paper 13/111.

La Porta, R. and A. Shleifer, 2014, "Informality and Development," *Journal of Economic Perspectives*, American Economic Association, Vol. 28(3), pp. 109–26.

Luttmer, E.F.P. and M. Singhal, 2014, "Tax Morale," *Journal of Economic Perspectives*, American Economic Association, Vol. 28(4), pp. 149–68

OECD, 2014, "Compliance Risk Management: Managing and Improving Tax Compliance," *Guidance Note*.

Saez, E., 2010, "Do Taxpayers Bunch at Kink Points?" *American Economic Journal: Economic Policy*, 2(3), pp. 180–212.

Thackray, M., E. Hutton, and K. Kapoor "Finland: Technical Assistance Report—Revenue Administration Gap Analysis Program—The Value-Added Tax Gap," IMF Country Report 16/60.