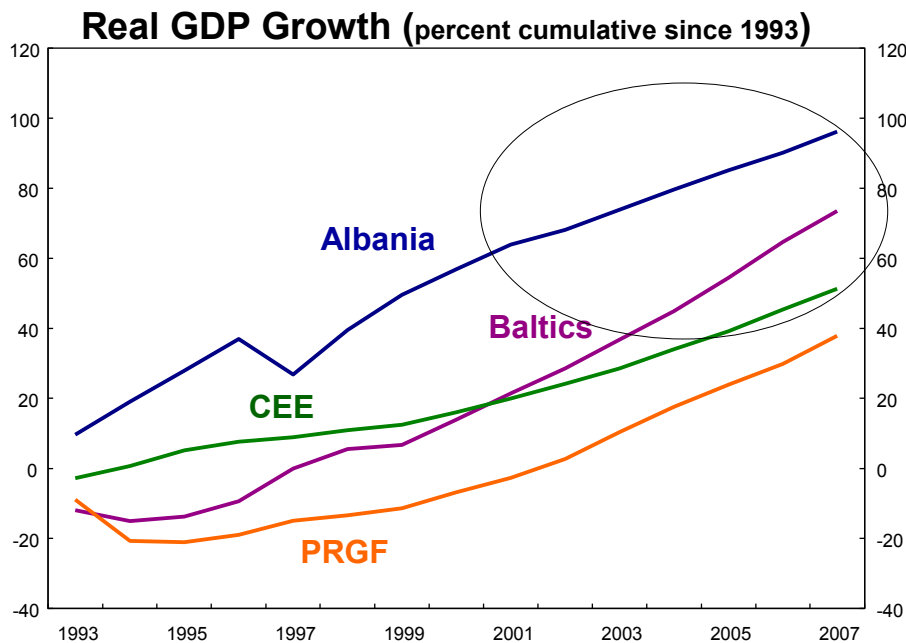


## IMF: Our concerns on “the fiscal revolution”

*Interview by Arben Rrozhani*

**Ms. Westin, the IMF will end its mission in Albania in a few months. You have been in Tirana for only a few years, but how would you define the 17-years history of the relations with the Albanian governments? After three years in power for Mr. Berisha’s government, how would you consider the macroeconomic development of Albania?**

After some 16 years of IMF programs and even more years of transition, Albania now has macroeconomic stability firmly entrenched. Growth has been stable and high, with per capita income more than doubling in the last decade, and inflation has been well contained, reflecting prudent fiscal and monetary policies. This is an achievement of the Albanian authorities, the current government as well as previous governments, and we are happy to have been partners of this successful transition.



Macroeconomic stability has also been retained under the current government, with the overall public debt burden continuing to decline, from 58 percent of GDP in 2005 to a currently projected 52 percent this year; and with inflation well contained within the Bank of Albania’s 2–4 percent target range, despite external shocks in food and fuel prices.

**How much does the government need assistance beyond the expiration of the current mission? Technically what does it imply the end of the IMF mission in Albania and the end of the economic “recipes ” for the Albanian government?**

There are a number of reasons why countries chose to have an IMF arrangement. First, there is access to Fund financing. However, also apart from the financing, several countries have chosen to have a Fund program to maintain the close policy dialogue on macroeconomic policies and to signal to the rest of the world that policies are on track. This signaling effect might be particularly important when official statistics are still not up to international standards. Signaling to international observers and investors that policies are on track might also be more important in an election year.

Irrespective of whether Albania has a program with the Fund or not, prudent macroeconomic and structural policies will need to be maintained to lay the foundation for continued poverty reduction and sustained high economic growth. Hence, for some time now, the IMF has advocated that the authorities commit to some clear and credible fiscal rule, such as an expenditure, deficit, or debt ceiling, to anchor policies. This will be all the more important as Albania plans to access global financial markets.

Whether a member country has an arrangement with the IMF or not, it will still have access to our technical assistance and we will still undertake the Article IV consultations, which we do with all our member countries. During these consultations, which are undertaken every or every other year, we do an overall analysis of the economy, sometimes focusing on certain key sectors, and provide our recommendations.

**How open and cooperative has the Albanian government been during your mission?**

Our relationship and cooperation with the Albanian government during this program, which happens to coincide with my tenure here and with the current government’s mandate, has been and remains excellent. We have an open and productive dialogue, where we sometimes disagree but where we almost always in the end have been able to reach good solutions that can meet all concerns involved.

**The IMF has made some recommendations to Mr. Berisha’s government i.e. on the implementation of the flat tax, the drafting of supplementary budgets, the uncontrolled increase of wages and pensions, maintaining a low rate of inflation or borrowing commercially to finance infrastructure projects. They have not been considered. What impact have this unilateral decisions had in the Albanian economy?**

It is not correct to say that our recommendations have not been considered. On the so called flat tax, our main concern was that the suggested tax cuts be financed upfront, i.e., we did not accept a priori the assertion that tax revenues would be higher as a result of lower taxes but we required compensatory revenue increases. In this area, we did reach agreement. On

budget policy, what we do agree on are overall revenues and the overall deficit, and hence the expenditure envelope. Within expenditures we focus on priority spending, such as education, health, and investment. We also focus on wages and pensions, given their direct impact on household consumption, and we did reach agreement on this in the context of the supplementary budget last summer. On inflation, well, that's the job of the Bank of Albania, which is doing a very good job at keeping inflation within its 2–4 percent target range. And finally on commercial borrowing, we have an explicit ceiling in the program for external commercial borrowing (apart from a limit on domestic borrowing).

All in all, just to sum up, the program focuses on key parameters, such as those mentioned above. Before reaching agreement, there might be significant discussions. However, so far we have managed to agree on “the bigger picture” and all reviews under the current program up until now have been concluded on time. At the same time, there might be less important issues that we do not agree on in the end, but rather “agree to disagree.”

**Two years ago you had many reservations about the so-called “fiscal revolution” introduced by the Albanian government. Did this really happen and what impact it had on the economy?**

Our main concerns with the introduction of the so called “flat taxes” for personal and corporate income taxes were twofold: (1) that the estimated cost to the budget be financed upfront (we did not accept including in the budget any possible revenue improvements stemming from a reduction in the informal sector but would rather spend this revenue improvement, if it materialized, in a supplementary budget); and (2) that the flat tax policy did not become a panacea at the expense of other equally important reforms. On both accounts our concerns were satisfied.

In the event, the introduction of a simpler tax system with lower rates and broader base has worked well in Albania, a country with still weak tax administration and large informal economy. It is easier to administer a simple tax system, which also gives less opportunities for discretion and hence for corruption. At the same time, at the current low corporate income tax rate of 10 percent, it simply pays off for businesses to pay their tax dues and be part of the formal economy, which e.g. also allows them to participate in the VAT refund chain and in public tenders, rather than keep hiding in the informal sector.

Lastly, just to note that this does not mean that the goal should be ever lower tax rates. The last thing you want is a “race to the bottom” where countries in the region are competing for foreign investment with ever lower tax rates. In the end there is only so much improvement in tax revenue that can come from trying to reduce informality through lower tax rates. And there are still significant spending needs in Albania, in particular in education, health, and infrastructure investment.

**The Mission Chief Gerwin Bell will come again in Tirana in November, but his last visits, few days ago, was not so calm, because he had many reservations on the high budget deficit or the lowering of the social contribution rate. Where is the IMF opposition based?**

We are not in favor of the proposal to reduce the social security contribution rates at this stage as any such reform should be done in the context of an overall pension reform, on which the authorities have been working for quite some time now together with donors. In contrast to other European economies, which have found such a reform essential but extremely difficult, Albania's favorable demographics make this kind of reform a real possibility. There should be a better link between contributions and benefits, something that will cost money in the short run; hence, the necessary fiscal space should not be wasted now on rate cuts. In such a future system, contributions should be viewed as savings, rather than taxes, giving incentives to self enforcement and reducing informality, apart from improving fiscal sustainability. Establishing a pension system will also be important for the development of capital markets.

**The IMF under your direction assisted in the drafting of the budget of the last 3 years and will give its advice for the 2009 budget as well. Well-known economists and finance people in the country are worried on the drafting of this budget which is done few months ahead of the parliamentary elections of June 2009, considering it as an electoral budget. What would be the main IMF advise on the drafting of this draft-budget and the main objectives it should have?**

To safeguard macroeconomic stability, we are cautioning the government not to add any further fiscal stimulus to the economy next year given both domestic concerns, such as the large current account deficit and the still high credit growth, and external concerns stemming from the unsettled global financial markets.

Given this, and the still quite slow capital spending implementation this year, at this stage we are recommending a deficit for next year of 3.5 percent of GDP at the most. Meanwhile the authorities have suggested a deficit of 4.2 percent.

This is still being discussed and we hope to reach agreement on the 2009 budget by the time of the upcoming review mission in early November, when we will also have more data on capital spending in 2008.