

Report No. 21390

Albania Country Assistance Evaluation

November 16, 2000

Operations Evaluation Department



Currency Equivalents

Currency Unit = Lek
calendar 1993 1 US\$ = Lek 100
March, 1994 1 US\$ = Lek 100

Abbreviations and Acronyms

AB	Agricultural Bank
BAD	Bank for Agriculture and Development
BoA	Bank of Albania
CMEA	Council of Mutual Economic Assistance
CAS	Country Assistance Strategy
EBRD	European Bank for Reconstruction and Development
EC-PHARE	European Union Assistance Program for Eastern Europe
ERA	Enterprise Restructuring Agency
EU	European Union
ESU	Enterprise Support Unit
FSU	Former Soviet Union
G24	Group of 24 Industrialized Nations
GDP	Gross Domestic Product
GDT	General Department of Taxes
IDA	International Development Association
IMF	International Monetary Fund
MFE	Ministry of Finance and Economy
MIME	Ministry of Industry, Mining and Energy
MIS	Management Information System
MOLSP	Ministry of Labor and Social Protection
NAP	National Agency of Privatization
NCB	National Commercial Bank
NMP	Preparatory Commission for the Process of Privatization
OED	Operations Evaluation Department
PCPP	Preparatory Commission for the Process of Privatization
PIP	Public Investment Program
RCA	Revolving Credit Account
RCB	Rural Commercial Bank
SB	Savings Bank
SII	Social Insurance Institute
SOE	State-Owned Enterprise
VAT	Value-Added Tax
VCFs	Village Credit Funds

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MEMORANDUM TO THE EXECUTIVE DIRECTORS AND THE PRESIDENT

SUBJECT: Albania: Country Assistance Evaluation

Attached is the report *Albania: Country Assistance Evaluation* prepared by the Operations Evaluation Department. This Country Assistance Evaluation (CAE) represents a continuation of the series of country focused studies designed to evaluate the relevance, efficacy, and efficiency of the Bank's assistance in one country and provide lessons for the future. A working draft of the CAE was sent to the Government of Albania, but comments were not received. A draft of this evaluation was discussed by CODE on July 15, 1998 and a report of that discussion is attached as attachment 1. This report is now being re-issued for the purpose of public disclosure.

Until the collapse of many pyramid schemes and the breakdown in civil order in early 1997, Albania's macroeconomic performance was unsurpassed amongst all the transition economies. Furthermore, the pace of structural transformation in many key areas was unprecedented. Many individual IDA funded projects did well, and in some cases were highly innovative, but the sum of these commendable efforts was not sufficient to ensure a sustainable development path.

Excellent country relations were established between IDA and the Government of Albania, resulting in rapid progress in a variety of areas (agriculture, external debt management, small and medium scale privatization, tax reform, price and trade liberalization and the rehabilitation of infrastructure). Much of this has endured despite the breakdown in civil order.

There were weaknesses in IDA's prioritization of assistance and the depth and focus of some sector assistance efforts, most notably the financial sector. While progress was made in rehabilitating health and education facilities, limited success was achieved in transforming the overall policy framework. Furthermore, the quality of infrastructure and delivery of services has improved only marginally due mainly to an inability to strengthen the public sector institutions involved.

A number of key lessons emerge from this CAE. First, strong attention must be given to the prioritization and sequencing of IDA's future interventions in Albania, with an appropriate balance of lending, supervision and non-lending activities. Second, future project design should seek to improve the accountability of service providers and implementing agencies through the involvement of all stakeholders in the design process. Third, future country assistance efforts should emphasize institutional reform, and where possible broad social participation in all project interventions.

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Contents

Preface.....	i
Overview	iii
1. Background.....	1
Historical Context	1
The Pre-Reform Economic System.....	2
The Developing Crisis.....	8
2. Evolution of IDA’s Strategy	9
Introduction	9
The Early Strategy—Learning and Responding	9
The Middle Strategy—Refining and Broadening	10
The Early Post Crisis Strategy—Focusing on Essentials.....	15
3. Strategy Implementation.....	17
Lending	17
Economic and Sector Work	20
Aid Coordination.....	21
4. Development Outcomes—Progress Towards a Market Economy	23
Introduction	23
Macroeconomic Stabilization and Overall Performance	23
Structural Changes	26
Unraveling of State Control and Macroeconomic Stabilization	36
5. Efficacy of IDA’s Assistance Strategy: Overall Assessment.....	37
Introduction	37
Relevance of the Overall Country Assistance Strategy	37
Sector Evaluations.....	40
Aid Coordination.....	48
The Efficiency of IDA’s Assistance Program.....	48
Conclusion.....	50
6. Lessons for the Future	51
General Lessons	51
Sector Lessons.....	52

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Boxes

1.	The Albania Country Assistance Strategy (FY99-01)—A Response to the CAE.....	xvii
4.1	Albania—External Debt Management: Commercial Bank Debt Restructuring	25
4.2	Albania—Development of the Pyramid Schemes.....	29
5.1	Partnerships for Educational Progress: The Work of the Soros Foundation’s Albanian Education Development Program.....	43

Figures

3.1	Total Aid Disbursements by Donor, 1992–1996	22
3.2	Total Aid Disbursements by Sector, 1992–1996	22

Tables

1.1	Albania—Selected Structural and Economic Features	2
1.2	Comparison of Agricultural Productivity Among East European Countries, 1988.....	4
2.1	Main Outline of IDA’s Assistance Strategy—FY94–96	11
2.2	Agriculture Sector Assistance Strategy.....	13
3.1	Portfolio Ratings and Supervision Effort.....	19
3.2	Intensity of ESW	21
4.1	Albania—Selected Development Indicators	24
4.2	Indicators of the Changing Structure of Albanian Agriculture.....	27
4.3	Albania—Wages and Employment in the Budgetary Sector	35
5.1	Comparative Data on the Efficiency of Bank Assistance Programs from FY92–96	49

Preface

This Country Assistance Evaluation (CAE) presents the findings of an OED team that visited Albania in December, 1997. This team held extensive discussions with government officials, representatives of the civil society and the academic community, NGOs, other donors and Bank staff in the Resident Mission. The valuable contribution and cooperation of all is gratefully acknowledged.

This CAE covers a period from 1992 to 1997 of IDA involvement with the Government of Albania and its development effort. The Evaluation covers 22 projects, a substantial economic and sector work program and an active policy dialogue that covered most aspects of economic life. The report presents a synthesis of the evaluation findings about a comprehensive and intense country assistance program. The bibliography encompasses nearly a hundred reports, books and journal articles, as well as voluminous operational documentation. All materials, as well as detailed working papers on each sector, are lodged in OED's Albania CAE files and available on request.

The CAE's main conclusion is that IDA's assistance to Albania was effective, and the partnership forged with the Government scored some notable successes. The breakdown in civil order in 1997, and the subsequent destruction of property was a major setback to all of the development progress achieved. But all was not lost. Good progress was made in agriculture, external debt management, small and medium scale privatization, tax reform and price and trade liberalization and this has endured. There were weaknesses in IDA's prioritization of assistance efforts and the depth and focus of some sector assistance efforts (most notably the financial sector, but also health and education). Perhaps of more fundamental importance was the lack of progress in state institution and public administration reform.

The lessons drawn from the CAE are presented at a general and a sector level. The aim has been to develop key issues and themes, culled from prior experience in Albania and elsewhere, that will assist IDA refine its country assistance strategy and future assistance efforts.

IDA's Assistance to Albania: An Overview

Introduction

1. Albania's economic and social development since the fall of communism in 1992 is riddled with paradox. Until the collapse of the pyramid schemes at the end of 1996, macroeconomic performance had surpassed all of the transition economies. Remarkably, growth was restored in 1993 and averaged over 9 percent per year for four years. Inflation was quickly reduced, falling from over 200 percent in 1992 to just 6 percent in 1995. Domestic savings, particularly private savings, steadily improved and investment as a proportion of GDP quadrupled in three years. Foreign assistance was massive. In the five years 1992 to 1996, Albania received US\$1.525 billion, or about US\$475 per capita, in total aid, the vast bulk of which (68 percent) were official grants. A measure of fiscal control was restored in 1993, and the domestically financed portion of the fiscal deficit declined continually up to the end of 1995.

2. There was a strong improvement in the balance of payments from 1992 to 1996, in part due to a massive increase in workers remittances which were estimated at over US\$300 million per annum in 1996. Growth in exports was strong, due to progress in the development of non-traditional exports such as garments and shoes and domestic food production increased rapidly reducing dependence on imports. Foreign reserves improved rapidly from the critical levels of 1991, and stabilized at about 3.5 months of imports equivalent. External debt management improved following conclusion of a debt reduction exercise, and efforts to improve debt monitoring are continuing.

3. According to conventional wisdom then, Albania was a 'star performer'. Not only were the macroeconomic indicators impressive, but the pace of structural transformation in many key areas was unprecedented. From almost zero in 1990, private sector employment accounted for over 75 percent of the domestic workforce by 1996. Much of this change was accounted for by the growth of smallholder agriculture and the construction industry. Also, given the rapid liberalization that occurred within the economy, there was a large increase in the trade and services sector and investment in light manufacturing.

4. One of the most striking changes that occurred in the country's economy was in the agricultural sector. By 1995, there were about 450,000 farms with an average size of 1.1 hectares, compared to about 550 farms with an average size of 1060 hectares in 1990. State farms completely disappeared by the end of 1992. For the period 1989 to 1995, it is estimated that total factor productivity has increased by 35 percent, the bulk of this increase deriving from an increase in labor productivity.

5. Albania moved swiftly on a privatization program and disengaging the state from commercial activities. This effort was undertaken via auction sale of small and medium enterprises and mass privatization, and by mid-1996 about 7500 firms had been sold. The larger State Owned Enterprises (SOEs) proved more intractable. While some budget discipline was imposed, progress in attracting strategic investors for the large SOEs proved disappointing. On the other hand, the environment for private sector development improved. State trading monopolies were abolished, external trade liberalized and the regulatory system made less onerous.

6. Progress began to unravel from mid-1996. In the run up to municipal and national elections, a fiscal deficit equivalent to 10.5 percent of GDP contributed to an acceleration in inflation to 17.5 percent in 1996 compared to 6 percent in the preceding year. But the collapse was triggered by the phenomenon of the investment funds and pyramid schemes, of which there were 17. They flourished from 1992 to 1995, offering depositors or "lenders" returns of between 1.5 to 4 percent per month. Some started out as quasi-legitimate investment funds, with commercial and trading activities (some of which involved smuggling and illicit arms trade). But by early 1996 things changed. Trading opportunities disappeared, partly as a result of the ending of economic sanctions against the Federal Republic of Yugoslavia. Liquidity became tighter. Hence monthly interest rates escalated rapidly (to between 10 and 40 percent a month by February 1996) and a collapse was inevitable. Up until November 1996, the Government was remarkably complacent about these funds, and evinced no desire to protect the public.

7. As 1996 progressed the mania surrounding the pyramid schemes increased in intensity, culminating in the collapse of the first in November 1996. Thereafter the house of cards collapsed quickly such that only five funds remained in existence by March 1997. The impact of this was massive, leading to widespread civil disorder and a complete breakdown in State control. By late 1996 it was estimated that 60 percent of Albanians placed funds in these companies and eight out of ten families had a least one depositor. The economic costs of this breakdown were high. There was extensive destruction of infrastructure and private property, many families experienced a loss of wealth and confidence in the State was further eroded. The loss in national income was large, with a real fall in recorded GDP of about 7 percent for 1997.

8. What had gone wrong? Were IDA and the other Donors blinded by the very good traditional macroeconomic indicators? What lessons relevant to development assistance in transition economies can be drawn? What are the implications for the Bank's future country assistance strategy to Albania? The objective of this Country Assistance Evaluation is to throw light on these questions. In order to do this it is necessary to understand the historical perspective that brought Albania to democracy in June 1992, how IDA's strategy evolved to deal with the development constraints, how this strategy was implemented and what can be said about the relevance, efficacy and efficiency of this assistance effort.

The Historical Context

9. First, what are the historical antecedents of Albania's unique development challenge? The country has undergone a turbulent history. Occupying a strategic position at the southern entrance to the Adriatic Sea, the country has been occupied and fought over ever since the Roman Empire conquered the entire Illyrian kingdom in 168 BC.¹ Over the centuries, Albania emerged as the interstice between three major civilizations and influences—the Turco-Muslim, the Slavic-Orthodox and the Western European.² From the 1470's, the country was part of the Ottoman empire, which ended with a declaration of independence from Turkey on November 28, 1912. The present national boundaries and nation state stem from a frontier demarcation made by an international commission in 1913. Occupied by Italy during the First World War, a provisional national government was formed following the Congress of Lushnje in January 1920.

1. Elez Biberaj, *Albania: A Socialist Maverick*. Boulder, Colorado: Westview Press, Inc., 1990

2. Fatos Lubonja and John Hodgson, "Why Perpjekja?" in *Perpjekja/Endeavor: Writing From Albania's Critical Quarterly*, Tirana, Albania, MNS, 1997

10. The period between the World Wars was marked by political instability, culminating in the autocratic regime of the self declared King Zog from 1928 to 1939. The country was annexed by Italy in 1939, and occupied by Germany in 1943. The Albanian Communist party (founded in 1941) formed a National Liberation Movement, and when the German troops left the Balkans in late 1944, assumed control under leader Enver Hoxha filling the political vacuum that existed at the end of World War II. Mr. Hoxha was the unchallenged leader of the country until his death in 1985.

11. After World War II, the country forged strong political links with various parts of the communist world (Yugoslavia, 1945-48, USSR, 1949-61 and China, 1961-78) and then pursued an isolationist foreign policy. Albania joined the Council for Mutual Economic Assistance (CMEA) in 1949, but withdrew in 1961. The country under Mr. Hoxha was totalitarian with one of the most repressive and centralized nations witnessed in the modern era. This centralism in the Albanian context meant both centralized planning and direction of the economy and central control of the political, social and the cultural life of the country and its people.

12. The long experience of foreign invasion and occupation fostered a strong nationalism and patriotic fervor, and in many respects, the Hoxha regime represented an attempt to forcibly establish and reinforce this national identity through rigid economic and social control. Thus, until the fall of the communist regime in 1990, Albania had no experience of democratic self government, but there was a strong tradition of social reliance on clan and family ties.

The Pre-Reform Economic System

13. In Albania's centrally-planned economy, all productive assets (including public utilities, agriculture, and land) were either state or collectively owned. Private property virtually vanished. By the early fifties, most market mechanisms had disappeared or gone underground and economic decisions related to production, pricing, investment and distribution became centralized and implemented through five-year plans. Agriculture was the predominant sector of Albania's economy. About two thirds of the population worked in the rural areas, and while the sector generated about 35 percent of GDP in the eighties, this understates its importance given biases in the administered pricing systems.

14. The industrial sector was the largest sector in the economy accounting for about 45 percent of net material product during the eighties. By 1990 there were approximately 400 State Owned Enterprises (SOEs), covering a very broad industrial base, including mining, heavy industry, and light manufacturing. These SOEs had limited managerial and financial autonomy, were over-manned, and were inflexible in adjusting products to market demand. Factor productivity was low, and by 1990, most of the country's industrial capital stock, factory equipment, and production technology were obsolete and in need of replacement.

15. Investment and maintenance of the country's infrastructure was deficient for much of the period of central planning. Albania is rich in power resources, with over 90 percent of present generation deriving from 11 hydropower stations. Severe institutional constraints in the service provider and deficient maintenance throughout the eighties steadily reduced the quality of service. Albania is also a water rich country with an annual average water availability of 3,080 cubic meters per person, the highest in Central and Eastern Europe. While 80 percent of the population had access to piped water in 1990, the country has been unable to supply the entire population with safe water. Low investment, poor operations and maintenance, and other institutional constraints resulted in unreliable and intermittent water supplies to all urban areas.

16. While data on the health situation of the Albanian population is incomplete, the health status was reasonably good. Life expectancy is nearly 73 years and the crude death rate is low reflecting the young age structure of the population. Medical personnel were cut off from global advances in technology and inadequate recurrent expenditure resulted in a gradual decline in health care quality in the eighties. Infant mortality was 24.2 per 1000 live births in 1988, but this worsened to 30.4 in 1995.

17. The education system in Albania was good and literacy almost universal. Nevertheless the quality of education deteriorated in the eighties, primarily due to inadequately funded recurrent and capital expenditures. The *social safety net* in Albania was primarily a social insurance system that provided retirement and disability pensions as well as some maternal, widows and orphans benefits. As employment was a right enshrined in the 1976 Constitution, unemployment benefits per se did not exist.

18. The financial sector existing in communist Albania was merely a counterpart to the five year plans. The sector was limited to a state bank, a savings bank and a state agricultural bank. The financial system had no independent decision making authority. Loans were not made on an economic basis and there was no analysis by bank staff of the viability of borrowers or their capacity to repay. As importantly, borrowers felt little obligation to repay.

19. Institutional development and governance up to 1990 was shaped by the imperatives of a highly centralized one-party state. By the nineties, this system produced a range of institutional problems that undermined the quality of public administration, service delivery, and governance. These problems included poorly defined institutional arrangements, endemic politization, poor "material" incentives, and widespread patronage and corruption. Confidence in, and respect for, any centralized public administration was at a very low level in 1990.

20. After decades of economic mismanagement and central planning, Albania could only survive with mass infusions of foreign assistance from the USSR and China. From 1950 to 1978, aid provided by the USSR and China amounted to the equivalent of 44 percent of total national investment, and 12 percent of national income. When this ended the system began to unravel. By 1989 mass unemployment (caused by the closure of many factories due to lack of inputs), rampant inflation and commodity shortages were drawing Albania into chaos. GDP fell by 10 percent in 1990 and a further 30 percent in 1991.

21. By early 1990, the demise of communism in most of eastern Europe, and the steadily deteriorating economy, had created strong public pressure for change. Following student demonstrations in December 1990, the Government of Ramiz Alia allowed the formation of opposition parties and promised free elections and independent trade unions. The ruling communist government announced a reform program, and undertook an internal reform of the party's economic and social policies. Elections were held in March 1991, which were won by the Party of Labor (the ex communist party). However the accelerating economic decline, a country-wide general strike and further demonstrations forced the renamed Socialist Party to form a coalition with the opposition Democrats in preparation for new elections in March 1992. These 1992 elections ended 47 years of communist rule as the Democratic Party won a majority in the newly re-designed Parliament.

22. In assessing the evolution and content of IDA's country assistance program for Albania, it is important to set the appropriate context. At the time of joining the World Bank Group the country and its economy were in disarray, and on the very brink of a complete breakdown in civil

order. It was, for all practical purposes a “failed state,” needing assistance across all sectors. Domestic institutional capabilities were very weak and civil society was fractured. By the Spring of 1992, over 30 percent of the urban work-force was not working, and this problem was being aggravated daily by large internal migration into the Tirana-Durres corridor. External migration exploded from near zero in 1990 to over 100,000 in 1991. This provided a “safety valve” in the absence of domestic social safety nets to cushion the economic decay in Albania. But it presented severe problems for surrounding nations. Hence, the readiness to provide concessional development assistance and the pressures on IDA to play an active role.

Evolution of IDA’s Strategy

23. In 1992, IDA’s strategy envisaged an intensive policy dialogue, in the context of an IMF supported macroeconomic stabilization program. Resolution of the critical food situation and restoration of critical elements of the country’s infrastructure were also considered high assistance priorities. In assessing Albania’s development prospects, IDA repeatedly identified weaknesses in state institutions and public administration as a major risk factor for individual projects as well as the entire country program.

24. In recognition of the volatility and uncertainty characterizing the implementation environment, IDA’s strategy emphasized flexibility as the best method to deal with macroeconomic uncertainties and the maintenance of the social consensus necessary for continued movement toward a market based economy. From an operational point of view, IDA argued for (i) a large number of small operations, (ii) an increase in co-financing to maximize the leverage of scarce IDA resources, (iii) a broad ESW effort to focus attention on potential lending areas through a public investment program, and (iv) the need to minimize preparation time for individual projects.

25. Areas afforded special attention included rehabilitation of basic infrastructure, development of private agriculture and a social safety net, restoration of basic education and health services, privatization of small and medium scale enterprises, downsizing large SOEs, development of a financial system, and normalization of relations with external creditors.

26. IDA’s strategy for *infrastructure* focused on physical rehabilitation, institutional strengthening of existing service providers, and a movement towards full cost recovery. It did not consider private sector participation at this stage given the urgent need to restore basic services. In the *agricultural sector*, IDA followed a comprehensive agricultural sector strategy completed in October, 1992 which was publicly endorsed by the Government shortly thereafter.

27. With regard to the *health and education sectors*, the focus of IDA’s strategy was to rehabilitate the basic infrastructure and restore critical supply inputs. The existing “health pyramid” was to be streamlined through consolidation of hospitals and a redefinition of the administration of primary and district level health care. For education, the immediate focus was on repairing classroom facilities and improving textbook supply with an aim towards building institutional capacity for planning, management, and quality assurance.

28. Throughout all aspects of IDA’s country assistance strategy at this time was a strong focus on *poverty alleviation and the social safety net*. It envisaged technical assistance to revise the legal and administrative frameworks for social insurance and social assistance systems. Poverty alleviation efforts were to include temporary interventions by the Government in rural poverty reduction, skill retraining, and special assistance to the most vulnerable. The longer term

program would restore actuarial soundness to the pension system and develop poverty monitoring mechanisms to improve benefit targeting.

29. The *financial sector* strategy, while not articulated separately, involved the creation of a strong and autonomous central bank, effective bank supervision, an appropriate legal and regulatory structure for commercial banks, and the creation of a competitive environment for universal banks. The strategy focused on the need to first build the necessary "regulatory/operational infrastructure" for a modern banking system before privatizing the existing state banks and encouraging the entry of new private banks.

30. The Bank considered the poor condition of *Public Sector Management* and *Institutional Development* the basic cause of poor absorptive capacity in the core public sector. However, no comprehensive strategy was enunciated for overall reform of the core public sector. Public administration reform is inherently a complex medium to long term challenge, and the Region believes that given the initial conditions and other more urgent issues, it was not possible for the authorities to focus on comprehensive public administration reform. There is merit to this view. In terms of the short run stabilization effort, the Bank sought to enhance revenue collection capacity by broadening the tax base and modernizing tax administration.

31. Given its urgency, IDA called for a variety of *privatization* methods. IDA's recommendations for privatization envisaged the reforms in the financial and enterprise sectors as concurrent. IDA also saw rapid privatization of small and medium scale firms and the creation of a "private sector friendly" legal and regulatory environment as simultaneous processes.

Strategy Implementation

32. IDA commitments to Albania during the period under review (1992-1996) amounted to US\$272.5 million with approval of 22 projects. Since growth in Albania's agricultural sector would have arguably had the largest impact on reducing poverty, the Bank undertook six lending operations in this sector. Transport infrastructure, a severe constraint on economic growth, received three IDA operations focusing on national and rural roads as well as market-oriented policy reforms. Two major operations in the energy sector aimed to reduce non-technical electricity losses and inefficient use of electricity as well as strengthening distribution systems. Seven projects addressed the broad ranging issues of human resource development.

33. The industry and finance sectors were both the focus of a complex Enterprise and Financial Sector Adjustment Credit (EFSAC) in 1994. The credit supported the development of the banking system, the continued privatization in the industrial sector, and the liquidation or downsizing of non-viable SOEs. An earlier TA operation also supported the Government's privatization efforts and sparked initiatives in financial sector reform. Finally, two IDA operations in the agricultural sector attempted to provide credit to farmers through the establishment of an Agricultural Bank and the provision of targeted micro-finance.

34. The urban sector received two lending operations from IDA to (i) support the transition to a largely market-oriented housing sector and (ii) deliver micro-credit and small urban works by participatory means. The water supply sector received one IDA operation to improve the efficiency and management of existing Durres water supply and sewerage systems.

35. In the initial stages, IDA commitments were disbursed quickly. However, institutional weaknesses in public administration and delays in key reform conditionalities reduced disbursement ratios over time although they remained above IDA averages. In some sectors, IDA scored major gains towards physical project objectives and created demonstration effects by circumventing the Government's inefficient public administration using (i) temporary management institutions such as project implementation units (PIUs), (ii) quasi-governmental organizations or foundations (QGO/Fs), and (iii) innovative participatory techniques for service delivery. The relatively low level of supervision effort across these ongoing projects between 1992 and 1996 can be partially attributed to a young portfolio. Supervision ratings of projects during this early period were almost universally satisfactory. The two completed projects in the portfolio had satisfactory outcomes. But sustainable progress on institutional development remained elusive.

36. Over the 1992-1996 period, ESW undertaken on Albania was significantly lower than other transition countries. In the case of agriculture and the environment, ESW preceded major lending activity and provided a sound conceptual basis for operations. To a lesser extent, ESW focused on human resource development, through an early health sector review in 1992 and a poverty assessment in 1997. During the period between 1992 and 1995, the ESW effort fell dramatically, which was not consistent with the stated country strategy particularly in transport, the financial sector and public administration reform. A Public Expenditure Review (PER) was planned for 1997, but was canceled due to the civil disorder

37. Twenty two major donors are currently supporting 309 ongoing operations in Albania. The European Community is the largest donor, followed by the Government of Italy, and then IDA. The bulk of assistance by donors between 1992 and 1996 went for humanitarian (i.e., food aid and medical supplies) and balance of payments assistance. While the productive and social sectors appropriately received approximately a third of all assistance, infrastructure with 11% seems to have been under-funded given IDA and other donors' stated priorities³. In addition, state institution and public administration reform, a key constraint, was under-funded by all major donors. Albania's aid consortium has been led jointly by the EC and IDA.

Overall Assessment of IDA's Assistance Strategy

Relevance of the Strategic Vision

38. In the early stages, with the IMF taking the lead, IDA placed a high priority on macroeconomic stabilization. This early strategy was highly relevant. Following the initial success of stabilization, the focus of the strategy became more blurred, as prioritization and sequencing of the reform agenda became more difficult. The country program envisaged a large number of small, targeted operations of simple design and thereby straightforward to implement. Given the weak domestic institutional capacity, and the ability of IDA to leverage other donor resources, there was merit to this approach. But there were also risks, some of which did materialize (see paragraph 5.6 in the main body of the report).⁴

3. It should be noted however that in IDA's portfolio from FY92, 45% was allocated to infrastructure development.

4. The ECA Region does not agree with this finding, and argues that there was an effort to prioritize country assistance efforts throughout the period under review.

39. One of the many paradoxes found in Albania is that many individual projects did well, and in some cases were highly innovative (see the agricultural sector evaluation in paragraph 45 below), but the sum of sound projects was not sufficient to ensure an overall development path that was sustainable. Key macroeconomic indicators which were performing well, coupled with rapid progress in liberalization perhaps diluted perceptions of key policy and regulatory omissions and the danger that they posed. For most of the period under review, IDA tried to do a bit of everything, and perhaps did not fully appreciate the fragility of the evolving political system. This is not to suggest however that the Bank could have done more to address these underlying political issues.

40. While the need for assistance in all sectors was clear, IDA's strategy from 1993 to early 1996 did not fully appreciate the risks of overload inherent in a rapidly growing and diverse portfolio and a fragile institutional framework.⁵ The events and crisis in Albania in the first half of 1997 led to a rethinking of the country assistance strategy. Recognizing that trust in government and public authority was at a low ebb, IDA set three very clear priorities—fundamental reform of public administration, re-establishment of macroeconomic stability and a focus of key constraints to the revival of economic activity.

Sector Evaluations

41. *Agriculture.* In partnership with the Government, IDA did well in the agriculture sector. The sector strategy followed by IDA was relevant, led by good ESW undertaken in 1992 which was embraced by the Government as its own sector policy framework. The balance in the lending program has been good and well targeted. IDA took a very participatory approach with its assistance to the sector, and in a number of instances was quite innovative. Efforts in rural poverty alleviation were highly satisfactory, as were efforts in rehabilitating the country's irrigation system. In both cases, creation of beneficiary associations contributed to successful project outcomes. Despite the breakdown in civil order, much of what was achieved in this sector has been sustained and represents a solid foundation for future development.

42. *Health.* Little progress has been made in resolving the fundamental problems of the health sector. Sector issues are little changed from the pre-crisis period, but are now more urgent. While progress was made in primary health center rehabilitation, creation of a sector strategy with a shared vision of sector priorities has proven to be elusive. The Ministry lacks capacity for planning and policy. The need for comprehensive sector work to facilitate a consensus on the part of the Government and the donor community on a medium term development agenda is overdue.

43. *Education.* IDA's initial focus on school rehabilitation was correct, and progress was made in repairing the physical plant from 1993 to 1996. Nevertheless little progress has been made in addressing the remaining fundamental problems of the sector which include inadequate financing, lack of accountability for teaching outcomes, institutional reform in the Ministry, and an appropriate role for the private sector and NGOs. IDA's involvement has not followed a strong beneficiary participation approach.

44. *Infrastructure.* IDA's strategy for infrastructure was straightforward—rehabilitate and restore. While this was done to some extent, the quality of infrastructure and delivery of services

5. The ECA Region believes that there were crucial issues in all sectors that could not be ignored by the Government and IDA assistance on all of these issues was necessary given the weak public administration framework.

has improved only marginally over the past six years, even discounting for the damage and disruptions caused by events in 1997. The primary reason has been an inability to strengthen the public sector institutions providing these infrastructure services. IDA was overly optimistic that these weaknesses could be cured by technical assistance, training and organizational realignments. IDA's policy dialogue to secure policy change in the infrastructure sector had mixed results, and more emphasis should now be given to a greater role for the private sector in the provision of utility services.

45. IDA's assistance in port rehabilitation was relevant, effective and sustainable, and included a plan to have a staged approach to the privatization of the variety of port services. Modest progress was made in developing the road network. Assistance to housing failed.

46. *State Owned Enterprises and Privatization.* Overall, IDA's partnership with the Government in transforming industry and removing the public sector from commercial activities was successful. Small and medium scale privatization has been largely completed, and has been sustained despite the crisis. Entrepreneurial dynamism is very strong in Albania, but the need for a regulatory environment that is transparent and uniformly applied has now become acute. Vibrant private sector initiative is a powerful development ingredient, but in the absence of some basic "ground rules" transactions costs escalate rapidly and anarchy ensues.

47. The relatively low attention accorded the large, so called "strategic" SOEs by IDA allowed the Government to temporize in both restructuring and obtaining the involvement of strategic investors. This was a conscious IDA strategy in order to focus on small and medium enterprises and thereby accelerate employment generation. The Enterprise Restructuring Agency, supported by IDA, was faced with a politically sensitive mandate which ultimately diminished its effectiveness. IDA's emphasis on privatization accelerated in 1995 and 1996, with assistance and policy advice to the Government on the mass privatization program. This program was successful in distributing vouchers to the population and in share auctions. However, a fully functioning share market has yet to be developed, and few of the firms subject to mass privatization are under the effective control of new managers.

48. *Finance and Banking.* IDA's efforts to create a viable and self sustaining financial sector did not work. This was not from want of trying. But sustained Government commitment to deal more forcefully with the publicly owned banks was absent. The initial sector strategy was flawed in the belief that restructuring state banks, without a fundamental change in their internal accountability and incentive frameworks, could bring about performance and efficiency improvements. The emphasis of IDA's efforts and policy dialogue in the sector varied continually throughout the five years under review. The fact that a comprehensive financial sector study was not completed in 1992 or early 1993, mirroring the work done in the agriculture sector, was a mistake.

49. Some progress was made in strengthening the Central Bank, but the pace of progress on certain key issues, such as a unified banking system chart of accounts, proved very slow. Some restructuring of state owned banks was achieved, but the Government never displayed the full commitment to deal with these institutions' bad debt portfolios and there was considerable political interference in both lending decisions and day to day management of banks. In contrast to the successful developments in credit delivery to the poorer rural areas where there was a manifest understanding of the psychology and needs of those served, IDA's strategy for the larger state banks did not take fully into account the tradition of non-repayment of loans deeply embedded in the society given the past roles of these institutions.

50. The Bank expressed concern about the lack of formal regulation of the investment funds and pyramid schemes in January 1995. This was communicated in an Aide Memoire to the Minister of Finance in February 1995. The Government took no action, despite attempts by the Governor of the central bank to subject the schemes to central bank inspection. The Bank as well as the IMF did not appreciate the scale and parlous state of these funds until the third quarter of 1996.

51. *State Institution and Public Administration Reform.* Even though IDA recognized that public administration in Albania in 1992 was very weak, a comprehensive strategy to reform the core public sector was not developed. The strategy relied on "substitution TA" to fill gaps, and essentially addressed symptoms rather than the roots of the institutional problem. Despite high levels of corruption, patronage and politicization, neither the Bank, nor other donors, fully recognized the need for an effective governance strategy, including an anti-corruption component and a focus on improving the transparency of government processes.

52. The use of Technical Assistance credits to restructure key agencies (Tax and the Social Safety Net) was strategically sound and did support institutional development. This success was a function of clear and simple project design with highly specific objectives. The Bank underestimated the value of ESW and its long term utility in dealing with a public administration reform agenda. One example is the lack of a comprehensive Public Expenditure Review. In sum, the efficacy of IDA's public administration reform program was poor. What was done was limited to short run improvements in performance in a few agencies, with little overall impact on governance.

53. *Aid Coordination.* Initially aid coordination was weak but it improved over time. Up to 1996 it consisted of an annual donors group meeting which outlined each donor's intentions. There was informal interaction, normally between groups represented in Albania, on sector issues and project progress but this was ad hoc. What was missing was a fully integrated development agenda, with agreement between donors on the components and the timetable of sector involvement.

54. Aid coordination improved in 1997, with much more frequent meetings of the donor group. Furthermore, sector group meetings in the country have started to meet more frequently with the goal of agreeing upon a common sector strategy, individual donor responsibilities and accountabilities, timetables and project sequencing. In this latter regard, IDA's role in providing comprehensive ESW is a crucial ingredient for improving the quality of the donor coordination and the strategic selectivity of IDA intervention.

Efficiency of IDA's Assistance Program

55. The Albania program compares favorably in terms of Bank-wide measures of budget efficiency. But, the low ratio of total staff-years or lending staff-years per project is partially a function of the extraordinarily high numbers of operations approved. Lending required nearly half the total staff-years allocated to Albania, which is significantly higher than the Bank-wide average of 30 percent. The supervision effort fell below Bank-wide averages for the period under review, in part due to the newness of the program. The considerable breadth of lending across multiple sectors had a price in terms of the depth or intensity of staff effort for each operation, in terms of ESW prior to lending or supervision during a project's life. The Region

believes, however, that considerable sector work was undertaken in the context of project preparation and therefore the reported ESW staff time is misleading.⁶

Main Conclusions

56. Excellent country relations were nurtured between IDA and Albania. Very good progress was made in agriculture, external debt management, small and medium scale privatization, tax reform, price and trade liberalization and a contribution was made in the rehabilitation of infrastructure. But lack of progress in key areas overshadowed these positive achievements. There were weaknesses in IDA's prioritization of assistance efforts and the depth and focus of assistance efforts in the financial sector, and also in health and education. Initially, the Bank's concerns about the need for stricter scrutiny and regulation of the investment funds/pyramid schemes were not expressed forcefully enough.

57. The pyramid schemes were symptoms of a deeper set of problems and a breakdown in civil order might have occurred even if the collapse of the pyramid schemes would have been avoided. Political polarization and macroeconomic management problems were emerging in late 1995. Development of public administration and state institutions along lines suitable for a liberal market economy did not occur. The lack of a strong focus on governance and institutional reform was a critical omission.

Lessons for the Future

General Lessons

58. Implementing the following two principles would improve IDA's effectiveness in Albania:

- More thought needs to be given to prioritization and sequencing of IDA's interventions.
- Greater care needs to be paid to the "balance" in IDA's program of lending, supervision and non-lending activities. Where detailed sector strategies are absent, suitable ESW resources should be devoted to filling the gap.

59. *Develop a System of Graduated Response for Crucial Issues.* The Region and the Bank should develop a process that ensures that crucial issues or policy slippage are brought to the attention of senior management expeditiously. These special concerns should be brought to the attention of the authorities and of the entire donor community and the Bank may want to consider establishment of a formalized system of graduated response to key policy issues.

60. *Increase Emphasis on the Accountability of Systems.* Future project design must seek to improve the accountability of those responsible to provide a service or complete a project. Therefore project design must involve all stakeholders, if only to define the parameters of project accountability. The value of participatory techniques for enhancing accountability was clearly manifest in the Rural Poverty Alleviation Pilot Project's reliance on civic traditions of mutual

6. The Region believes that the supervision effort was appropriate given the small country characteristics of Albania—repeated projects; annual CPPR exercises; extensive procurement assistance; and single Ministries with multiple project responsibilities.

trust among villagers to ensure good repayment performance. By contrast, the top down, supply-driven approach of the Education and Health Rehabilitation projects provided little by way of stakeholder ownership and therefore, accountability.

61. *Aid Coordination Needs Greater Attention.* Experience suggests that aid coordination needs to be conducted on two levels: consultative/donor group type meetings, and sector level coordination meetings dealing with each donor's progress in project implementation, and identification of problems encountered and sequencing of complementary efforts.

Sectoral Lessons

62. *Agriculture.* Most of the lessons from IDA's assistance to the agriculture sector in Albania are positive—timely ESW, participatory approach in project design, creation of community based institutions, simple project design, and strong Government ownership. The challenge for the future will be how to build on this success. The incentive frameworks are in place and good progress has been made in rehabilitating the supporting infrastructure, with the possible exception of rural roads in the more remote areas. Listed below are key items for the next phase of assistance:

- a) Land holdings are small and fragmented. This will be a constraint to the transition from the current, largely subsistence farming to a market oriented, commercial agriculture. An active land market needs to develop to facilitate consolidation. The legal framework is in place, but the titling and registration process is still underway with assistance from USAID. Progress needs to be monitored carefully and IDA support in parallel with USAID might accelerate the process.
- b) Rural credit will also be a constraint. IDA recognizes this and is seeking to transform some of the Village Credit Funds (VCFs) into more self sustaining rural credit union type financial institutions. The approach is cautious (on a pilot basis) which is good and the effort needs to be monitored closely.
- c) Further efforts are needed to strengthen the organizational sustainability of the WUAs in the irrigation system. A key element in this will be institutional development of the district water enterprises and improving their financial viability.
- d) Future growth in the agriculture sector will mainly come from improved technology and input use. Agricultural research and extension services will be a critical component in this. Progress has been made in establishing a national public extension service, but the approaches and quality vary quite markedly across districts. A variety of donors are involved, however coordination guided by a national extension conceptual framework, that encapsulates a role for the private sector in the national extension service plan.

63. *Health.* Comprehensive sector work is needed as a vehicle for policy dialogue and agreement on a sector strategy. There needs to be definition of an appropriate role for the Ministry of Health, district level administrations, the training establishments and the private sector. Institutional development is a high priority, with a strong need to improve the incentives and accountability of those providing health care services. Further assistance to rehabilitate primary health centers should only proceed when there is agreement on a sector policy framework.

64. *Education.* A sector strategy is absent, and appropriate institutional roles for those involved in education have yet to be defined. There is little parent involvement at local and district levels with the result that accountability for the quality of service delivery is poor. The scope for beneficiary participation in project implementation in this sector is high. Furthermore there is scope for greater partnership in this sector, particularly with active members of the NGO community.

65. *Infrastructure.* Seeking to work with dysfunctional public utilities, without a fundamental change in management and employee incentive and accountability structures, does little to improve the quality of essential services such as power and water. Attempts at institutional development often fail because the entrenched vested interests in maintaining the status quo are too strong. Thus, the Bank Group should focus more intensively on working with the Government in setting up an infrastructure privatization program and the related regulatory framework. Furthermore, experience in other countries has shown, that greater beneficiary participation in the provision of rural power and water is possible. This lesson is applicable to Albania.

66. *State Owned Enterprises and Privatization.* The lessons gleaned from IDA's assistance to Albania are similar to those learned in other transition economies. Endeavoring to restructure large SOEs without strategic investor involvement rarely works. Mass privatization, to be fully effective, needs to proceed in parallel with capital market development to allow consolidation of control shareholdings by investment groups and funds. This requires securities legislation and an oversight regulatory body for share transactions. Small, and in certain cases medium level, firm privatization can be rapid and can include cash auctions and past management/employee involvement with payments being made on a deferred basis. The important issue is to have managerial oversight that is focused on profit generation. For the future, IDA and the Government must be more vigorous in seeking private involvement in the larger so called "strategic" SOEs. IFC can play a major role here. To be successful, potential private sector investors should be granted flexibility to effect changes in firm organization and operations.

67. *Finance.* The major lesson here is that trying to restructure state owned banks in the transition economies has rarely proved successful. Key objectives in the future should be to continue to strengthen the central bank, particularly in bank supervision, and ensure its freedom to act to enforce sound prudential and bank licensing regulations. IDA should take a more proactive role in seeking to encourage the development of the nascent private banking system in the country, as well as encouraging other members of the donor community (such as IFC and EBRD) to be active in the sector.

68. *Public Administration Reform.* Improving governance and the quality of public administration and public perceptions of State institutions should receive a high priority in IDA's future assistance strategy. From the past experience in Albania certain key directions and principles are manifest.

- a) A sound conceptual framework for the core public sector and public management must be articulated. This should encompass all layers of State institutions, including service delivery entities.
- b) Very comprehensive sector work is necessary, both to articulate the conceptual framework and to be used as a means of reaching consensus with the Government of Albania of the reform path. A Public Expenditure Review is long overdue.
- c) Past experience in Albania has shown that a strong participatory approach in service delivery and governance builds ownership and has had a very positive effect on outcomes and sustainability. It is therefore an important ingredient of any legal, regulatory or anti-corruption initiative.

Box 1: The Albania Country Assistance Strategy (FY99-01)—A Response to the CAE

The Region is preparing a new CAS for Albania which is expected to be presented to the Board shortly. The CAS takes into account the main lessons learnt from the CAE and the 1997 crisis. One of the main lessons is that the root cause of the crisis - which derailed Albania's development process - was an extremely weak state, which in itself is caused by a fragmented society with stronger allegiances to family clans than to joint citizenship. Low commitment to community values, the lack of authority of the state and inefficiencies of public structures were important reasons for the widespread civil disruptions and the set-back in economic progress experienced in 1997.

The strengthening of this weak state will be a key theme of IDA's country assistance strategy for FY99-2001. Reforms in public administration, legal/judicial reforms, efforts to combat corruption; the creation of Government structures at the municipal or local level will be the focus of attention in the CAS strategy. Strengthening of governance and public institution building are long term efforts which will need to be complemented by engaging the population in the development process. In our future strategy, IDA will rely, to a greater extent than in the past, on participatory approaches. Local population groups are expected to be engaged in the design and implementation of projects in the education sector, the delivery of social services, in maintenance of infrastructure projects, in communal works programs and microcredit operations. Through these participatory approaches we hope to create ownership among the population for these operations which would protect development projects from destruction should civil disorder again disrupt and assure greater user efficiency.

IDA will continue to work closely with the IMF in assuring macroeconomic stability, a necessary condition for growth. IDA will especially focus on rationalization of public expenditures. The sectoral reform agenda will be more focused than in past years on three main clusters of activities: governance and financial sector reforms, cost-recovery based infrastructure (especially water and power), and social sector reforms. Support will be provided through structural adjustment lending as well as investment operations. Banking sector reforms will be focused on privatizing and restructuring the public banking sector in order to create conditions for private sector banking to develop. In the power and water sector the objective is to privatize management in order to increase efficiency of these services. Through social sector reform programs, IDA intends to assist in the formation of human capital through access to basic education and health facilities. Social protection will be provided to the most vulnerable groups in society. Systemic reforms in education, health and social protection systems are required in order to improve the delivery of social services and increase efficiency. IDA will only proceed with adjustment and investment lending in any of these areas, if agreement has been reached on a satisfactory reform agenda.

The strategy to be pursued under the upcoming CAS is still a broad based sectorial strategy. Albania's situation - a country surrounded by much more developed countries and closely linked to wealthy European countries (especially Greece and Italy) - does not allow for a gradualist approach to development. Internal social pressures to reach higher levels of consumption, combined with very weak state structures and lack of public authority, carry the risk of further eruption of civil disorder. Visible progress in the development agenda, built on the broad-based support of the population, is needed. This requires the Albanian authorities to undertake ambitious reforms and progress in several key sectors concurrently. The Albanian Government has repeatedly approached IDA requesting support in the design and implementation of these essential reform programs. The Region proposes to remain a partner in Albania's key development challenges - rather than intervening only selectively - in the belief that these reforms will be better achieved with than without IDA assistance. IDA will pursue these objectives in close cooperation with other donors, domestic and international NGOs and foundations.

1. Background

1.1 This Country Assistance Evaluation provides an assessment of the World Bank's assistance to Albania since the country joined the World Bank Group on October 15, 1991. The economic and political development of the country up to the commencement of IDA assistance is traced in this chapter. Chapter 2 provides an outline of the initial development constraints and IDA's strategy for dealing with these constraints, and how this strategy evolved over time. Chapters 3 and 4 discuss how IDA implemented its articulated strategy, with also a discussion of the efficiency of this implementation, and the development outcomes. The final two chapters provide an overall assessment of the relevance, efficacy and efficiency of the country assistance strategy, followed by recommendations and lessons for the future.

The Historical Context

1.2 Albania cannot be properly understood without some historical perspective. The country has undergone a turbulent history. Occupying a strategic position at the southern entrance to the Adriatic Sea, the country has been occupied and fought over ever since the Roman Empire conquered the entire Illyrian kingdom in 168 BC.¹ Over the centuries, Albania emerged as the interstice between three major civilizations and influences—the Turco-Muslim, the Slavic-Orthodox and the Western European.² From the 1470's, the country was part of the Ottoman empire, but this ended with a declaration of independence from Turkey on November 28, 1912. The present national boundaries and nation state stem from a frontier demarcation made by a international commission in 1913. Occupied by Italy during the First World War, a provisional national government was formed following the Congress of Lushnje in January 1920.

1.3 The period between the World Wars was marked by internal political instability, culminating in the autocratic regime of the self declared King Zog from 1928 to 1939. The country was annexed by Italy in 1939, and occupied by Germany in 1943. The Albanian Communist party (founded in 1941) formed a National Liberation Movement, and when the German troops left the Balkans in late 1944, assumed control under leader Enver Hoxha filling the political vacuum that existed at the end of World War II. Mr. Hoxha was the unchallenged leader of the country until his death in 1985.

1.4 After World War II, the country forged strong political links with various parts of the communist world (Yugoslavia, 1945-48, USSR, 1949-61 and China, 1961-78) and then pursued an isolationist foreign policy. Albania joined the Council for Mutual Economic Assistance (CMEA) in 1949, but withdrew in 1961. The country under Mr. Hoxha was totalitarian with one of the most repressive and centralized nations witnessed in the modern era. This centralism in the Albanian context meant both centralized planning and direction of the economy and central control of the political, social and the cultural life of the country and its people. In 1967, Albania became the first self proclaimed atheist country and strictly outlawed all religious practices.

1. Elez Biberaj, *Albania: A Socialist Maverick*. Boulder, Colorado: Westview Press, Inc., 1990.

2. Fatos Lubonja and John Hodgson, 1997. "Why Perpjekja?" in *Perpjekja/Endeavor: Writing From Albania's Critical Quarterly*, Tirana, Albania, MNS, 1997.

1.5 Two general phenomena emerge from this historical experience. The long experience of foreign invasion and occupation has fostered a strong nationalism and patriotic fervor, and in many respects, the Hoxha regime represented an attempt to forcibly establish and reinforce this national identity through rigid economic and social control. Nevertheless, within the country the traditions of loyalty are strongly embedded in extended families, clans and villages which was a natural means of survival in the face of alien occupiers or domestic oppressors. Furthermore, until the fall of the communist government in 1990, Albania has had no experience of democratic self government. Therefore, there is a lack of deep understanding of the concepts of individual rights, the limits to power of governments and the political independence of public administration.

1.6 By early 1990, the demise of communism in most of eastern Europe, and the steadily deteriorating economy, had created strong public pressure for change. Following student demonstrations in December 1990, the Government of Ramiz Alia allowed the formation of opposition parties. Further demonstrations brought new concessions, including the promise of free elections and independent trade unions. The ruling communist government announced a reform program, and undertook an internal reform of the party's economic and social policies. Elections were held in March 1991, which were won by the Party of Labor (the ex-communist party). However the accelerating economic decline, a country-wide general strike and further demonstrations forced the renamed Socialist Party to form a coalition with the opposition Democrats in preparation for new elections in March 1992. These 1992 elections ended 47 years of communist rule as the Democratic Party won a majority in the newly redesigned Parliament.

The Pre-Reform Economic System

1.7 The Albanian economy was characterized by the fact that over time all productive assets were either state or collectively owned and private property virtually disappeared. All public utilities and foreign capital was nationalized in 1946, and all agricultural estates larger than 5 hectares were confiscated. Contrary to the speedy assumption of all industry assets, collectivization in agriculture was much slower, only being completed by 1967. The new Constitution of 1976 legalized the nationalization of all land. Internal trade was fully state owned and controlled, and external trade was carried out by a few specialized state enterprises.

1.8 By the early fifties, most forms of market mechanisms in the country had been replaced by central planning. All economic decisions related to production, pricing, investment and distribution were centralized and implemented within the context of five-year plans. Prices and wages were fixed, and remained unchanged for long periods, and the domestic prices of tradeables were insulated from external influences through taxes or subsidies. The system of state planning was very similar to the Soviet model, with a State Planning Commission, subordinate to the Council of Ministers, tasked with formulating a detailed plan of output for each productive unit within the economy. From the very beginning of central planning, there was a strong bias in favor of industry, especially heavy industry, and the mineral sector.

1.9 Goods shortages were a frequent phenomena and rationing of consumer goods was common. Labor mobility was very low, and each enterprise had a well defined employment structure with a fixed allocation of workers. To ensure nominal full employment, it was not uncommon for the allocated work-force in a particular enterprise to be increased extant from a planned increase in output. The State Budget was linked strongly to the State Enterprises, with the budget financing all investments and/or losses and receiving 90 percent of the profits. The state enterprises tended to be large (average employment of about 700 in 1989) due to horizontal

and vertical integration. Firm managers had no economic decision making autonomy, relying solely on directives from their respective branch ministry.

1.10 The planning system as applied in Albania in the 1980's was much more rigid and extreme than that applied in other Eastern European countries. Up until 1988, there was never any serious attempt to decentralize; rather the changes that were periodically introduced led to further centralization and further reductions in firm level accountability. Agricultural collectives were given some freedom (with only 10 percent of their "profits" transferred to the budget), however even some allowable small-holder activity (e.g. livestock) was prohibited in the early eighties.³

1.11 In common with other centrally planned economies, gross investment, as a share of GDP, has been historically high at about 30 percent. The quality and productivity of this investment was low however. When compared to other East European countries a dismal picture emerges. Over the period 1981-89, Bulgaria's capital productivity was almost twice as high as Albania, and that for Czechoslovakia about 50 percent higher. The reasons for the obsolescence and low productivity of the capital stock in the country may be directly traced to Albania's foreign economic policies over the past four decades. Most capital goods originated from the socialist countries, with frequently outdated or inferior technology. Equipment was maintained long beyond its normal service life, often with domestically produced spare parts which downgraded still further the quality of the capital stock.

Table 1.1: Albania—Selected Structural and Economic Features^a

	1985	1988	1988	1989	1990	1991
GDP Growth (% change)	0.4	-0.8	-1.4	9.9	-10.0	-30.0
Share of Net Material Product (%)						
Agriculture	34	34	33	32	33	40
Industry	43	44	43	44	45	38
Personal Consumption	64	68	69	66	78	n.a.
Net Fixed Investment	22	24	24	24	22	12
Resource Balance (% GDP)	-2.2	-0.1	-2.8	-2.8	-8.0	-17.4
Exports (% GDP)	16.2	15.5	16.4	17.9	15.1	10.7
Imports (% GDP)	18.5	15.6	19.2	20.7	23.1	26.4
Overall Fiscal Deficit (% GDP)	0.1	1.7	1.2	8.6	15.2	33.2
Consumer Prices ^b	0	0	0	0	0	35.5
Unemployment (% work-force)	5.9	5.2	6.0	6.7	8.6	8.9

a. *Source:* Various Government of Albania, IMF, and World Bank Documents.

b. All prices were administratively set until 1991, when they were partially liberalized.

1.12 External trade was relatively low for a country of Albania's size. Imports averaged about 19 percent of GDP in the last five years of the eighties, and exports a modest 16 percent. This reflects the very closed nature of the economy. Most of the trade was with the CMEA and developing countries, with mineral and energy exports to hard currency areas accounting for about 30 percent of total export values.

1.13 *Agriculture* is the predominant sector of Albania's economy. About two thirds of the population worked in the rural areas, and while the sector generated about 35 percent of GDP in the eighties, this understates its importance given the biases in the domestic pricing system. As

3. For a fuller description of Albania's economy in the eighties see World Bank, *Albania: Policies for the Development of a Market Economy*, Report No. 10462-ALB, February 28, 1992. Also IMF, *Albania: From Isolation Toward Reform*, Occasional Paper 98, September 1992.

noted, collectivization of land proceeded in various stages over a thirty year period culminating in the 1976 Constitution declaring that all land was the property of the state. Arable land in 1990 was about 700,000 hectares, and increased significantly during the sixties and seventies through land reclamation, extension of irrigation and electricity services and soil improvement programs. In 1990, there were 150 state farms (cultivating about 24 percent of arable land) and 492 cooperative farms. Some private plots were permitted for members of the cooperatives (about 4 percent of arable land), but it is notable that these private holdings are estimated to have contributed about 21 percent of total agricultural output.

1.14 Real growth of gross agricultural output averaged about 1.7 percent annually, with the major component being crops (58 percent) of which grains accounted for about 40 percent of arable land and livestock (30 percent of output). This production pattern reflected the national strategy of attaining self-sufficiency in food production. Productivity in the sector was low even by centrally planned economy standards (see Table 1.2 below). Also data for 1980-90 shows either stagnation or declines in yields for nearly all categories of crops, fruit and livestock. Investment in the sector was focused on irrigation development and farm machinery, however capital formation in the cooperative sector was very erratic given their greater dependency on own-resources.

Table 1.2: Comparison of Agricultural Productivity Among East European Countries, 1988

	Albania	Bulgaria	Czechoslovakia	Hungary	Poland	Romania
	(in tons per hectare)					
Wheat	3.20	4.01	5.28	5.45	3.48	3.58
Potatoes	5.41	9.73	20.64	n.a.	18.60	n.a.
Sunflower seeds	0.70	1.57	n.a.	n.a.	n.a.	1.51
Sugar beets	17.19	16.08	18.60	39.34	34.14	11.36
Milk yield per cow (in liters)	1,274	3,397	3,777	n.a.	n.a.	2,074
Eggs per chicken	96	170	247	n.a.	n.a.	154

Source: World Bank, IMF

1.15 The *Industrial sector* was the largest sector in the economy accounting for about 45 percent of net material product during the eighties. Given internal price distortions however this may have been overstated. The sector accounted for about 42 percent of gross investment and provided employment for about 23 percent of the work-force during the eighties. By 1990 there were approximately 400 State Owned Enterprises (SOEs), covering a very broad industrial base, including mining (chrome, copper and nickel), heavy industry (steel) and light manufacturing (clothing, food processing). This broad base reflected autarkic development rather than the economy's comparative advantage and the sector expanded rapidly from a very small base in the sixties and seventies. This rate of growth declined to an annual average of about 3 percent in the eighties.

1.16 Albania's industrial SOEs were not incorporated and functioned simply as production units of various branch ministries. They had limited managerial and financial autonomy, were over manned, had little market knowledge and were very inflexible in adjusting product to market needs or demand. Factor productivity was low, and by 1990, most of the country's industrial capital stock was obsolete, much of the factory equipment was in need of replacement or rehabilitation and production technology more akin to that employed in the fifties in Western Europe.

1.17 Investment and maintenance of the country's *Infrastructure* has been deficient for much of the period of central planning. Albania is rich in *Power* resources, with over 90 percent of present generation deriving from hydropower sources (11 hydropower stations). The country's hydropower potential is estimated to be more than three times as large as the amount already developed, which produces about 4000 Gwh in a normal hydrological year.⁴ Electricity supply was managed by an agency (KESH) under the Ministry of Industry which was responsible for generation, transmission and the activities of 30 distribution companies. Development of the power sector was constrained by inappropriate pricing policies, with energy being sold at below cost of provision, especially for energy used by households. Artificially low revenues affected maintenance, operations and investment. Maintenance was deficient throughout the eighties with a consequent steady decline in the quality of service. Furthermore, there were severe institutional constraints within KESH reflecting the lack of an accountable "corporate culture" and limited expertise beyond technical functions.

1.18 Albania is a *water* rich country with an annual average water availability of 3,080 cubic meters per person, the highest in Central and Eastern Europe. Both ground water and surface water are prevalent. The Ministry of Construction had overall control, although there was some devolution to municipalities, towns and villages. However these local units lacked control over budgets, investment or prices. Despite this relative abundance of water, the country has been unable to supply the entire population with safe water. About 80 percent of the population had access to piped water in 1990, however because of low investment, poor operations and maintenance, service delivery was very poor. As with power, institutional constraints have been a fundamental problem. The water providers did not operate on a commercial basis, with poor management and inadequate cash flows due to artificially low administered prices. The Council of Ministers set a uniform price cap for all water entities, and these tariffs did not provide for full cost recovery. There were no incentives to use water carefully (with a low flat tariff rate), and lack of accountability meant that maintenance was very poor. This resulted in massive leakage from the system, which got progressively worse throughout the eighties, requiring limits to water being pumped into many distribution networks to three or four hours per day.

1.19 Only 1.2 percent of GDP was invested in the *Transportation* sector in the late eighties. And forty percent of this went to the railway network, which was not economic except for the transport of minerals. Funding was drawn from the Central Budget, and maintenance of the country's transportation networks became progressively worse as the eighties progressed. No road use taxes were collected, and the prices of all fuels were subsidized. The situation of the road network of about 18,000 kilometers (paved, 2900 kms, unpaved 4900 kms and rural 10200 kms) would have much more difficult had it not been for the fact that private cars were not allowed until 1991. In 1990, it was estimated that about 400 villages, with a population of nearly one million, were inaccessible to motor vehicles for at least part of the year. The main port of Durres suffered from continual under investment and poor operating practices, with much of the handling equipment being inoperative by 1990.⁵

4. World Bank, *Albania, Staff Appraisal Report: Power Transmission and Distribution Project*, Report No. 14532-ALB, January 17, 1996.

5. World Bank, *Albania: Staff Appraisal Report: Transport Project*, Report No. 11494-ALB, April 23, 1993.

1.20 Albania had perhaps the worst *housing* in all of Eastern Europe. The average urban apartment was 30 square meters of usable space, or about 7.5 meters per person.⁶ All construction was undertaken by the Government, SOEs, state farms or cooperatives; there was no private housing. Central heating was a rarity, and it is estimated that in 1990, about a third of the country's 675,000 individual dwellings had piped water. Maintenance of the housing stock was deficient throughout the eighties, further eroding the quality of housing.

1.21 The country has 3.3 million people. The population has been growing at a relatively high rate of 2.2 percent when compared to other European countries. However for a country at Albania's per capita income level, this population growth rate is about average. The total fertility rate in 1989 was 3.0, which is somewhat below the average for countries in the same income group, and the estimated infant mortality rate of 28 per 1000 live births is good even in comparison to middle income countries. Data on the *Health* situation of the Albanian population is incomplete, however the data that does exist suggests that the health status is reasonably good. Life expectancy is nearly 73 years and the crude death rate is low reflecting the young age structure of the population. Under the communist system, the Albanian population had universal entitlement to a full range of state provided medical and dental services. Resource allocation within the public health system was centrally planned, management decisions were highly centralized, and the system offered few incentives for quality of care, efficiency and cost control. Given the country's international isolation, medical personnel were cut off from global advances in technology and pharmacology. In common with other aspects of the country's infrastructure, facilities and equipment in the health sector steadily deteriorated through the eighties due to inadequate recurrent expenditure allocations. By the end of the decade the quality of health care was poor and there was considerable dissatisfaction among both providers and recipients.

1.22 *Education* in Albania was quite good for a country at this income level. Literacy is high (almost universal), and the free system provided advance training in most disciplines. Nevertheless the quality of education deteriorated in the eighties, primarily due to inadequately funded recurrent and capital expenditures. The system showed the signs of neglect and isolation from international trends and innovations, and facilities and materials were progressively becoming inadequate. Education was highly centralized, including curriculum development and teacher training, and there was no involvement of parents, and accountability for outcomes was almost non-existent.

1.23 In common with other centrally planned economies, the *Social Safety Net* in Albania was mainly focused on a social insurance system. This system provided retirement, invalid and disability pensions, together with some provisions for widow and orphans and maternal benefits. As employment was a right enshrined in the 1976 Constitution, unemployment benefits per se did not exist, but of course over-manning existed throughout the economy. The structure of the social insurance system, which was funded by state enterprise contributions, was complex varying according to a variety of criteria. Different treatment was given to urban versus rural dwellers, types of prior employment category and prior earnings. The original social security law of 1966 was successively modified, with a host of special exemptions, resulting in 1989 with a system that was both cumbersome and difficult to administer. Also throughout the eighties, the financial viability of the system was continually eroded. By 1990, expenditure on social insurance was 17 percent of the state budget (as against 6.6 percent for health and 11.8 percent

6. World Bank, *Albania: Staff Appraisal Report: Housing Project*, Report No. 11747-ALB, June 3, 1993. The average number of square meters of living space per capita was 15 in Romania, 17 in Bulgaria, 20 in Poland, and 26 in Hungary.

for education and culture) and the budget subsidy required represented 2.8 percent of GDP. Expenditures as a proportion of GDP doubled from 1980 to 1990. This trend was not sustainable.

1.24 The *Financial Sector* existing in communist Albania was merely a counterpart to the five year plans. The sector was limited to a state bank, a savings bank and a state agricultural bank. The financial system had no independent decision making authority and loans were made solely on the basis of whether it was in the plan. Most of the financing was for working capital balances, given that the bulk of fixed investment was financed through the budget. All enterprises had an account with the state bank, which essentially played a bookkeeping role of equilibrating the surpluses and deficits of the SOEs. Interest rates were unchanged throughout the eighties and served no allocative function. This system started to come under stress in 1988 when the SOEs were given some limited decision making powers. As the enterprises operated without budget constraints, and there was automatic financing of their deficits which was translated into the overall fiscal deficit, managerial inefficiency and accountability was perversely rewarded.

1.25 It is important to understand the psychology surrounding the practices of the banking system at the end of the eighties. Loans were not made on an economic basis and there was no analysis by bank staff of the viability of the borrowers or their capacity to repay. As importantly, the borrowers felt little obligation to repay. Household deposits in the savings bank were simply excess balances not utilized for output available to consumers. Inevitably money balances deposited in the banking system exceeded demand for these balances at prevailing prices; the excess being conventionally labeled the monetary overhang. In years when output exceeded expectations, this monetary overhang declined, and increased when the reverse occurred. At the end of 1990, these balances were estimated to have been one third to one half of total broad money.

1.26 *Institutional Development and Governance* up to 1990 was shaped by the imperatives of a highly centralized one-party state. The core public sector was designed for a command economic policy regime and a political-administration system to safeguard the interests of the "party". By the mid-eighties, this system afforded senior decision makers a great deal of discretion in policy and administration with little accountability. By the nineties, this system produced a range of institutional problems that undermined the quality of public administration. These problems include poorly defined institutional arrangements, endemic politization, poor "material" incentives, and widespread patronage and corruption.

1.27 These institutional deficiencies in the core public sector affected incentives for line managers and staff in all operational departments and agencies. They also affected the development of effective delivery systems for public goods and undermined the very legitimacy of the State itself. There was a complete absence of a conceptual framework for the provision of public goods that aimed to maximize efficient and effective outcomes and beneficiary participation was absent. Local institutions (cooperatives, state farms etc.) were essentially deconcentrated units of the totalitarian center. The communist party politicized civil society and associational life in Albania, depleting social capital and reducing voluntary participation in self-governance. The judicial system served the larger ideological and political objectives of the regime in power.

1.28 This distorted institutional and societal development over four decades in Albania has had important implications for the country when the "monopoly of power" was broken. The

scope and arbitrariness of rules and regulations while ostensibly designed to extend control, ultimately undermined much of the authority of the state. The capacity for enforcement was progressively eroded resulting in a host of informal activities in economic and social life. These economically viable, informal activities created strong interest groups and stake-holders for whom the State was neither a legitimate nor credible enforcer of the rule of law. Confidence in, and respect for, any centralized public administration was at a very low level in 1990.

The Developing Crisis

1.29 The political crisis in 1990 can be directly linked to a worsening economic crisis. Decades of economic mismanagement started to come to a head by the mid-eighties. The centrally planned system in Albania could get by, but only with mass infusions of foreign assistance. From 1950 to 1978, aid provided by the USSR and China amounted to the equivalent of 44 percent of total national investment, and 12 percent of national income. When this ended the system began to unravel. Growth was zero in per capita terms in the first half of the eighties and zero in overall terms in the second half. The efficiency of investment had been declining steadily from the sixties (the incremental capital/output ratio was 17.4 in the eighties and 4.3 in the sixties—based on cross country experience an ICOR of 6 is considered high and an indication of inefficient use of resources). In 1988, the Government sought to deal with these difficulties with some modest loosening of economic controls. However the greater discretion given to SOEs, with administered prices remaining unchanged simply resulted in a growing fiscal deficit and a worsening of commodity shortages. Beginning in 1990, many factories closed for lengthy periods due to a shortage of inputs. Finally, a major drought in 1990 adversely affected agriculture and electricity generation and made a bad situation worse.

1.30 As is revealed in Table 1.1, the economic situation was rapidly getting out of control. Industrial production virtually ceased and the internal food distribution network broke down. By late 1991, mass unemployment, rampant inflation and commodity shortages were drawing Albania into chaos. GDP fell by 10 percent in 1990 and a further 30 percent in 1991. The state farm and cooperative systems collapsed. Foreign reserves fell to an equivalent of two weeks of imports, and all sources of commercial foreign financing, including short term trade credit, were closed. The Government held discussions with the Bank and the Fund on an appropriate emergency stabilization program and assistance to restart the economy. Albania also turned to the G-24 group of nations for immediate assistance on grant terms. The response was positive, and major donors (the European Commission, the Governments of Italy, Germany and the United States) pledged large amounts of humanitarian aid and food. The unstable political situation throughout 1991 inhibited the flow of assistance however and delayed agreement on an appropriate macroeconomic stabilization program.

1.31 *Was Albania a failed state?*⁷ By 1990 the communist state in Albania was a system in the process of institutional degeneration. From a governance point of view, the Albanian state did not possess the basic prerequisites for effective policy making, efficient service delivery, and transparent, credible state-society relations. The very fabric of civil order was collapsing by mid-1991, and the economy was close to anarchy. In many respects, it is inappropriate to classify Albania as a "traditional" economy in transition. Arguably, the catharsis of the change in the social and economic order was more rapid and profound than any of the former communist countries.

7. William Zartman, ed., *Collapsed States: The Disintegration and Restoration of Legitimate Authority*, Boulder, Colorado: Lynne Rienner Publishers, INC., 1995.

2. Evolution of IDA's Strategy

Introduction

2.1 In looking at the evolution and content of IDA's country assistance strategy for Albania, it is important to set a context for this strategy. At the time of joining the World Bank Group the country and its economy were in disarray, and on the very brink of a complete breakdown in civil order. Assistance was necessary in all sector and domestic institutional capabilities were very weak. By the Spring of 1992, it was estimated that over 30 percent of the urban work-force was not working, and this problem was being aggravated daily by large internal migration into the Tirana-Durres corridor. External migration, much of it illegal, exploded from near zero in 1990 to over 100,000 in 1991. This provided a "safety valve" and informal social safety net to cushion the economic decay in Albania but it presented severe problems for surrounding nations.

2.2 The immediate short term agenda required emergency humanitarian assistance and a targeting of resources to ensure that vital economic sectors could be resuscitated, and a minimal level of public administration restored. This required immediate food aid, medical supplies and key agricultural inputs to ensure vital human needs could be met. Furthermore, the restoration of power generation and distribution and the country's transport network required a speedy infusion of spare parts and equipment.

2.3 The fact that elections in March 1992 resulted in a Government that was publicly committed to create a market economy within the framework of a multi-party democracy also had a major bearing on the early assistance effort. The traumatic experience of the 1991 collapse provided a "window of opportunity" to effect reform and change. Public expectations were high but the political situation was still fragile. As a result there was a strong sense of urgency permeating all donor assistance efforts. In particular, it is important to recognize that the formulation of a medium and longer term development strategy was to be colored by short term imperatives. The need for speedy interventions was readily understandable simply to provide the "breathing room" necessary to develop a more comprehensive assistance strategy.

The Early Strategy—Learning and Responding

2.4 In mid-1991, a large economic mission visited the country for the first time which culminated (February 1992) in a comprehensive assessment of the state and structure of the Albanian economy. This report diagnosed key development constraints and identified measures necessary to create a market-based economy. The early assistance strategy was drawn from this report. In 1992, however, the immediate strategic priority was macroeconomic stabilization and fiscal management. Budget revenues had all but disappeared as SOEs had ceased to function, and control over fiscal expenditures was minimal. By mid -1992 the overall fiscal deficit was running at an annual rate equivalent to over 40 percent of GDP and monthly inflation was running at 10 to 15 percent. In addition, the critical food situation and the restoration of critical elements of the country's infrastructure (particularly the port of Durres needed to handle grain shipments and the power grid) were considered high assistance priorities.

2.5 By mid-1992 an IMF program was in place with a strong focus on control of budget expenditures, with strict monetary targets, and comprehensive price liberalization. The first steps

in creating a two tier banking system and an autonomous central bank were made. IDA identified support to the agricultural sector as a key element in the country's reconstruction. This was partially in recognition of the rapid break-up of the farm collective system in 1991 into individual holdings, and the strongly stated government intent to disassemble the state farm systems.

2.6 In this early stage of IDA's involvement with Albania, it was explicitly recognized that time was needed to expand sector knowledge and define in more precise terms the exact nature of sector reform strategies. Constraints and problems were identified, however the path, prioritization and sequence of the development reform agenda was still in a process of formulation. Nevertheless IDA placed strong emphasis on short term poverty alleviation and speedy development of a social safety net, given the human hardship that had already been experienced. Maintaining some degree of social consensus and cohesiveness in a fragile and vulnerable political environment was a key objective.

2.7 This early strategy envisaged a strong and intensive policy dialogue, in conjunction with the IMF, with the authorities on the implementation and design of the macroeconomic stabilization program. Coupled with this was the perceived need for an intense ESW program to help the Government establish a workable and integrated development framework and its capacity to implement it. Technical assistance was to constitute a major component of the country assistance strategy and was bifurcated in two ways. One was the provision of TA to develop capacity in the core public sector across the broad spectrum of public services and policy making. The other was the provision of TA in key line ministries to support and expedite immediate project start up and implementation.

2.8 At the outset, IDA recognized that aid and donor coordination would be a crucial requirement in Albania given the rapidity and magnitude of G 24 support following the transition. In particular, the ESW program was designed to support the development of donor assistance strategies and development of their own lending (or grant) programs.

The Middle Strategy—Refining and Broadening

2.9 Throughout the latter part of 1992 and early 1993, IDA worked closely with the IMF on developing a Policy Framework Paper (PFP) that would set out a consistent medium term macroeconomic framework with sector strategies more carefully defined. This PFP was presented to the Board in July 1993. An IDA Country Assistance Strategy was presented to the Board in the President's Report for the Technical Assistance Project for Social Safety Net Development (Credit No. 2543-ALB) in August 1993. Table 2.1 below outlines the main elements of this assistance strategy.

Table 2.1: Main Outline of IDA's Assistance Strategy—FY94–96

<i>Sector</i>	<i>Objectives</i>	<i>Nature of IDA support (Projects and ESW)</i>
Rehabilitation of infrastructure and basic public services	<ul style="list-style-type: none"> • Rehabilitation of existing equipment and new investments • Cost recovery for the main utilities 	<ul style="list-style-type: none"> • Power Projects (2) • Transport Project • Water Supply Project
Support to private agriculture	<ul style="list-style-type: none"> • Improvement in Infrastructure • Creation of incentive framework (pricing policy and new entries in agroprocessing and distributing sector) • Building of rural credit 	<ul style="list-style-type: none"> • Rural Roads Project • Irrigation Project • Privatization Study for Agro-Enterprises
Social sectors and policies	<ul style="list-style-type: none"> • Move social insurance toward actuarial basis • Target better social assistance • Develop policy for poverty alleviation 	<ul style="list-style-type: none"> • Social Safety Net Project • School Rehabilitation Project • Health Rehabilitation Project • Labor Market Project • Urban Poverty Project • Poverty Surveys
Privatization, restructuring and financial sector restructuring	<ul style="list-style-type: none"> • Privatization of small- and medium-scale enterprises • Restructuring of ERA Enterprises • Development of Bank Infrastructure • Introduction of competition in financial sector 	<ul style="list-style-type: none"> • Enterprise & Financial Sector Project
Development of new central, and local administration	<ul style="list-style-type: none"> • Improve capacity for reform preparation and implementation • Improve absorptive capacity 	<ul style="list-style-type: none"> • 1994–96 Public Invest. Program • Study on Civil Service Reform • Tax Administration Project • IDA-Only Debt Reduction Facility • Public Administration Action plan
Foreign debt	<ul style="list-style-type: none"> • Facilitating a voluntary negotiated settlement consistent with the nature of Albania's Debt and the country's debt servicing capacity 	<ul style="list-style-type: none"> • Use of IDA-Debt Reduction Facility

2.10 "Neither Albania's own development strategy, nor the Bank's assistance strategy should attempt to be the blueprint for the future. The challenge for Albania and the Bank over the next years will be to create an integrated framework for change that will be compatible with short term macro stabilization; will combine 'rules with discretion'; and will be flexible enough to accommodate the major structural shifts that are likely to continue to take place in the economy.....What is needed is a flexible strategy that responds quickly to new information while maintaining an overall framework that promotes (i) stability; and (ii) new entrepreneurship

and private initiative."⁸ This quotation provides a succinct overview of IDA's assistance strategy by mid-1993. In recognition of the still weak implementation and public administration capacity, IDA believed a broad sector strategy with maximum flexibility, offered the best method to deal with macroeconomic uncertainties and the maintenance of a social consensus for continued movement toward a market based economy.

2.11 Certain priority areas were specified however for policy attention and resource allocation. These include:

- rehabilitation of basic infrastructure, and in the case of power, the effort was focused on reducing large power distribution losses;
- support for the development of private agriculture;
- establishment of a new social safety net;
- restoring basic education and health services;
- privatization of small and medium scale enterprises;
- downsizing large SOEs;
- development of a financial system;
- building a new core public administration; and,
- normalizing relations with external creditors.

IDA strategy at this time, did not prioritize these objectives, but rather felt they would need to be pursued simultaneously, although the emphasis might have to change based upon immediate circumstances and perceived success in one area versus another.

2.12 In pursuit of this country assistance strategy, four key assistance issues were considered necessary to implement the strategy. Firstly, there needed to be a large number of small, targeted operations, which were simple in design and implementable by a single agency. This approach would afford maximum flexibility in reinforcing successes or redesigning potential flaws in the strategy. Secondly, IDA would make strong efforts to seek cofinancing to maximize the leverage of its own scarce resources, thereby maximizing resource flows to the country. Thirdly, a broad ESW effort was envisaged to develop the public investment program and focus attention on potential lending areas. Finally, there would be a strong need to keep individual project preparation time to a minimum.

2.13 Despite suggesting prioritization of key identified development constraints and issues was not crucial, IDA did later suggest in the same document that "because the dilapidated state of infrastructure constitutes perhaps the major bottleneck for private sector development" the lending program should be oriented toward investment projects.⁹ For *infrastructure* IDA's strategy focused on physical rehabilitation, institutional strengthening of existing service providers and a movement to towards full cost recovery. A strong private sector role in the provision of infrastructure was not considered feasible in mid-1993, although it was noted that management contracts, leasing and contracting out of services might be useful adjuncts to the rehabilitation effort. Power distribution system and the transportation network were identified as priorities within infrastructure.

8. World Bank, *Albania: President's Report: Technical Assistance Project for Social Safety Net Development*, August 18, 1993, Report No. P-6058-ALB, page 5.

9. *ibid.*, page 10.

2.14 IDA's assistance strategy for the *agricultural sector* was guided by a very comprehensive agricultural sector strategy completed in October, 1992 and publicly endorsed by the Government shortly thereafter.¹⁰ From this emerged a detailed medium term development strategy. Table 2.2 below provides an outline of the strategic objectives in the agricultural sector and their recommended course of action.

Table 2.2: Agriculture Sector Assistance Strategy

<i>Area/subsector</i>	<i>Constraint/condition</i>	<i>Strategic objective</i>	<i>Recommended strategy</i>
1. Land reform	Small size of farms	Develop of land markets to increase efficiency of the agricultural sector through market-based land consolidation	Develop legal framework for land markets with passage of land registration and land leasing laws Establish a land registry system Authorize the sale and leasing of land
2. Irrigation system	Poor physical state; inadequate institutions for small scale irrigation	Maintain and expand irrigation network Develop new and sustainable water distribution and maintenance systems Establish incentives for efficient water use	Repair damaged infrastructure Establish water user associations (WUAs) responsible for water distribution and network maintenance Raise water fees; base fees on water amount and not per ha.
3. Rural credit	BAD/RCB cannot provide credit to small farmers	Facilitate access to credit by small farmers	Establish a system of solidarity based village credit funds; start with subsidized interest rates and move rapidly to market-determined rates
4. Rural infrastructure	Poor state through lack of maintenance and damage	Rehabilitate rural infrastructure Improve rural roads to improve farmers' market access	Repair and upgrade rural infrastructure with public works program Develop and implement a rural roads project
5. Agricultural inputs	Dire shortage	Provide inputs in the short-term to generate a rapid supply response Develop infrastructure and enabling environment to support private sector trade	Use donor-financed imported inputs Provide trade credit Support the development of private farmer's associations (PFAs)

2.15 With regard to the *health and education sectors*, the focus of IDA's strategy was to rehabilitate and resuscitate the basic infrastructure and restore critical supply inputs. Based upon preliminary sector work in 1992, a health sector development strategy was put forward which

10. World Bank and The European Community, *An Agricultural Strategy for Albania*, Washington, October 1992.

outlined the need to streamline the existing "health pyramid" through consolidation of hospitals, redefinition of health districts according to population and epidemiological criteria, and a redefinition of the level of administration of primary and district level health care. Strong emphasis was placed upon improving the quality of primary health care and encouraging a gradual private sector involvement in health care provision. It was also felt necessary to investigate alternative sources of financing for health care, including health insurance schemes, local governments, and the NGO community.

2.16 For education the immediate assistance strategy was to help the Government sustain delivery of basic education and build institutional capacity for planning, management and quality assurance. The focus was primarily upon repair of classroom facilities and improving textbook supply.

2.17 Throughout all aspects of IDA's country assistance strategy at this time was a strong focus on *poverty alleviation and the social safety net*. It was explicitly recognized that the existing system of social insurance and unemployment insurance was not sustainable without improved targeting. For this, IDA envisaged technical assistance to revise the legal and administrative frameworks for pensions, unemployment insurance, and job placement systems. IDA also recognized that poverty alleviation efforts required short and longer term agendas. The first requiring, short run, temporary interventions by the Government in rural poverty reduction, skill retraining and special assistance to the most vulnerable. The longer term agenda encompassing restoring actuarial soundness to the pension system and expansion and development of stronger poverty monitoring mechanisms to improve benefit targeting.

2.18 A strategy for the *financial sector* emerged initially from an "Issues Paper" in January 1992. A variety of development issues and constraints were identified and a full financial sector study was recommended. The study was never done. The key elements of reform were known however and included the creation of a strong and autonomous central bank, strong bank supervision and a proper legal structure for commercial banks, including collateral and bankruptcy laws, the need for uniform accounting, auditing and disclosure procedures, dealing with the stock of bad debts in the state banks and restricting further access of defaulters (mainly SOEs) to the banking system and creation of a competitive environment of universal banks. The strategy recognized the need to privatize the existing state banks and encourage the entry of new private banks. However, at the time (mid-1993), privatization was not considered feasible given the need to build the necessary "regulatory/operational infrastructure" for a modern banking system. With regard to the larger problem SOEs (30), these would be housed in an Enterprise Rehabilitation Agency (ERA) and would not have access to the existing banks. It was felt that extensive training, re-capitalization and an aggressive bad debt recovery program would create a stronger, more commercially oriented banking system in parallel with the legal framework development.

2.19 IDA recognized from an early stage that *Public Sector Management and Institutional Development* was weak. In the context of the stabilization effort, fiscal reform was necessary and the focus was on broadening the revenue base. There was a need to develop a new tax base that would require extensive technical assistance to reorient tax administration and design a tax system suitable for the type of economic activity (small scale farming, trade and services and light manufacturing) foreseen over the next decade. Hence IDA proposed a lead role for itself in providing a unifying framework for the variety of other donor assistance programs in this area. Furthermore, by working in partnership with the Government on the development of a public

investment program, it was envisaged that design and management of public investment would be improved.

2.20 In the early stages of IDA's involvement with Albania, the Bank considered an inefficient public administration to be the basic cause of poor absorptive capacity and institutional weakness in the core public sector. Among its early recommendations, was a downsizing strategy for the civil service, as well as a heavy reliance on TA to develop capacity in line ministries, policy making bodies and aid coordination units. However no comprehensive strategy was enunciated for overall reform of the core public sector. In specific project areas, there was a focus on improving service delivery through the use of quasi-government organizations /foundations and on "organic" or participatory decentralization. In some sectors the Bank recommended and followed service delivery strategies that emphasized beneficiary participation and coproduction of public services. This type of decentralization focused on building social capital between beneficiaries and represented an alternative to the more politically contentious path of administrative decentralization. IDA did support measures to strengthen local government bodies, but was cautious in supporting a full scale decentralization effort.¹¹

2.21 From an early stage, IDA envisaged a significant *Privatization* effort by the Government. Given the urgency of needed reforms combined with varying enterprise conditions, IDA felt that a pragmatic approach was called for, employing a variety of privatization methods. A further element of IDA's country assistance efforts in privatization was the belief that reform in the financial and enterprise sectors had to proceed concurrently. IDA advocated very rapid privatization of small and medium scale firms, in conjunction with creation of a "private sector friendly" regulatory and legal environment. For the larger SOEs, employment and regional concentration issues suggested that restructuring, downsizing and break-up of large units into smaller and more competitive parts was the only viable strategy in the short to medium term. Liquidation and/or sale of peripheral assets of the larger SOEs was also envisaged.

The Early Post Crisis Strategy—Focusing on Essentials

2.22 A full discussion of the nature of the events leading up to the collapse of civil order in Albania in 1997 is presented in Chapter 4. This crisis and its aftermath produced a profound rethinking and change in IDA's country assistance strategy. The Recovery Program put forward in July 1997 set some very clear priorities in helping the country to return to a sustainable economic development path. Three broad areas were prioritized as follows:

- restoring and developing governance and support for civil society;
- designing and implementing sound economic and social policies; and
- focus on key constraints to the revival of economic activity.

2.23 In mid-1997, trust in public authority was at a low ebb. Past government and political institutions were discredited by their complacency over the pyramid schemes and their inability to restore public order. IDA recognized that simply restoring pre-crisis institutions would not be sufficient. Rather fundamental reform of public administration was necessary. Executive and judiciary powers would need to be separated, oversight and transparency of all aspects of public administration must be strengthened, a strong plan for decentralization of certain public administration responsibilities must be prepared and greater local level participation was

11. World Bank, *Albania: Country Strategy Paper*, March 1994.

necessary in rebuilding certain public institutions. Creating an independent civil service and reducing the extent of politization and corruption was a high priority, coupled with a functional review of all ministries and key institutions. The goal was to define new ministerial roles and mandates, simplify organizational structures and identify areas and scope for deconcentration and decentralization. IDA advocated a much more focused and results oriented TA effort by all donors, and much more participation of civil society and regional authorities in the decision making process.

2.24 Clearly reestablishing macroeconomic stability was a key strategic goal. In the short term the focus again would have to be on fiscal recovery, particularly reestablishing the framework for mobilizing fiscal revenues. A similar priority was to be given to establishing a sound financial sector. Emphasis would be on strict enforcement of banking laws and prudential regulations, with highly specific measures to deal with the pyramid schemes and informal investment funds, the state owned banks and institutional strengthening of the central bank. This was to include liquidation and/or privatization of the state owned banks over a one year time frame.

2.25 Strong efforts were identified in IDA's evolving strategy to bringing support to vulnerable groups and reduce the severest levels of poverty. The need for an early update to the Poverty Assessment was identified, together with a Social Assessment to identify major social issues. Restoring priority health services was also seen as an immediate need, but with a focus only on those areas where an adequate health governance framework was in place. Nevertheless, strong emphasis was given to a medium term agenda to improve management, governance and fiscal sustainability. Similarly, in education stronger emphasis has been given to improving sector governance.

2.26 In reviving economic activity, IDA emphasized participatory micro-credit schemes (as was done in rural areas), channeling funds through the small private banks already existing in the country, guarantees against political risk for foreign investment partners, equity funds and accelerated privatization of SOEs. Restoring and developing the country's infrastructure was still a key item in IDA's country assistance agenda, however much stronger emphasis has been given to the governance and management of utilities, with a stronger drive to encourage private sector participation. Strong emphasis was also given to improving cost recovery and enforcement of existing laws and regulations, particularly with regard to billing and collection.

3. Strategy Implementation

Lending

Amount and Allocation

3.1 IDA commitments to Albania during the period under review (1992–1996) amounted to US\$272.5 million with the approval of 22 projects. Over the six years of IDA's involvement in Albania, per capita commitments rose rapidly from US\$12.9 in 1992 to US\$22.0 in 1996. Disbursements during the period totaled US\$146.12 million.

3.2 Adjustment lending constituted 12.8 percent of total commitments, approved in 1993 and 1995, but in terms of overall sector allocation, the Transportation sector was the largest recipient of assistance with 21 percent of total commitments. The second largest recipient was the agricultural sector and environment (19 percent), followed by energy (13 percent), human resources (12 percent), urban (7 percent), industry and finance (6 percent), water supply (4 percent), and State Institutions & Public Administration Reform (SIPAR) (3 percent). The significance of agriculture and transportation in the lending program reflects IDA's dual focus of long-term poverty alleviation in sectors with the largest potential development impact and the removal of obstacles to growth (i.e., poor infrastructure).

3.3 The emphasis on agriculture was appropriate given Albania's largely agrarian economy as well as the collapse of the manufacturing sector in 1990. Since growth in the agricultural sector would have arguably had the largest impact on poverty alleviation, the Bank undertook six lending operations in the *agricultural sector*. The first adjustment operation, the Agricultural Sector Adjustment Credit (ASAC), was designed to support ongoing structural reform in the sector. The Rural Poverty Alleviation Pilot project and its follow-up Rural Development project provided credit to villagers to promote private sector activity in the agriculture sector. They both used an innovative strategy to elicit repayment through mutual obligations at the village-level. In addition, the rural works component of the projects sought to employ a demand-driven methodology to repair basic rural infrastructure. The Irrigation Rehabilitation project aimed to increase agricultural productivity by rapidly rehabilitating existing irrigation and drainage infrastructure and ensuring sustainability of irrigation investments through farmer participation. The Agroprocessing Development project sought to develop the agroprocessing industry and restructure the financial sector to facilitate the marketing of farm products. Finally, the Forestry project focused on restoring degraded State-owned forest and pasture areas, promoting conservation of natural forest ecosystems, and modernizing forest/pasture management for the demands of a market economy.

3.4 The desperately poor state of Albania's *transport infrastructure* was a severe constraint on economic growth and deserved IDA's early focus on national and rural roads as well as market-oriented policy reforms in the sector. The Transport project as well as the National Roads and the Rural Roads projects were three operations that served this purpose. The *energy sector*, which suffered largely from institutional weaknesses in distribution systems, was given a relatively high priority in the 1993 country strategy document. While a component of the Critical Imports credit supported immediate repairs to the Drin River hydropower stations and distribution systems, the Power Loss Reduction project and the Power Transmission and Distribution project constituted the major Bank operations in this sector. These former aimed to reduce non-technical electricity losses and inefficient use of electricity. The latter sought to

improve power supply through reducing unbilled electricity and strengthening distribution systems.

3.5 *Human resource development* received a relatively small proportion of IDA lending. Seven projects addressed the broad ranging issues of human resource development. The Rural Poverty Alleviation Pilot project, and the follow-up Rural Development and Urban Works/Microenterprise projects were designed to alleviate poverty by providing small farmers and microentrepreneurs with credit and rehabilitating rural and urban infrastructure. The Technical Assistance projects for Social Safety Net Development and Labor Market Development were aimed at supporting and rationalizing the Government's programs for attenuating the social costs of transition. Finally, the Health Service Rehabilitation and Education Rehabilitation projects aimed to rebuild, repair, and re-equip educational and health infrastructure damaged or destroyed during the civil unrest of 1991. Both operations also sought to rationalize and strengthen service delivery systems for human resource development.

3.6 *Industry and finance sectors* both deserved significant attention given the dual requirements of privatization of state-owned enterprises and creation of a modern banking system. Since the privatization of SOEs in formerly centrally planned economies has direct implications for the liberalization of the financial sector, IDA provided the Enterprise and Financial Sector Adjustment Credit (EFSAC) in 1994. This was a complex operation. The objectives of the credit were to support the development of the banking system, continued privatization in the industrial sectors, and the decisive liquidation or downsizing of non-viable SOEs. Prior to the EFSAC, the components of the Technical Assistance Project for Economic Reform supported the privatization and financial sector development objectives. The Agricultural Sector Adjustment Credit (ASAC) also carried a component that aimed to establish an Agricultural Bank to provide credit under market conditions to farmers. Furthermore, the Rural Development Project provided credit to local villagers through a specially created foundation and a participatory strategy of using social capital to elicit loan repayments.

3.7 The *urban and water supply sectors* received a small proportion of the lending even though both scarcity of adequate housing and urban infrastructure as well as water were diagnosed as serious infrastructural constraints in the Bank's strategy. The urban sector received two lending operations from IDA—the Housing project and the urban works/microenterprise project. The Housing project aimed to initiate a market-based housing system by completing and selling government rental flats, broadening the role of private sector operators in housing supply, and establishing a National Housing Authority (as an “effective agent of change”). The urban works/microenterprise project essentially was the urban counterpart to the rural development project, which initiated credit schemes and participatory rural works. The only water sector operation, the Durres Water Supply Rehabilitation project, aimed to improve the efficiency and management of existing water supply and sewerage systems.

3.8 Finally, *SIPAR* also received nominal attention in spite of the Bank's recognition that severe weaknesses in State institutions adversely affected the transition process across sectors. IDA lending addressing core public sector problems consisted of three operations—the Technical Assistance Project for Economic Reform, the Tax Administration Modernization Project, and the Technical Assistance Project for Social Safety Net Development. These were appropriate to the short term needs of State institutions, namely supporting macroeconomic management, improving revenue collection, as well as the development of social assistance and social insurance systems.

Implementation

3.9 IDA resources to Albania disbursed rapidly with disbursement ratios well above ECA region averages throughout the 1990s.

Table 3.1: Portfolio Ratings and Supervision Effort

Country	Portfolio ratings (average FY92-FY96)		Supervision effort (staffweeks/project)
	Avg. # of projects under supervision	% of projects rated less than satisfactory	FY92-96
Bankwide	1756.8	17.5	16.7
Azerbaijan	1.2	33.3	7.3
Croatia	4.6	4.3	4.8
Czech	1.6	0.0	17.2
Hungary	17.4	17.2	13.3
Lithuania	2.8	14.3	16.0
Poland	18.0	22.2	22.3
Slovak Republic	1.0	0.0	8.0
Slovenia	3.0	6.7	5.2
Vietnam	1.8	0.0	13.0
Zimbabwe	12.2	4.9	24.3
Albania	10.8	7.4	10.6

Source: PBD

3.10 Institutional weaknesses in public administration, such as poor incentives and information asymmetries, undermined the efficiency of development assistance. In some sectors, however, IDA achieved project objectives and created demonstration effects by circumventing the GOA's inefficient public administration in three ways. The first technique, common to other Bank operations, was to establish temporary management institutions such as project implementation units (PIUs). GOA staff in these units were typically paid higher wages (albeit with a 20 percent cap on salary top-ups) and had access to training and other technical assistance facilities specific to relevant projects. Despite these measures, PIUs continued to experience problems with procurement (especially the transparency of tender and bidding procedures), as well as the use of training/TA resources in ways not directly related to project objectives. The second approach that IDA employed was the use of quasi-governmental organizations or foundations (QGO/Fs), which were service delivery institutions largely independent of the State. These institutions tended to have better incentives for staff and employed a demand-driven approach to delivering IDA-supported services. Finally, the Bank used participatory techniques, particularly in the agricultural sector, to counter a major obstacle to effective implementation of development projects, namely, widespread mistrust of top-down government programs.

3.11 It is worth noting that disbursement ratios for Albania began to fall well before the 1997 crisis. In fact, after peaking at 59 percent in 1994, disbursement ratios fell to 29.3 percent in 1996. This large decrease was partially caused by delays in key reform conditionalities.

3.12 There are two closed projects which were reviewed by OED and found to be satisfactory. The rest of the twenty projects in the portfolio are still ongoing. The relatively low level of supervision effort across these ongoing projects between 1992 and 1996 can be partially attributed to a young portfolio. Other countries with relatively new portfolios (i.e., Azerbaijan, Croatia, the Slovak Republic, and Slovenia) also had lower than average supervision effort. It is likely that supervision may receive increased staff time and resources as IDA's Albania portfolio matures. Alternatively, Albania's relatively low supervision rates may also reflect the larger lending bias in IDA's program.¹² Lending enjoyed more resources and staff time at the expense of both ESW and supervision. Early on, Albania's portfolio enjoyed rather high supervision ratings for development objectives and implementation progress. In fact, prior to the crisis in 1997, all projects, with the exception of the Housing project, received at least satisfactory ratings for both these standard criteria.

Economic and Sector Work

3.13 The intensity of economic and sector work on Albania has been lower than the Bankwide average over the 1992–1996 period. Specifically, ESW on Albania was significantly lower than other transition countries (see Table 3.2), even though there were several strong reasons for a robust ESW program, conducted in collaboration with GOA units, as well as local research institutions. These include a general lack of knowledge of the country due to past isolation, the poor quality of informational and analytical capacity in ministries, and the well-noted value of ESW in increasing returns to lending Bankwide.

3.14 For the life of the Albania portfolio, ESW has steadily suffered at the expense of lending. In fact, ESW effort fell significantly between 1992 and 1995. Sector work has not been consistent with the stated country strategy particularly in transport, the financial sector as well as State institutions and public administration reform (SIPAR). There have been two country economic reports or memoranda, in 1992 and 1994, three environmental studies, a joint publication with the EC on agriculture policy, a sector note on health, and another one on energy, a policy research paper on decentralization, and a poverty assessment.

3.15 The two economic reports covered *industry* and *finance* issues, with particular emphases the privatization efforts. The financial sector received some treatment in the 1994 CEM. However, there was no sector work focusing on the financial sector throughout Albania's relationship with IDA. Similarly, *infrastructure*, especially the transport, housing, and water supply sectors, were addressed only sparingly in the CEMs by way of diagnosing constraints on private sector development. *Energy* was the exception in infrastructure with the publication of a 1993 sector report covering power, petroleum, natural gas, coal, and energy conservation.

3.16 *SIPAR*, particularly on the core public sector, was largely absent from IDA's ESW agenda. No Public Expenditure Review (PER) has been completed for Albania, although one was planned in 1997 and canceled due to the crisis. Some background papers for a CEM such as the one on *government pay and employment reform* were undertaken in 1996. In 1994, the Bank did issue a policy research working paper on fiscal decentralization to enhance the GOA's awareness and knowledge of administrative decentralization, which was considered important for the efficiency of service delivery.

12. The Region believes that the supervision effort was appropriate given the small country characteristics of Albania—repeated projects, annual CPPR exercises, extensive procurement assistance, and single Ministries with multiple project responsibilities.

Table 3.2: Intensity of ESW

<i>Country</i>	<i>ESW SYs</i>	<i>ESW SYs as a % of total SYs</i>
Slovenia	0.3	16.3
Albania	2.1	14.3
Lithuania	2.1	27.7
Croatia	0.9	19.4
Slovak Republic	1.0	24.9
Azerbaijan	1.3	27.9
Hungary	2.4	17.5
Czech	0.1	11.1
Zimbabwe	14.8	20.6
Poland	4.4	20.1
Vietnam	4.0	28.0
All Countries	535.7	18.4

Notes:

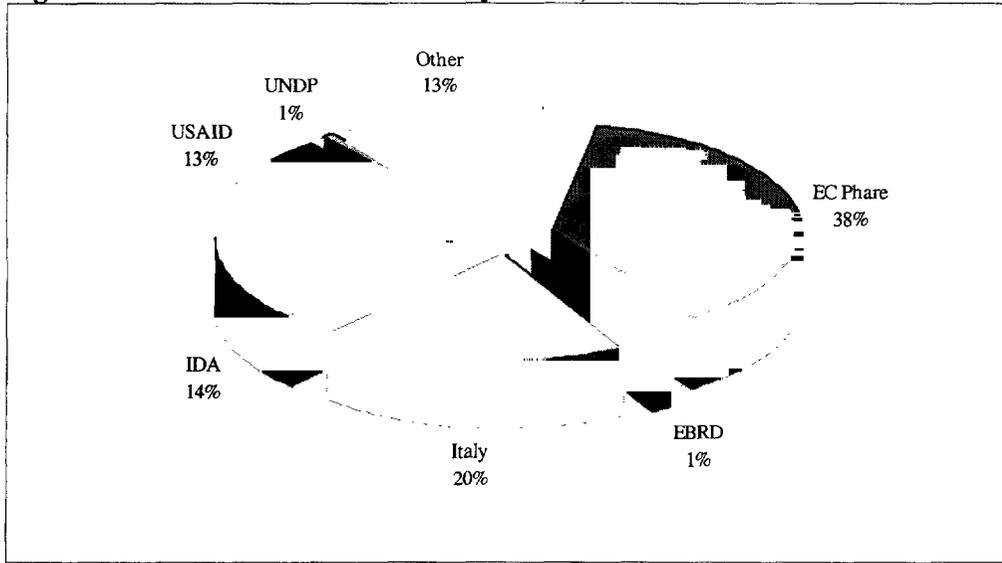
1. Countries are ranked according to population size.
2. ESW SYs (Economic and Sector Work Staffyears) are yearly averages, based on data for FY92-96. SY data include borrower country-identified staffyears only.

Source: PBD

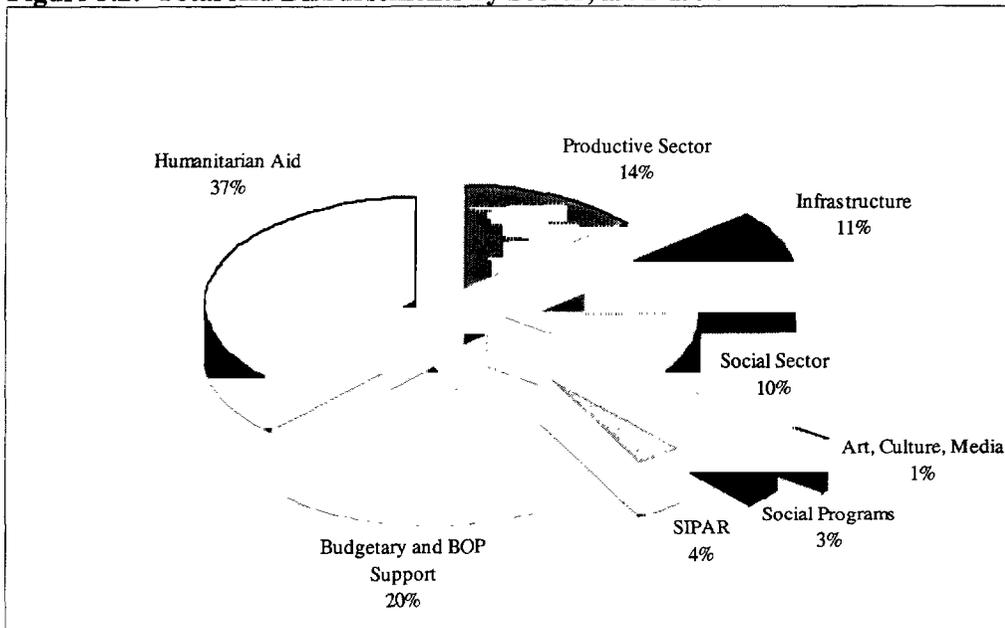
3.17 *Agriculture and the environment* were the focus of the bulk of ESW with an agriculture strategy report (jointly published by the Bank and EC in 1992) as well as three environmental studies (i.e., an environmental strategy study, a national environmental action plan, and an environmental assessment for the Forestry project). An Agricultural Sector Assessment was completed in 1996. In the case of agriculture and the environment, ESW preceded major lending activity and therefore provided a conceptual basis for operations. To a lesser extent, ESW focused on *human resource development* only sporadically through an early health sector review in 1992 and a poverty assessment in 1997. A notable exception to this body of ESW was the lack of detailed sector and policy work on education.

Aid Coordination

3.18 According to data provided by the Monitoring and Evaluation Department of the State Ministry of Development and Economic Cooperation, 22 major donors are currently supporting 309 ongoing operations. There are, however, many more international agencies and NGOs operating in Albania, which have not been counted. Foreign assistance has been massive. In the five years 1992 to 1996, Albania received US\$1.525 billion, or about US\$475 per capita, in total aid, the bulk of which (68 percent) were official grants. The EC is the largest donor with 38 percent of the share of assistance to Albania, followed by the Government of Italy, and then IDA (see Figure 3.1).

Figure 3.1: Total Aid Disbursements by Donor, 1992-1996

3.19 The bulk of assistance by donors between 1992 and 1996 went to humanitarian (i.e., food aid and medical supplies) and balance of payments assistance (See Figure 3.2). With rapid growth in the agricultural sector, this component of assistance quickly decreased. While the productive and social sectors appropriately received approximately 30 percent of assistance, infrastructure with 11 percent seems to have been under-funded given IDA and other donors' stated priorities. In IDA's portfolio from FY92, infrastructure was allocated 45 percent of commitments, which was consistent with the stated intent to rehabilitate these basic services. A key constraint, state institution and public administration reform, was also under-funded with only 4 percent of total assistance by donors.

Figure 3.2: Total Aid Disbursements by Sector, 1992-1996

4. Development Outcomes—Progress Toward a Market Economy

Introduction

4.1 This Chapter provides a description of Albania's progress toward a self sustained growth path and development of a market economy. The analysis will encompass two periods. The first from mid-1992 to early 1996, the second, developments that occurred from early 1996 to mid-1997. The reason for this dichotomy is obvious. The near civil war in early 1997, and the ensuing civil disorder, has represented a severe setback to the country's economy. Infrastructure and private businesses which were undergoing a period of restoration and consolidation were damaged or destroyed. Business confidence, both domestic and foreign, was severely shaken. A weak public administration was further undermined and in some cases completely disappeared. While this fragile political framework and process underwent a severe test, the elections in June suggest it is a little more robust than many had previously thought.

Macroeconomic Stabilization and Overall Performance

4.2 Stabilization progress and macroeconomic performance from mid-1992 to early 1996 was remarkable and unique amongst all transition economies.¹³ This is even more so given that the country was Europe's most underdeveloped with extremely weak administrative structures. Positive growth was restored in 1993 and averaged over 9 percent per annum for four years. Inflation was quickly reduced, falling from over 200 percent in 1992 to just 6 percent in 1995. Domestic savings, particularly private savings, steadily improved and investment as a proportion of GDP quadrupled in three years. Private investment as a proportion of GDP grew by 11 times in the same period. Key factors contributing to this strong performance was the early privatization of agriculture and a strong inflow of workers remittances. Also, while no accurate figures are available, anecdotal evidence suggests that considerable contraband traffic was taking place into the Federal Republic of Yugoslavia during the Bosnia crisis up to the end of 1995. This lucrative trade undoubtedly financed a portion of the relatively high levels of private domestic investment.

4.3 A measure of fiscal control was quickly restored in 1993, the domestically financed portion of the fiscal deficit declined continually up to the end of 1995. This trend was reversed in early 1996, with a sharp decline in the revenue mobilization efforts, which in part can be linked to the national elections in mid-1996. In fact revenue mobilization and an increase in the revenue to GDP ratio was the least satisfactory part of the fiscal performance throughout the period under review. However good progress was made in controlling expenditures, and in particular in the imposition of hard budget constraints on the larger SOEs.

4.4 The current account of the balance of payments showed rapid and sustained improvement, in part due to the massive increase in workers remittances which were estimated at over US\$300 million by 1996. Growth in exports was strong due to progress in the development of nontraditional exports such as garments and shoes. The massive level of food imports

13. It should be noted that the quality of national account data in Albania is not good, in common with many transition economies. The rapid structural changes that took place quickly made earlier systems of data collection redundant and informal sector activities are rarely captured at all. The rapid growth of the trade and services sector and small-holder agriculture, combined with changing tax systems, makes under reporting endemic. Nevertheless the bias in the data appears to be generally in the same direction. Namely, that real economic activity is underestimated.

required in 1991 and 1992 declined progressively thereafter as domestic agricultural output was restored. This alone brought a strong improvement in the resource balance. Foreign reserves improved rapidly from the critical levels of 1991, in part due to the flows of foreign assistance, and stabilized at about 3.5 months of imports equivalent.

Table 4.1: Albania—Selected Development Indicators^a

	1992	1993	1994	1995	1996	1997 (est)
GDP growth (% change)	-7.2	9.6	9.4	8.9	9.1	-7.0
Domestic Saving (% GDP)	-71.9	-33.7	-9.7	-0.7	-6.8	-13.0
Public (% GDP)	-17.4	-5.9	-4.4	-1.9	-7.5	-8.9
Private (% GDP)	-54.5	-27.8	-5.3	1.2	0.7	-4.2
Investment (% GDP)	5.2	13.2	17.9	21.0	20.5	12.0
Public (% GDP)	4.0	9.5	8.6	8.2	4.5	4.7
Private (% GDP)	1.2	3.7	9.3	12.8	16.0	7.3
Resource balance (% GDP)	-77.1	-46.7	-27.6	-22.0	-27.3	-25.2
Current account balance (% GDP) (excluding official transfers)	-61.1	-29.7	-14.3	-7.5	-9.3	-12.2
Exports (% GDP)	9.9	9.1	7.1	8.5	8.5	7.3
Imports (% GDP)	73.8	48.9	30.4	28.1	34.2	30.1
Official transfers (% GDP)	46.5	26.1	7.2	4.9	3.0	3.4
International reserves (months of imports)	1.2	2.2	3.0	3.3	3.0	4.3
Real exchange rate (index)	53.7	72.5	93.5	100.0	97.3	88.9
Overall fiscal deficit (% GDP)	20.3	14.4	12.4	10.4	11.9	12.7
Domestically financed deficit (% GDP)	20.0	9.1	7.0	6.7	10.5	10.6
Revenues (% GDP)	23.5	25.7	24.5	24.0	18.5	17.0
Expenditures (% GDP)	44.0	40.3	36.3	34.3	30.4	29.7
Consumer prices (% change) (end year)	236.6	30.9	15.8	6.0	17.4	42.1
Prices subsidies (% GDP)	2.52	3.48	2.24	0.83		
Employment (% change)	-23.6	-4.6	11.1	-0.6	-0.3	
Unemployment (% workforce)	26.5	22.4	18.4	13.1	12.1	
Migrant workers (000's)	200	236	295	295		
Privatization of small and medium enterprises	n.a.	1,560	2,775	2,821		
Private sector employment (% of Total) ^b	5.8	64.1	73.5	76.1		
Registered private enterprises	11,093	25,010	46,631	56,068		
Electrical energy (000 kwh)	3,357	3,482	3,904	4,414		

a. Sources: Various Government of Albania, IMF, and World Bank documents.

b. After 1992, all agricultural employment was in the private sector.

4.5 Throughout this four year period, the Albanian economy underwent a profound structural transformation. Not only did a large part of the workforce seek employment abroad, but private sector employment within the country increased rapidly. From almost zero in 1990, private sector employment accounted for over 75 percent of the domestic workforce by 1996. Much of this change was accounted for by the growth of smallholder agriculture and the construction industry. Also, given the rapid liberalization that occurred within the economy, there was a large increase in the trade and services sector that emerged to fill the vacuum existing under the previous centrally planned economy. There was also investment in light manufacturing (mostly garments and shoes), albeit modest, mostly from foreign sources (Italy and Greece) driven by the

relatively low domestic wage levels and the country's proximity to markets in Europe. While modest in terms of the proportion of the domestic workforce involved, this light industrial development augured well for the future.

Box 4.1: Albania—External Debt Management: Commercial Bank Debt Restructuring.

Until 1988 Albania had no convertible currency external debt. Between mid-1989 and mid-1991 the Government accumulated an external hard currency debt of just over US\$500 million. This massive increase in external obligations was caused by ill advised foreign exchange transactions by the State Bank resulting in defaulted foreign exchange spot transactions of US\$225 million. There were also unsettled letters of credit and money market overdrafts amounting to US\$160 million and interest arrears of US\$115 million. By defaulting on these obligations, Albania was cut off from further commercial bank credit, and most importantly from trade credit.

The Government of Albania developed a debt management strategy the objective of which was to restore normal working relations with creditors and maintain contractual debt service within affordable limits. In August 1993, the Government appointed a National Committee for External Debt Negotiations and invited both Paris Club and commercial banks to negotiate. Because Albania's bilateral debt consisted of arrears on short term credit this was eligible for rescheduling under the Paris Club. Short term debt to Paris Club creditors was rescheduled in December 1993, and Albania paid off medium term arrears to Paris Club creditors by March 1994.

A Bank Advisory Committee was formed in May 1994 and negotiations commenced at this time. Government efforts were supported by an IDA US\$1 million technical assistance grant under the Debt Reduction Facility for IDA-Only Countries approved by the Board in June 1993. A agreement was finally reached in March 1995, using an innovative approach that established that Albania would pay up-front in cash, the present value of a reasonable debt reduction package. Two options were offered. Cash buyback, up to a maximum of US\$285 million at 20 cents on the dollar. And the issuance of 30 year par bonds, the principal of which would be collateralized by U.S. Treasury Zero Coupon Bonds consistent with so called Brady deals for debt restructuring and reduction. This latter component ameliorated concerns by the creditors for the foreign exchange spot transaction defaults. Namely that the face value of the foreign exchange transactions should not be reduced as this would create a precedent for foreign exchange transactions worldwide. The total cost of the program was limited to US\$96 million to settle claims worth US\$371 million of principal and US\$111 million in past due interest. IDA supported this with a US\$25 million grant from the Debt Reduction Facility for IDA-Only Countries and was approved by the Board in June 1995.

The outcome of this debt reduction exercise was highly satisfactory IDA played a very active role, and the technical assistance grant was able to fund the necessary technical advice for the Government in its negotiations. The successful conclusion of this program of debt reduction was a strong factor in improving the viability of the balance of payments. External debt declined to 29 percent of GDP in 1996 from 108 percent in 1992, and the debt service burden was reduced considerably.

4.6 Macroeconomic outcomes worsened in 1996, although growth remained at a high level. A number of influences were at work. National elections planned for mid-1996 were a source of uncertainty and contributed to a reversal of the fiscal consolidation process. The domestically financed fiscal deficit rose to 10.5 percent of GDP compared to an average of 7.5 percent of GDP in the prior three years. Public sector wages were increased twice (October 1995 by 10 percent and April 1996 by 20 percent) and budget subsidies and transfers rose. The lifting of the international trade embargo against the Federal Republic of Yugoslavia was also a major shock to both the economy and fiscal revenue. The substantial rents obtained by traders from the violation of this embargo and the transit taxes collected (equivalent to almost 1 percent of GDP) disappeared. After the elections in July 1996, two positive fiscal developments did occur however. First, the 15 percent flat turnover tax was replaced by a 12.5 percent value added tax

with few exemptions. Second, domestic prices for wheat, flour and bread were decontrolled. The VAT garnered roughly twice the revenue of the previous turnover tax and helped to forestall some of the worsening fiscal situation.

4.7 The higher fiscal deficit was associated with an acceleration in broad money growth, with considerable central bank financing. A further influence emerging in early 1996 was the rapidly changing nature of the informal financial market. Pyramid schemes mushroomed, driving up real interest rates in the market to very high levels. This in turn affected monetary expansion as foreign inflows attracted by the schemes rose markedly. A parallel development was a sharp contraction in currency demand, particularly in the latter part of 1996, reflecting the public's conversion of cash to claims on the informal market.

4.8 All of these factors contributed to an acceleration in inflation, and the price level rose by 17.5 percent in 1996. Of this increase, about 4 percent could be attributed to adjustment in administered prices and 3 percent to the introduction of the VAT. The remaining underlying price rise of about 11 percent was nearly double the preceding year's inflation.

Structural Changes

Agriculture

4.9 One of the most striking changes that have occurred in the country's economy during the period under review has been in the agricultural sector. By 1995, there were about 450,000 farms in the country with an average size of 1.1 hectares, compared to about 550 farms with an average size of 1060 hectares in 1990. State farms completely disappeared by the end of 1992. As might be expected given the massive change in average farm size, the composition of agricultural output and the production function employed have also undergone massive change. Land use has changed with a decline in the areas used for grain cultivation (areas under wheat cultivation, for example, declined by nearly 30 percent by 1995) and an increase in land use for vegetable production (by over 50 percent in the same period). There has also been a large increase in livestock production, including dairy, however poultry and pig production has declined as has fruit production. The cause of the declines in the latter products is due to the decline in the factory or "estate" production employed under the previous state farm system.

4.10 Another noticeable achievement in the agricultural sector has been the improvement of yields for higher value crops. Yields for vegetables have improved by about 30 percent over the past five years, and for forage by over 60 percent. This is due to the rehabilitation of irrigation systems; the creation of Water User Associations to maintain these systems; and the increased availability of fertilizers, pesticides, and higher yielding seed varieties. Using data from the 1996 Annual Survey of Agriculture, rough estimates have been made of farm productivity. For the period 1989 to 1995, it is estimated that total factor productivity has increased by about 35 percent. The bulk of this increase derives from an increase in labor productivity and a reallocation of effort towards commodities with higher gross values.

Table 4.2: Indicators of the Changing Structure of Albanian Agriculture^a

	<i>Average 1985-90</i>	<i>1995</i>	<i>% Change</i>
Farm Structure			
Number of farms	550	450,000	n.a.
Average farm size (hectares)	1060	1.1	n.a.
Land use (000 hectares)			
Wheat	198	141	-28.8
Maize	75	69	-8.0
Potatoes	13	12	-7.7
Vegetables	23	36	56.5
Tobacco	29	6	-79.3
Oilseeds	35	1	-96.3
Cotton	14	0	-100.0
Livestock numbers (000s)			
Cattle	655.4	840	28.2
o/w Dairy	262.5	470	79.0
Sheep	1,442.8	2,480	71.9
Goats	998.2	1,650	65.3
Ags	200.8	100	-50.2
Poultry	4,867	3,900	-20.0
Value of production (million lek, 1994 prices)			
Crops	41,801.6	41,465.7	-1.0
Fruit	7,511.5	6,085.5	-19.0
Livestock products	22,249.0	42,268.5	90.0
Total	71,562.1	89,820.7	26.0

a. *Source:* Government of Albania, Ministry of Agriculture and Forestry, Annual Agricultural Surveys, 1994 (Special) and 1995/96.

4.11 The gross value of agricultural output (in constant 1990 prices) has increased by 57 percent from 1991 to 1995. As a result, the share of agriculture in GDP has climbed from 42 percent in 1991 to over 55 percent in 1996. For all of the positive features in the transformation of agriculture in Albania, however, it must be remembered that the present system of production is at a relatively low technological level, containing a large proportion of subsistence level activity and production for own consumption. Given the nature of the smallholder production functions currently employed in Albania, it is uncertain whether the high output growth rates can be sustained. Clearly, commercial agriculture in Albania will have to undergo a further transformation if farm incomes are to rise in line with incomes in non-farm activities. This in turn may require a degree of land consolidation, either through sale or leasing, in order to achieve minimum economic scales of land use and production.

Financial Sector

4.12 By the end of 1992 some of the essential building blocks for a financial system suitable for a market economy were in place. A central bank was established, under a central banking law, and the three state banks were "commercialized" under a commercial bank law. Over the next four years, however, little progress was made in creating a sound financial sector. A standardized chart of accounts for the banking sector has yet to be operationalized, the payments system between banks is rudimentary, and collateral and bankruptcy laws were late in coming

(1996) and have yet to be tested. Four private banks were licensed.¹⁴ However, these banks have remained very small, with no branch network and a very restricted range of activities confined mostly to foreign trade transactions and dealing with worker's remittances.¹⁵

4.13 Throughout the period under review attempts were made to improve the functioning of the publicly owned banks, through merger and/or transformation involving some attempts to improve solvency by the Government assuming responsibility for the large inherited bad debt portfolio. A complex web of interbank liabilities inherited from 1991 was never resolved properly which further compromised the banks' balance sheets. Management and operational reforms in these banks was limited. As a result, bank performance improved very little and the severe governance problems, including corruption, remain. By the end of 1994, of loans made from mid-1992, 27 percent were nonperforming. By the end of 1995 in two of the three public banks, overdue loans accounted for over half the loan portfolio. There were some attempts to privatize one of the banks (RCB) which were basically donor driven. The GOA was not strongly committed and declined to proceed.

4.14 Throughout the period 1992 to 1996, Albania was essentially a cash economy with severe financial disintermediation as evidenced by the high currency/broad money ratios. Liquidity was flowing into the domestic economy from remittances, contraband trade and high aid flows, and this liquidity was not being captured by the formal banking system. This set the stage for development of informal financial intermediation and the growth of investment funds and ponzi schemes. By mid-1996, there were twenty such schemes in operation. A full description of the growth of these schemes, and their eventual demise, is shown in Box 4.1 in this chapter. Some of these schemes were completely fraudulent at the outset, however others did start out with some semblance of commercial legitimacy. The early funds evolved from import/export trading activity, while others engaged in domestic trade and construction. While accurate information on the size of this informal intermediation is not available, the IMF estimated in February, 1997 the total liabilities at about US\$1 billion or about 38 percent of GDP.¹⁶

4.15 All was not disappointing in the development of Albania's financial sector however. In rural credit some innovative, albeit modest, lending systems were introduced in the context of an early IDA project (Rural Poverty Alleviation Pilot Project, Credit 2461-ALB). A funding agency was established to focus on rural credit needs for smallholders (the Albanian Development Fund), channeling donor funds for any income generating activity, including purchase of livestock or agricultural inputs. Up to mid-1996 nearly 200 Village Credit Funds had been established, with elected councils, to oversee lending and repayment by villagers. The repayment rates have been close to 100 percent. While this does not represent development of a full rural financial intermediation system (the resource mobilization part is absent), progress is very encouraging. Plans are afoot to expand the experiment on a cautious pilot basis toward the full development of rural credit unions.

14. In early 1997, preliminary licenses were granted for three more.

15. By mid-1996, the three state owned banks accounted for over 95 percent of deposits in the formal banking system.

16. IMF, *Staff Report for 1996 Article IV Consultation*, February 19, 1997. It should be noted that this massive amount reflects accrued interest which at the rates prevailing at the time (8 to 16 percent per month) could be quite substantial and the actual deposit liabilities much less.

Box 4.2: Albania—Development of the Pyramid Schemes

Few countries have experienced such a rapid development of pyramid schemes and certainly none has experienced such a catastrophic breakdown in civil order verging on civil war following the demise of these schemes. The first such scheme emerged soon after the fall of the communist government in 1990. The number of pyramid schemes and investment funds grew to twenty by 1996. Not all schemes started out as pure, fraudulent pyramids. Some were more legitimate investment funds with commercial and trading activities that took on the characteristics of pyramid schemes somewhat later because of cavalier management and changes in the business environment (for example the end of U.N. sanctions against the Federal Republic of Yugoslavia in 1995). The emergence of these schemes does reflect the weaknesses in the formal banking system and its inability to efficiently intermediate domestic savings, but it is unlikely that any legitimate bank could have offered deposit rates that would have forestalled the flow of funds into the schemes. Also, bearing in mind the country's earlier history, the general public were quite unsophisticated in financial matters and there was no regulatory framework that could tell them to be more cautious.

Monthly interest rates for deposits or loans to the schemes were initially 1.5 to 2 percent, rising to about 4 percent in 1993 and 1994. While high, given the lucrative scope for trade, particularly contraband trade in violation of U.N. sanctions against Yugoslavia, in the initial stages there may have been a measure of solvency in the investment funds, albeit of a high risk nature. There were of course pure pyramid schemes, one of the largest of which started as a lottery and others were registered as charitable organizations, and they became more common from mid-1994. Thus at this time there were two types of schemes. One type that made highly visible "showcase" investments in productive assets and the other that was more opaque, made no productive investments and preyed on the greed and gullibility of the general public. Preliminary estimates made in 1997 suggested that over 60 percent of Albania's population placed funds in these companies and eight out of ten families had at least one depositor.

The fact that there were two different basic types perhaps initially blurred perceptions as to the real danger of these companies. Certainly the Government evidenced no desire to exercise appropriate measures to protect the public. In fact, Government complicity was active and for certain companies the Government actively supported their activities in the media and in public announcements. This undoubtedly led to strong expectations amongst the depositors that the Government would protect their deposits, providing bail out funds where necessary. Not all were so complacent however. The Central Bank in particular from early 1994, frequently expressed strong concerns about these companies to the Government and the judiciary, and requested inspection and regulation. The Central Bank drafted two laws dealing with usury and money laundering, which were submitted to Government but they were not enacted. The Bank of Albania requested the courts and the attorney general to terminate the companies activities as deposit taking institutions, which should only be undertaken by registered banks. The Government, President and the judiciary argued that this activity was covered under the country's civil code and the "deposits" were in fact "lending".

Obviously a collapse was inevitable, and by February 1996 with monthly interest rates of between 10 and 16 percent, it would not be long in coming. By October, 1996, under very strong pressure from the Bank and Fund, the Minister of Finance made a public announcement about the risks of these schemes. But by then it was far too late, and in November the first scheme defaulted on its payments. The house of cards collapsed quickly with more schemes declaring bankruptcy in January 1997, at which point the Government froze assets of these bankrupt companies in the banking system and the central bank placed withdrawal limits on the others. The Government said that compensation would be limited to what was realized from the assets of the companies themselves and distribution of some of these seized assets commenced. In February 1997, the Government passed a hasty law banning pyramid schemes, but these schemes were not properly defined, and as civil disorder escalated, all the companies ceased regular payments, although some made sporadic payments to selected depositors.

Box 4.2 (Continued)

In 1993 and 1994, the Bank took the view that the various investment funds might be a positive development in financial intermediation in a country that had almost none and that these funds could eventually evolve into legitimate banks. Bear in mind, at the time the economy was performing very well and the macroeconomic stabilization and systemic reform agenda was on track. In this environment, stringent criticism of these funds, some of which appeared to be engaging in legitimate economic activity might not be readily forthcoming. This changed in January 1995. The first supervision mission of IDA's EFSAC was highly concerned. One of the members of the mission wrote that "...The activities of the informal lending market are becoming preoccupying and there is the feeling that something should be done to put a stop to such unregulated and uncontrolled activities that could end in ruining many small savers and in financial-political scandals, as has happened in other countries." This concern was prescient and was communicated to the Minister of Finance. The Government took no action.

By the Spring of 1996 however, both the Bank and the Fund became more strident in their requests to the Government to take action. IDA withheld tranche releases under the EFSAC and ASAC. In a letter to the President in September, the Bank Country Director recommended immediate Government action to curtail the schemes. Given local elections in May, and national elections in October, the Government was reluctant to act on what was by this time a very widespread public issue.

It is uncertain if the Government took action in December 1995 or January 1996, whether the magnitude of the collapse and financial loss, with the ensuing civil disorder, could have been avoided. It is the view of this CAE, that this was too late and the damage was irrevocable and the collapse inevitable—by this time. However, if steps were taken by the Government in January or February 1995, when the Bank staff first expressed concern, then the outcome could have been profoundly different.

State Owned Enterprises, Privatization and Industrial Development

4.16 Albania moved quickly, largely on its own initiative, to disengage the state from productive activities by privatizing. The Law on Privatization (August 1991) set the principles for privatization and created the National Agency for Privatization as the responsible body. This law, together with the Law on Commercial Companies (November 1992) created the foundation for private sector development.¹⁷ The Decree 248 of May 1993 established procedures to privatize rapidly small-medium enterprises through an auction system, with ex-owners and/or employees receiving preference. In 1995 the process for privatizing small and scale firms was streamlined by Decree 203 which specified that only 5 percent of the purchase price needed to be paid in cash and provisions were made for a reduction in book value when there was no interest in the first auction. This adjustment resulted in an acceleration in the sale of small and medium size enterprises, and by mid-1996 about 7500 firms had been sold.

4.17 The larger SOEs presented a more intractable problem. Many were overmanned with inefficient systems and machinery. Some, most probably in the mining sector, were viable, but all needed private sector owners who could restructure and inject fresh capital. Initially the Government enforced hard budget constraints on these larger SOEs and instructed the state owned banks to cease further lending. These efforts did lead to the essential liquidation of some enterprises, however some "strategic" SOEs continued to receive budget transfers through "ministerial conservation funds". Furthermore political pressures became stronger on the state banks to provide financing for some SOEs.

17. Igor Artemiev and Gary J. Fine, "Albania," p.177, in *Between State and Market: Mass Privatization in Transition Economies*, Ira W. Lieberman, Stipon Nestor and Raj Desai (eds.) Studies of Economies in Transition, No. 23, World bank, 1997.

4.18 By early 1994 the country's privatization program in the industrial sector had been categorized into four groups. The first consisted of so-called "strategic" firms which encompassed utilities and the oil and gas, chrome and copper sectors. The plan envisaged privatization, but at a measured pace. Very little progress has been made in finding strategic investors although there have been some discussions with foreign interests on the chrome and oil and gas sectors. The second group consisted of 32 problem large SOEs which were lodged in an newly created Enterprise Restructuring Agency (ERA) (July 1993) that would focus on restructuring before privatization and/or liquidation. The ERA was effective in assisting and downsizing enterprises (employment declined from a peak of 50,000 in early 1992 to less than 7,000 by the end of 1995). However, the privatization effort was somewhat less effective, as only 10 of 32 were privatized and only 1 was liquidated. In July 1996 the Government decided to abolish the ERA and transfer control of the remaining firms to a newly created Ministry of Privatization.

4.19 The third element was the aforementioned small and medium scale firm auctions. The fourth element was the Mass Privatization Program (MPP) which was introduced in May 1995. Privatization vouchers were distributed to the wider population to be used in share auctions for designated firms. The first auction took place in October 1995, and 97 companies were auctioned in five rounds of mass privatization to July 1996. There have been difficulties with the program however. The supply of vouchers exceeded demand for shares in the enterprises to be sold, with a strong fall in the secondary market value of the vouchers (4 percent of face value by November 1996). Furthermore, enterprise governance problems have emerged. While some investors and one investment fund have bought vouchers on the secondary market in order to gain sizable holdings in a few companies, the bulk of shareholding has been spread amongst many bidders. As a result, existing management remain in effective control of most enterprises resulting in modest firm level efficiency improvements. Finally, the absence of a functioning share registry has prevented emergence of a secondary market in shares.

4.20 There was a major improvement in the environment for private sector development. State trading monopolies were abolished, external trade liberalized and the regulatory environment made less onerous. A private sector has emerged in light industry, trade and services and construction and has been a strong element in the development of the country's exports. In 1996, manufactures accounted for 60 percent of exports, two thirds of which are in shoes and textiles. The role of the state in the industrial sector has declined considerably. The contribution of industrial SOEs declined from 42 percent of GDP in 1990 to 12 percent in 1995. This is not to suggest however that all factors necessary for a vibrant private sector have been put in place. Necessary strengthening of legal structures for enforcing transparent rules and a commercial code has not occurred and land title and collateral registration systems remain highly deficient. The domestic private sector is dynamic and imaginative, however in the absence of a formalized set of transparent rules, transactions costs are high and business uncertainties exacerbated.

Infrastructure Rehabilitation and Development

4.21 *Power.* The initial emphasis was on rehabilitation and success was achieved. Total blackout days in the larger cities declined to four in the winter of 1992-93 (from nearly thirty in the previous year) and the number of damaged transformers in the system declined by two thirds. From 1992 to 1995, electricity consumption increased by 51 percent and major transmission lines were restored to service. Progress was made in raising consumer prices, and by mid-1994 prices were close to or above the averages in other Central European countries. Despite improvements in financial viability, improvements in the efficiency of the country's power system have been

more limited. Distribution losses grew from 11 percent of electricity entering the system in 1989 to 49 percent by 1996.¹⁸ Billing and collection problems have worsened and theft has become more widespread. Government entities (the water supply companies and the large energy intensive SOEs) are in arrears to KESH, the generating entity, undermining its financial viability and further eroding the capacity to maintain generation and distribution systems.

4.22 Despite some promising privatization initiatives in 1995, and the creation of three pilot distribution companies, institutional development within the power system has been modest. Management and incentive systems are still deficient. Admittedly, many of the problems in the sector are not amenable to solution without reform in other sectors. Water companies do not have the ability to pay for electricity because of administratively set low water tariffs and key SOE users also lack the ability to pay in the absence of financial and operational restructuring. The result is that the power sector is hampered in further improving the quality and reliability of electricity provision and investing for the future.

4.23 *Water.* As with power, development of the country's water systems has not been good. Notional autonomy has been granted to local authorities, but this has not been achieved in an operational sense. Water tariffs are capped by the central government, and are far below cost recovery levels. In Durres (sight of an IDA water project), water is still only generally available for three hours a day, and given the internal migration to the major urban areas, demands on the water companies are continually increasing. Progress has been made in improving collections from households (for example in Durres collection rates for households was about 90 percent in 1996) but Government firms and entities are in arrears.

4.24 Little progress has been made in obtaining private sector involvement in the provision of water services. Studies and strategies have been developed for water system management contract concessions but little more; it should be noted however that the crisis in 1997 did interrupt progress in engaging greater private sector involvement in the sector.

4.25 *Transportation.* Progress has been made in establishment of market-based transport policies. Truck transport and interurban bus transport are significantly deregulated and road user taxes have been increased. Maintenance expenditures have also increased. Progress has been slow however in restoring the country's national road network, and even slower for rural roads. In many cases the lack of experience of local contractors is a constraint. The port of Durres has been rehabilitated, and necessary equipment has been installed and is operational. Institutional development is ongoing and a Port Master Plan and Privatization study completed.

4.26 *Housing.* Over the past five years the country has enjoyed a housing boom, the overwhelming bulk of which has been driven by private sector investment. Much of this development however has been outside any planned zoning and in the absence of any supporting infrastructure (roads, water, sewerage and power). Therefore future infrastructure problems have been compounded, and in high growth areas (the Tirana-Durres corridor for example) has become acute. Government initiatives in the housing sector have been limited and ineffective. The National Housing Agency is not financially self sustaining and no progress has been made in developing a housing/construction mortgage system. Laws and titles for land and land transfer are ambiguous, undermining the market for transfers of housing or other real estate.

18. The Region suggests that power theft became more widespread and distribution losses increased because of the large increases in power tariffs.

Health, Education and the Social Safety Net

4.27 *Health.* Albania has received considerable help from the donor community in rehabilitating and improving the country's health services (about 40 projects encompassing commitments of over US\$90 million). However many primary health centers were destroyed and looted in early 1997, as were district hospitals.¹⁹ It is difficult therefore to evaluate outcomes in the health sector.²⁰

4.28 What is clear today is that the fundamental problems of the health sector remain. The draft SAR of May 1997 for the proposed follow-up Health System Recovery and Development Project found that the main sector issues were essentially the same as those during the pre-crisis period, but were more urgent. The Ministry of Health was considered to have little capacity for sectoral planning; policy, management tools, and information systems needed to inform the planning process were largely nonexistent. Resources were severely constrained and financing and payment mechanisms were inadequate. Further, there continues to be a structural mismatch between health services provided and population needs, i.e. between curative care and preventive and community medicine.

4.29 There is an absence of incentives to motivate health sector staff. The problems of incentives for health care providers, particularly, for trained physicians to serve in remote, poor areas has not been solved. Moreover, administrative capacity at the district level is still poor. Administrators are not trained in preventive health care or community medicine and operate the system in a top down manner.

4.30 *Education.* Much of what has been stated above for health applies equally to the rehabilitation and improvement in the country's education system. Unfortunately, education facilities were a focus of public discontent and frustration and were damaged in early 1997. Undoubtedly progress was made in refurbishing schools prior to the civil unrest and new schools were opened in urban areas where demand is expanding most rapidly. Primary enrollments have returned to pre-transition levels and secondary school enrollments now exceed the pre-transition levels. The number of unqualified teachers had declined and there is increasing demand for new subject areas such as the social sciences, business, and law.

4.31 Despite some progress, there are important governance issues in the education sector that have not been resolved. Funding for the sector remains inadequate, there is little private education and no tuition is charged at any education level. The Ministry of Education is charged with development of all aspects of the system, including production and distribution of textbooks. There is limited parent involvement, and routine maintenance of schools is the responsibility of local authority works departments which have other competing demands. There is an almost total lack of quality assurance mechanisms and no national assessments exist, whether for diagnostic, exit or accountability purposes. Curriculum reform has lagged, as has development of teaching aids.

4.32 *Social Safety Net.* Progress has been made in establishing the legal and administrative framework for the main elements of the social safety net. The pension system, the social

19. In a study in the Fall of 1997, UNICEF estimated that no more than 20 percent of Primary Health Centers were operational.

20. IDA supervision reports up to 1996 suggest that progress on clinic rehabilitation was progressing albeit slowly. Capacity building was also considered to be proceeding smoothly with ongoing training in health system management and skill enhancement programs for doctors and nurses.

assurance system and unemployment insurance have been rationalized and strengthened. Nevertheless the fundamental problems of the social safety net have not been resolved. These include inadequate targeting of benefits, lack of actuarial soundness of the pension system, excessive reliance on payroll taxes and inadequacy in retraining. The fiscal cost of the system is considerable. Social safety net expenditures reached 15.4 percent of GDP in 1993, but have declined to about 10 percent of GDP over the past two years. This is still substantial.

4.33 A Social Insurance Law designed to rationalize the provisions of the system was passed in June 1993. Under the law, the social assistance system is administered by the Social Insurance Institute (SII), a semiautonomous extra-budgetary fund supervised by a tripartite board. SII collects payroll and self-employment taxes and pays all social insurance benefits, except for unemployment benefits, which are paid by the labor offices. Social assistance is administered jointly by Ministry of Labor and Social Affairs (MOLSA) and local governments. MOLSA establishes rules for allocations to local governments and provides block grants to local governments, based on their population and its socioeconomic status. Local governments have considerable discretion in granting social assistance and can retain the difference between its block grant and its benefit payments. The new social assistance law extended eligibility for social assistance to all low-income rural families, whereas the old law had provided benefits only to families in the northeast of the country, with land less than 0.2 hectares per person. The unemployment insurance system does not cover new entrants to the labor force, and eligibility to unemployment insurance benefits expires after one year.

4.34 Despite the progress that has been made in establishing the legislative framework and strengthening the institutions responsible for administering social assistance, serious issues persist. The most important of these is that in the absence of reliable poverty monitoring tools, neither the Government nor IDA can assess the need for effectiveness of antipoverty programs. Targeting of social assistance is not possible without household survey expenditure data and representative poverty lines. The first poverty assessment prepared by the Bank was not issued until 1997 (Albania: Growing Out of Poverty Report No. 15698-ALB, May 20, 1997). The fact that such a report was so long in coming was partly because Albania has not been able to undertake a nationwide survey of household income and expenditures and other socioeconomic characteristics.

4.35 There are major financial problems associated with the pension system. Despite Albania's youthful population, there were on average 1.45 recipients for every contributor. While about 60 percent of the labor force was covered by social insurance pensions, only about a third of those in the labor force contributed (only about 30 percent of those employed in the non-agricultural private sector). Under these circumstances, the goal of actuarial soundness appears unattainable. Payroll taxes associated with the social protection system are very high at almost 45 percent. There is a 36 percent payroll tax for pensions and short-term benefits (10 percent paid by the employee), a 0.5 percent tax for employment injury insurance, a 6 percent tax for unemployment insurance, and a 3.4 percent tax for health insurance (half paid by the employee). This high level of taxation is a deterrent to the expansion of formal sector employment.

4.36 The Ministry of Labor was established in 1992, together with 37 regional labor offices. Besides developing the legal and institutional framework necessary for labor market development, a Training, Enterprise, and Employment Fund (TEEF) was established to support the funding and contracting or purchasing of training and retraining services for the unemployed. TEEF is an autonomous agency. Local labor offices act as a gateway for firms wishing to avail themselves of TEEF training finance, preparing and submitting training projects to the TEEF.

State Institution and Public Administration Reform

4.37 Progress has been made in the reform of the core central government. Employment in budgetary institutions has fallen substantially from over 230,000 in 1992 to about 150,000 by mid-1996. Furthermore, within the context of budget limits and fiscal control, real civil service pay had returned to nearly 1990 levels by mid-1996. This is not to suggest however that the quality of public administration has improved or become more efficient. There have been "enclave" improvements (in tax and social assistance administration for example), but by and large accountability is still poor and motivation and productivity levels remain very low. Furthermore public perception of the civil service is not good.

Table 4.3: Albania—Wages and Employment in the Budgetary Sector

	<i>Total employment (000s)</i>	<i>Real wage index (Dec. 1990 = 100)</i>
1992	231.0	54
1993	187.9	56
1994	178.6	66
1995	160.8	76
1996	148.6	93

Source: Government of Albania and IMF staff estimates.

4.38 Within the core public sector, the capacity for strategic planning is still very weak, ministries are fragmented and ill-coordinated and lines of control are unclear. Higher quality professional staff are leaving because of poor incentives and career prospects. Patronage and political interference in personnel management is endemic. Information dissemination is limited and transparency in government activity is minimal. Key elements of government, such as the legal system, lack staff, and credibility with the wider society. This in turn undermines public respect and compliance with both legal and regulatory requirements.

4.39 In service delivery, NGOs have filled the gaps created by the failures of the central government. As a result some positive developments in terms of competition in service delivery of certain services has emerged. In education, NGOs are active and are engaging beneficiaries in a manner that encourages participation and accountability (for example the Soros Foundation in education). These developments with NGOs are also occurring in health and work skill development, and deregulation and liberalization in the transport sector has brought forth a rapid private sector response. Furthermore, there have been some encouraging initiatives in forging greater partnerships in particular public sector programs (the Tripartite Boards comprising Government, the private sector and the wider society for the Albania Development Fund and the TEEF represent good examples).

4.40 Little progress has been made in devolution and decentralization of some administrative and service delivery functions to communes and municipalities. Laws 7572 and 7608 of 1992 defined responsibilities of district council, municipalities and communes, but the responsibilities of these various levels of government vary across the country. Furthermore budget resources are allocated by the center which undermines real authority and accountability at the decentralized levels. Finally, the failures of the State to deliver or enforce common standards, regulations and property rights has encouraged the growth of illegitimate and informal parties to carry out those functions in parallel with the formal State. Organized crime, corruption, and informal local society groups have become a more formidable presence within society.

Unraveling of State Control and Macroeconomic Stabilization

4.41 Albania's transition stalled in 1996, with the Government's focus increasingly on upcoming municipal and national elections. The solid progress made on fiscal control slipped, with the domestically financed deficit increasing to 10.5 percent of GDP. This in turn led to a tripling of the annual inflation rate to 17.4 percent and a widening of the trade deficit to about 25 percent of GDP. Public sector wages were increased by 20 percent in April 1996 and the revenue mobilization effort waned. This period however was dominated by the pyramid schemes. For much of 1996, there was a sharp contraction in currency demand reflecting the public's conversion of cash into claims on the informal market. As 1996 progressed the mania surrounding the pyramid schemes increased in intensity, culminating in the collapse of the first in November 1996. Thereafter, the country rapidly descended into anarchy and near civil war.

4.42 Widespread rioting occurred throughout the country and many State institutions virtually collapsed. This intensified in March 1997, despite the announcement of new elections in June 1997, and the formation in early March of an all-party interim Government headed by the opposition. The arrival of a multinational peacekeeping force of 7,000 in mid-April 1997, followed by OSCE monitored national elections by the end of June, and the formation of a new Government by the end of July, all brought a measure of political stability to the country.²¹ Nevertheless, given the widespread looting of arms and the strong emergence of organized criminal elements, the security and political situation remained precarious throughout 1997.²²

4.43 The economic costs of this breakdown were high. There was extensive destruction of infrastructure and private property, most families experienced a loss of wealth and confidence in the State and its institutions was further eroded. The loss in national income was large with a fall in real GDP of about 7 percent for the full 1997, but fortunately agriculture, based on smallholdings, has been able to rebound quickly. The external accounts worsened, foreign aid was entirely disrupted and there was a sharp fall in workers remittances from abroad. The fiscal situation deteriorated sharply with a deficit of over 14 percent of GDP for the year and inflation accelerated rapidly to over 40 percent.

21. Organization for Security and Cooperation in Europe.

22. The recent unrest (February 22 to 25, 1998) and strong police and army assault to regain control from over 100 masked gunmen in the northern town of Shkoder shows how fragile the situation in Albania really is.

5. Efficacy of IDA's Assistance Strategy: Overall Assessment

Introduction

5.1 Any assessment of IDA's assistance strategy for Albania will be tarnished by the disastrous outcomes in early 1997. Not only was the fragility of the political system exposed, but much of what had been achieved in the move toward a sustainable, market driven growth path was set back. The painstaking process of creating a state with legitimate and transparent rules and regulations, in which there was a general consensus in society of fundamental rights and obligations was dealt a severe blow. The challenge for the present Government is not only one of economic development in Europe's poorest nation, but also of entrenching a political system grounded in strong democratic principles. There is an urgent need to build democratic institutions and a political culture that are robust enough to weather the normal economic tensions and strains common to all countries. If this is not achieved, then with the best will in the world, economic assistance efforts will achieve little despite the soundness of the assistance strategies.

5.2 Public expectations for progress in economic and social development in mid-1992 were very high. While disillusioned by the loss of savings in pyramid schemes and the destruction of infrastructure and social facilities such as schools and clinics, expectations are again high. This again will drive development efforts, but perhaps with a focused determination to prioritize the array of needs and options. Certainly the donor community should recognize that the magnitude of the flow of resources is a necessary condition to ensure stability and a rapid return to normality but not a sufficient one. From 1992 to 1996, Albania received US\$1.525 billion in overseas aid including the IMF, representing per capita assistance of about US\$465 over the five years. In 1996, 22 major donors were supporting 309 ongoing projects, and there are many more international agencies and NGOs operating in the country. This assistance has covered all sectors, including humanitarian assistance and assistance to the police and armed forces. Few countries, if any, have received such a concentration of assistance in such a short space of time.

5.3 This massive flow of assistance complicates the evaluation of the effectiveness of IDA's own lending and nonlending services. Establishing a counterfactual scenario, where there was no IDA involvement, is not technically possible. Furthermore measuring IDA's performance without an assessment of the performance of others involved in the development effort may ascribe to IDA a capability and independence of action which it does not enjoy. Nevertheless attempts are made in this chapter to provide an assessment of IDA's overall country assistance strategy and its method of implementation in the context of the identified development constraints. The relevance of the strategy will be assessed and the efficacy measured in the context of the stated strategy. With also the benefit of hindsight, the omissions in this strategy will be highlighted and appropriate lessons drawn which are contained in the following chapter.

Relevance of the Overall Country Assistance Strategy

5.4 In 1992, IDA's country assistance strategy was torn between the urgent need to rehabilitate and restart critical production (agriculture) and infrastructure and a medium term development program. The needs were large. In the early stages of IDA's involvement it was recognized time was needed to expand sector knowledge and thereby define in more precise

terms the exact nature of sector reform strategies. Sector work undertaken in 1991 and the first half of 1992 identified constraints and problems, however prioritization and reform sequencing was not fully identified. With the IMF taking the lead, IDA did place a high priority in the early stages on macroeconomic stabilization.

5.5 This early strategy was highly relevant. However, as the overall country strategy evolved in 1993 and 1994 the focus of the strategy became somewhat blurred.²³ The core of the strategy was flexibility with a continually shifting focus of emphasis as events unfolded. As a result this strategy envisaged a large number of small, targeted operations which were simple in design and therefore relatively straightforward to implement. Given the weak domestic institutional capacity, and the ability of IDA to leverage other donor resources, there was some merit to this approach. However there were a number of significant risks as well. First, it would place a considerable strain on IDA's own administrative resources with the risk that real understanding would be compromised and project design lack depth. Second, indicators of success in one area could provide a misleading picture of development progress because the weight given to these achievements was too high. Third, there would be a danger that a longer term sector vision would be over shadowed by short term expediency, thereby requiring more difficult remedial actions to ensure a sustainable policy framework. Fourth, maintaining a social consensus during the drive toward a market economy may be undermined, because a critical mass of effort is not applied in any one area and observable results or progress are diluted.

5.6 There are indications that all four risks cited above occurred during implementation of IDA's country assistance strategy.

- There was considerable imbalance in IDA's core activities. Nearly 50 percent of staff activities were devoted to lending, with ESW accounting for 19 percent and supervision for 14 percent. Following an initial burst of ESW in 1991 to mid-1993, staff years devoted to sector work declined dramatically thereafter. The average of 14.3 SYs for the period 1992-96 is over 20 percent lower than Bank-wide averages, and was much lower than all the other transition economies with the exception of the Czech Republic. Bearing in mind how little was known of this isolated country and the weak domestic institutional capabilities, the relatively low level of ESW undertaken on Albania is even more striking. Supervision was also low, over 30 percent lower than Bank-wide averages and below the averages for the transition economies.²⁴ The relative lack of ESW had negative consequences in a number of sectors.
- Albania's macroeconomic and growth performance from 1993 to 1996 was impressive, as was the transition in agriculture and small scale private sector activity. This may have inhibited perceptions by the Government and IDA of the seriousness of developments in other sectors. The obvious example maybe the pyramid schemes. The same may also be said for the gradual decline in public administration, the slow progress on large scale

23. The ECA Region does not agree with this judgment and argues that there was an effort to prioritize country assistance efforts throughout the period under review. The Region believes that there were crucial issues in all sectors that could not be ignored by the Government and IDA assistance on all of these issues was necessary given the weak public administration framework.

24. It should be noted that the portfolio for Albania was very new and in the early stages of implementation. This would cause the supervision effort to be lower than usual. Also the relatively low supervision effort could also be a sign of efficiency. To some extent this is borne out by the above average disbursement ratios for Albania.

privatization and the lack of progress in improving efficiency in the power and water sectors.

- In both the health and education sectors, development of a medium term vision has been tardy and perhaps has contributed to the general decline in service quality over the past six years. Also the failure to develop and publicize a comprehensive civil service reform program may have exacerbated the exodus of good quality staff and further reinforced public cynicism toward Albania's public administration. On the other hand, the early adoption (late 1992) of a comprehensive agriculture sector policy (supported by an earlier comprehensive sector report prepared by IDA and the EC) has undoubtedly contributed to the rapid transformation of the agriculture sector.
- Progress on rehabilitating schools and rural clinics was slowed because of a lack of basic complementary inputs such as power and water. Widely disparate sections of national highway were completed, but there is still no inter-city road of acceptable standards for its entire length linking two cities. Water in Durres is still only available for three hours a day, the same as the situation in 1992, despite an ongoing water project in the city. During the field mission, many of the interviewees questioned what had been achieved by foreign assistance over the past five years. This is of course unfair, as a lot was achieved, but it does suggest that a critical mass of effort, together with appropriate public information campaigns, may have been absent.

5.7 Albania in 1992 was an unusual country. The State was in an advanced stage of degeneration, and yet IDA's strategy treated Albania as a more conventional transition economy with sector and policy deficiencies that could be remedied by a swift inflow of resources, liberalization, regulatory reform, and traditional investment instruments. The strategy did not adequately recognize that the existing State/Society nexus was extremely fragile, demanding a very strong emphasis on governance issues and a prioritization of key institutional and sector reforms.

5.8 One of the many paradoxes found in Albania is that many individual projects did well, and in some cases were highly innovative (see the agricultural sector evaluation in paragraph 5.10 below), but the sum of sound projects was not sufficient to ensure an overall development path that was sustainable. Key macroeconomic indicators which were performing well, coupled with rapid progress in liberalization diluted perceptions of key policy and regulatory omissions and the danger that they posed. IDA's overall country assistance strategy for most of the period under review tried to do a bit of everything. While the need for assistance in all sectors was clear, IDA's strategy from 1993 to 1996 perhaps did not fully appreciate the fragility of the evolving political system. This is not to suggest however that the Bank could have done more to address these underlying political issues.

5.9 The events and crisis in Albania in the first half of 1997 did produce a profound rethinking and change in the country assistance strategy. Recognizing that trust in government and public authority was at a low ebb, IDA set three very clear priorities—fundamental reform of public administration, re-establishment of macroeconomic stability and a focus of key constraints to the revival of economic activity.

Sector Evaluations

5.10 *Agriculture.* In partnership with the Government, IDA has done well in the agriculture sector. The sector strategy followed by IDA has been highly relevant, led by very good ESW undertaken in 1992 which was embraced by the Government as its own sector policy framework. This collaborative approach has worked well. In recognition of the relative weakness of institutional capabilities, projects were designed around temporary project management units or newly established quasi-government bodies. With the possible exception of the Forestry Project, project design was not overly complex with very focused project objectives. Resource mobilization for the sector was also good. The five IDA projects in the sector (with commitments of US\$138.3 million) leveraged a further US\$82.5 million in cofinancing from other donors.

5.11 IDA has taken a very participatory approach with its assistance to the sector, and in a number of cases has been quite innovative. Wherever feasible, beneficiary associations were created (such as the Village Credit Funds (VCFs) in the Rural Development Project and the Water Users Associations (WUAs) in the Irrigation Project) and this has undoubtedly contributed to successful project outcomes.²⁵ The balance in the lending program has been good, and the adjustment operation supported a complete liberalization of the agricultural price and incentive framework. In addition, as of October 1997, about 92 percent of all small and medium agroprocessing and agricultural marketing enterprises have been fully privatized. This adjustment credit also supported revised land legislation (Law 8050, December 21, 1995 and Law 7983, July 27, 1995) which authorized the leasing and sale of agricultural land. Full development of a land transfer system is still pending however as the land titling and registration system is only about 10 percent completed.²⁶ Land fragmentation and the division of family farms into many parcels will present a future obstacle in trying to raise farm incomes and operational efficiency.²⁷

5.12 IDA has made a positive contribution in the alleviation of rural poverty, particularly in the poorer areas. The Rural Poverty Alleviation Pilot Project (RPAPP) and the follow up Rural Development Project (RDP) have been well targeted and have had a significant impact. The Performance Audit Report (PAR) for the RPAPP found that the credit component, which had a 100 percent repayment record, resulted in income increases for poor families from 15 to 70 percent and between 30 to 50 percent for better-off families. Furthermore, the PAR found that the project had a strong impact on participating village economic dynamics, diversification of activities and development of services.²⁸

25. The importance of project ownership at the grassroots level is evident from the starkly different behavior in the rural areas during the earlier crisis of 1990-01 and the more recent crisis in early 1997. In 1990-91, irrigation networks, along with other rural infrastructure, were widely destroyed. In 1997 by contrast, members of the WUAs guarded the irrigation systems in their areas day and night and virtually no damage occurred. Similarly, VCF borrowers are reported to have walked great distances to make their loan repayments at the height of the crisis in early 1997.

26. This exercise is being supported by USAID under the Immovable Property Registration System Project (IPRS).

27. Recent surveys have suggested that there is strong interest on the part of farmers for some form of land consolidation and numerous instances of informal mutual exchanges of land parcels have been reported. See *land Fragmentation and Some Alternatives for Land Consolidation in the Future*, by Galantina Canco et al, Soil Research Institute of Tirana, Tirana, March 1995.

28. See World Bank, *Albania: Performance Audit Report: Rural Poverty Alleviation Pilot Project*, Report No. 13819, December 12, 1994.

5.13 These two rural development projects had a very strong participatory approach leading to the creation of local institutions such as the Village Credit Committees and the aforementioned VCFs, as well as Users' Associations and village maintenance funds under the rural works component of both projects. These are likely to provide the building blocks for larger and more sustainable institutions of rural development.²⁹ IDA's assistance in the agricultural sector has not fully solved the needs of agricultural credit in Albania however. There are 192 VCFs, servicing just over 10,000 borrowers. Given that there are about 2900 villages and about 450,000 small farms in the country the need for broadening the coverage of a rural credit system is still strong. Furthermore there are very few VCFs in the coastal plains with relatively large and fertile farms with good market access, where expanded credit availability can produce significant increases in output.

5.14 The Irrigation Rehabilitation Project has been very successful in achieving project objectives. Despite the recent turmoil, the project is expected to be completed two years ahead of schedule.³⁰ Overall, the total area benefiting from irrigation and drainage rehabilitation under the project is expected to exceed the SAR estimate by about 35 percent, and the actual rehabilitation cost is expected to be about 25 percent lower than estimated. The overall ERR for the project is now estimated to be about 30 percent, far higher than the SAR estimate of 17 percent. This is a remarkable achievement. The following factors account for this success; relevant and timely ESW, use of a specialized project management unit, creation of WUAs to enhance ownership amongst end-users, focus on a limited, high potential area to maximize benefits, and finally of course, strong government ownership and commitment.

5.15 IDA assistance to agroprocessing and forestry has been somewhat less successful. The agroprocessing operation suffered because of the weakness of the Rural Credit Bank, and given that this bank is to be dissolved, the operation is now being restructured as a FIL to operate through three private financial institutions. In the case of forestry, the project design goes against a stated country assistance strategy of keeping project design relatively simple. The project attempts a radical reorientation of the forestry management system (which is needed), has a large number of components and sub-components, and involves creation of many new and complex institutions requiring new regulations and laws as well as coordination between different government agencies. Pace of progress has been slow, and the only component making satisfactory progress is the highly participatory, community based communal forestry and pastures management component. This forestry project lacks the simplicity and focus that has led to satisfactory implementation in other agricultural sector lending. Furthermore, a full appreciation of governance and institutional weaknesses perhaps was absent.

5.16 *Health.* Little progress has been made in resolving the fundamental problems of the health sector. The draft SAR (Health System Recovery and Development Project May 15, 1997)

29. It is useful to quote from a "Quality at Entry" review for the Rural Development Project, which stated "..... A best practice example of a well prepared rural development project which was assured of success at entry because of its design and an effective pilot. Its strengths are strong government ownership, effective implementation by a project management unit (rather than through the line ministry) called the Albanian Development Fund, and benefits focused on the poor.....The fully engaged, activist, nonbureaucratic, committed approach of the concerned Bank staff was critical to project success, though it is not the norm taught in the dominant Bank culture". See a memorandum from J. Goldberg (EA2RS) to Prem Garg (EXCQA). September 3, 1996.

30. See "Irrigation Rehabilitation Project: Summary Progress Report," MOAF, August 1997; "Albania Irrigation Rehabilitation Project: World Bank Mid-term Review Report," Tirana, December 4, 1996; and "Second Albania Irrigation and Drainage Rehabilitation Project: IDA Preparation Mission," Aide Memoire, Tirana, November 5-14, 1997.

found that the main sector issues were little changed from the pre-crisis period, but were more urgent. While some progress was made in primary health center rehabilitation, creation of a sector strategy with a shared vision of sector priorities has proven to be elusive. The central government ministry still lacks capacity for sector planning and policy and management tools and information systems needed to inform the planning process are largely non-existent. The issue of a structural mismatch between health services provided and population needs (i.e. the balance between curative care and preventive and community medicine) has not been resolved. Domestic resources allocated to the sector are inadequate. There are over 40 ongoing projects in the sector with a large number of donors and NGOs involved, yet donor coordination tended to be superficial and lacked a common strategy. The need for comprehensive sector work to facilitate a consensus on the part of the Government and the donor community on a medium term development agenda is overdue.

5.17 *Education* The strategy focus on school rehabilitation was correct in the initial years of IDA assistance in this sector, and quite good progress was made in repairing the physical plant from 1993 to 1996. Nevertheless little progress has been made in addressing the fundamental problems of the education sector which include inadequate resource allocations to the sector, greater accountability for teaching outcomes at all levels in the system, institutional reform in the central ministry and an appropriate role for the private sector and NGOs. IDA's involvement in the sector has not followed a strong beneficiary participation approach, and others that have been involved with the sector appeared to have enjoyed more success, at least at the school level, by a more intense presence "on the ground" and greater community involvement (see Box 5.1 in this chapter).

5.18 While a draft strategy note was done in 1993, this sector also appears to be a strong candidate for comprehensive sector work. While the outcome of this work may not necessarily add much to IDA's understanding of sector constraints, the process and the ensuing policy dialogue will present an opportunity to obtain a strong commitment to improve qualitatively the education system and the exact steps and timetable needed to achieve this. In the absence of this shared vision, IDA's assistance to the sector will not be fully effective. This sector, and perhaps the health sector, could benefit by an adjustable lending approach with mutually agreed check points to monitor progress on key issues. Furthermore, consideration should also be given to utilizing NGOs active in education in Albania, given their greater local supervision capacity. As was shown in the rural poverty alleviation projects, strong beneficiary involvement combined with a dedicated quasi-government implementation entity can produce very good development outcomes.

Box 5.1: Partnerships for Educational Progress: The Work of the Soros Foundation's Albanian Education Development Program

The Soros Foundation's primary focus is on building civil society. School construction/rehabilitation and curriculum reform are seen as integral to this effort. The Foundation's Albanian Education Development Program (AEDP) is based on a partnership between the Government, which sets overall strategy and establishes policy; the community, which is deeply involved in all elements of school-based activity from the outset; and AEDP, which provides advice and supports implementation. AEDP staff talk directly to the local community, seek to understand the economic, social, and political environment, and find out from the community what it expects from its schools.

Local priorities are established by a regional working group (a blue ribbon panel) of teachers, parents, government, and distinguished citizens. AEDP contact with the community begins early in the process of school construction to insure that the community is a full partner. Community organization specialists from AEDP meet with people in the community to ascertain their interest in a school and support for construction/reconstruction and/or curriculum change. After extensive interviews with potential community stakeholders, AEDP determines whether community interest and support is sufficient to warrant going forward. As a first concrete manifestation of its interest, the community must give written assurance that property to be built on is not encumbered and communities must be willing to contribute to school construction. Each community gives as much as it can. The amount and type of contribution is flexible and negotiated. Some communities may contribute cash or construction labor. But more frequently, they assume responsibility for water and electricity connections.

The stakeholders (the school director, teachers, students, and parents) are consulted on school design. There is no standard school design, in fact no two are the same. Schools are designed to encourage student interaction and group activities. Architects use local material and styles to blend the school into its community, and the community is involved in pre-qualification of contractors and helps monitor contractor performance during construction.

After the school is built, AEDF works with parents associations, school boards, PTAs, and school directors to allocate local government funds (from the state budget) for maintenance, teacher training, etc. It also tries to encourage community to community exchange, and advises the community in its interactions with the educational bureaucracy.

This approach is staff-intensive: AEDP has a staff of about 80 in Albania. But the payoff is large. During the disturbances of 1997, local communities defended their schools and not one AEDP funded school was damaged.

5.19 *Infrastructure: Power, Water, Transportation and Housing.* IDA's initial strategy for infrastructure was straightforward - rehabilitate and restore. While this was done to some extent, the quality of infrastructure and delivery of services has improved only marginally over the past six years, even discounting for the damage and disruptions caused by events in 1997. The primary reason has been an inability to strengthen the public sector institutions providing these

infrastructure services.³¹ The weak implementation and operational capacities were recognized at the outset, however IDA was overly optimistic that these weaknesses could be cured by technical assistance, training and organizational realignments. Over time, given the lack of progress in institutional development, the Bank did focus more actively on encouraging greater private sector participation either in the form of management contracts (for water companies for example) or franchise investment (in ports and power distribution).³² This was highly appropriate, but the Government was not fully committed. Nevertheless, progress was made in establishing three pilot urban distribution companies, together with the necessary legal and regulatory framework by 1995.

5.20 IDA's policy dialogue to secure policy change in the infrastructure sector had mixed results. Power tariffs were raised, however no success was achieved in raising water tariffs or achieving an active and forceful program to end illegal power connections. These issues are all interconnected, insofar as one of the biggest debtors to the power sector are the water companies. Furthermore, the failure of the Government to move more speedily in dealing with the large SOEs, has also affected the viability of the power sector.

5.21 IDA's assistance in port rehabilitation was relevant, effective and sustainable, and included a plan to have a staged approach to the privatization of the variety of port services. Progress was made in developing the road network, however IDA's contribution has been modest given the needs. Assistance in the housing sector failed, and IDA should never have become involved in this sector in Albania. Private sector construction is well able to meet most dwelling construction needs, and as is quite obvious to any visitor, the construction industry is booming.

5.22 *State Owned Enterprises and Privatization.* Overall, IDA's partnership with the Government in transforming industry and removing the public sector from commercial activities was successful. The Government of Albania undoubtedly took the lead in privatization and enjoyed early success. At the outset (1992-94), while IDA's strategy identified the need for a strong effort in privatization effort, attention was somewhat muted however. This is perhaps readily understandable, given the rapid privatization of land and small scale trade and service activities. With hindsight however, the relatively low attention accorded the large, so called "strategic" SOEs by IDA (such as Albkrom and Albpetrol) allowed the Government to temporize somewhat on moving forward expeditiously in both restructuring and obtaining involvement of strategic investors. This was a conscious IDA strategy in order to focus on small and medium enterprises and thereby accelerate employment generation. These large concerns continued to deteriorate, and in so doing affected negatively IDA attempts at improving the efficiency and financial performance in other sectors (most notably power as these firms were large users and did not pay their bills to KESH).

5.23 The Enterprise Restructuring Agency, supported by IDA, was faced with a politically sensitive mandate which ultimately diminished its effectiveness. By and large, there was a lack of private sector interest in many of the firms entrusted to the ERA. Further, the lack of an effective legislative and judicial framework proved to be a serious impediment in proceeding

31. There was a second important issue that emerged which was not adequately factored into IDA's initial infrastructure development strategy. What was not foreseen was the massive internal migration into the Tirana-Durres corridor from the rural areas. This placed even more of a strain on the existing infrastructure, placing much stronger pressures on the service providers.

32. A study was carried out in 1993 on the institutional and organization aspects of the power sector, which recommended a gradual approach to privatization.

with liquidations. Furthermore, in the initial stages, responsibilities for the privatization in Albania were diffused among too many different institutions. This has still not been completely remedied despite the formation of Ministry of Privatization in 1996. IDA's support and emphasis on privatization accelerated in 1995 and 1996, with strong assistance and policy advice to the Government on the mass privatization program. This program was successful in distributing vouchers to the population and in share auctions. However, a fully functioning share market has yet to be developed, and few of the firms subject to mass privatization are under the effective control of new and efficient managers.

5.24 *Finance and Banking.* IDA's efforts to create a viable and self sustaining financial sector did not work. The initial sector strategy was flawed in the belief that restructuring state banks, without a fundamental change in their internal accountability and incentive frameworks, could bring about performance and efficiency improvements. The strategy for the sector was not focused or prioritized on key sector reforms and their sequence. There was no clear recognition of the type of financial system that would be appropriate in the context of Albania, and the emphasis of IDA's efforts and policy dialogue in the sector varied continually throughout the five years under review. The fact that a comprehensive financial sector study was not completed in 1992 or early 1993, mirroring the work done in the agriculture sector, was a mistake.³³ This would have brought a greater understanding of the existing banking system, including the internal governance problems of the state owned banks. Also this work, and the resulting report, could have served as the blueprint for securing agreement with the Government on a sector wide reform agenda that was properly sequenced with a specific timetable for each step.

5.25 Some progress was made in strengthening the Central Bank, but even here the pace of progress on certain key issues, such as a unified banking system chart of accounts, has been very slow. Some restructuring of state owned banks was achieved, but the Government never displayed the full commitment to deal with these institutions' bad debt portfolios and there was considerable political interference in both lending decisions and day to day management of these banks. Banking laws (which were amended and upgraded in 1996 and the Bank of Albania is currently drafting a revised Banking System Act, with Fund advice) are in place, and bank supervision is gradually improving, but again strict enforcement of these laws is necessary, particularly with regard to the licensing of new private banks. While a two tier banking system was established, there was very little financial intermediation and while the productive parts of the economy were private, the banking system had not developed concomitantly to service it. What new lending was made to the private sector by the state owned banks quickly became non-performing.

5.26 In contrast to the successful developments in credit delivery in the poorer rural areas where there was a manifest understanding of the psychology and needs of those served, IDA's strategy for the larger formal financial intermediation system lacked an appreciation of how the state banks were viewed by the wider society. A tradition of non-repayment of loans was deeply imbedded given the past roles of these institutions. Progress was made in bringing the RCB to a point when it could be privatized but the Government demurred. While some of the problems of the state owned banks could be linked to the SOEs, IDA should not have linked these two issues in one operation in Albania (the Enterprise and Financial Sector Adjustment Credit) as this

33. In early 1992 an Issues Paper proposing a sector study was done.

tended to dilute efforts and attention on fundamental and speedy reform in the financial sector.³⁴ This operation was complex and included a broad range of policy and regulatory change (there were twenty pre-Board and twelve Second tranche conditions), but no clear priorities were established.

5.27 As noted in Box 4.1 in the previous chapter, the Bank did express concern about the lack of formal regulation of the investment funds in January 1995 during a supervision mission for the EFSAC. This was communicated in an Aide Memoire to the Minister of Finance in February 1995. The Government took no action however, despite attempts by the Governor of the Central Bank to have them be subject to Central Bank supervision and inspection. The Bank did not fully appreciate the scale and parlous state of these funds until the third quarter of 1996.

5.28 It is not obvious that higher level interventions by senior Bank management in the first half of 1995 would have persuaded the authorities to take firm action with these investment funds and pyramid schemes. Whether the lack of development of the formal banking sector encouraged the emergence of these funds in the first place is debatable. In some sense, these funds were providing resources to a newly emerging private sector which were not being met by the formal banking system. Since resources were also being used to fund highly rewarding contraband trade, justifying high deposit rates, it is unlikely that formal banks, both public and private, could have competed away the majority of the deposit base that eventually ended up in the investment funds and pyramid schemes.

5.29 *State Institution and Public Administration Reform.* Even though IDA recognized that public administration in Albania in 1992 was very weak, a comprehensive strategy for reform as part of the overall country strategy was not fully developed.³⁵ To the extent IDA pursued a strategy for the core public sector, it relied on "substitution TA" to fill gaps. This approach essentially addressed symptoms rather than the roots of the institutional problem plaguing the core. This approach of addressing public sector problems with TA on a loan-by-loan basis sacrificed uniformity and consistency. In some areas, however, IDA's approach to improving service delivery systems displayed a considerable degree of innovation, flexibility and diversity. The "organic" decentralization that occurred with the VCCs and WUAs are two good examples. The major omission was not developing central, strategic policy making capacity specifically to modernize the service delivery functions of the State.

5.30 Nor did IDA have an effective governance strategy, including an anti-corruption component and a focus on improving the transparency of government processes. Despite high levels of corruption, patronage and politicization, neither the Bank nor other donors fully recognized the need to forestall the continual degeneration of Albania's institutions. It is also conceivable that by IDA's provision of "substitution TA," without addressing wider issues such as transparency and accountability, the institutional decay might have been accelerated.

34. A Back-To-Office-Report on a supervision mission in December 1996 states the following, "..... there are some encouraging signs proving that the Government of Albania wants to take the first steps leading to the cleaning and restructuring of the state owned banks as part of their privatization strategy. However, the institutional, managerial, social and financial magnitude of this task largely exceeds the competencies and capacities of the Albanian Government and bank managers." This is over two and half years after the EFSAC was approved and over five years after the Economic Report of early 1992 provided an assessment of the needs of the Albanian financial sector.

35. Public administration reform is inherently a complex medium to long term challenge. The Region believes that given the initial conditions it was not reasonable to expect the authorities to focus on comprehensive public administration reform. There is merit to this view.

5.31 There are a number of plausible reasons for the absence of a comprehensive IDA strategy for state institution and public administration reform. First, the body of knowledge of transforming the State in the former communist countries was still nascent.³⁶ A further possibility is that there was a lack of political support for fundamental reform. Given the persistence of patronage systems within the Government after 1991, there was clearly a range of stakeholders who would resist institutional reform.

5.32 The use of TALs to restructure key agencies (Tax and Social Safety Net) was strategically sound and did support institutional development. This success was a function of clear and simple project design with highly specific objectives.³⁷ By contrast the TA for Economic Reform Project was an amalgam of various reform agendas for privatization, financial sector reform and macroeconomic management. This affected negatively government ownership and commitment and the sustained impact of the TA.

5.33 By and large, the Bank underestimated the value of ESW and its long term utility in dealing with a public administration reform agenda. One example was the lack of a comprehensive Public Expenditure Review. Some good work was undertaken in 1996 on pay and employment issues and this has proved to be very useful for the new Government as it seeks to rationalize the size of the public service. Further work was undertaken in 1994 on fiscal decentralization, however little progress was made on this issue due mostly to a lack of political interest in proceeding further. This is unfortunate given the importance of developing local government as a means to restore public confidence in public administration.

5.34 IDA's, and other donors', country assistance strategy in relation to State-society relations and the quality of governance had only a marginal impact. There was legal and regulatory reform, but this was not done in a framework that ensured compatibility across all aspects of the legal and regulatory system. Multiple donors were involved, which resulted in an amalgam of legislation and regulatory philosophy coexisting with the remnants of Albania's pre-transition legal system. In all cases, IDA, the other donors and the Government felt that redrafting legislation would be sufficient to affect changes, and little or no attention was given to enforcement capacity and the institutional change that this might entail. Participation of primary stakeholders (judiciary groups, bar associations, NGOs and private sector firms) was poor, and a public education process advising on changes in the law and their implications was deficient.³⁸

5.35 In sum, the efficacy of IDA's public administration reform program was poor. What was done was limited to short run improvements in performance in a few agencies of the core public sector, with little overall impact on governance. Given that the Albanian State was in a process of degeneration even before the collapse in 1990, this lack of reform at a systemic level merely allowed the various "administrative pathologies" such as poor incentives, politicization, patrimonialism, poor information and unclear rules to persist. The message is clear. A failure to adopt new institutional norms after a collapse simply leads to a continuation of degenerative institutions and the potential for another collapse.

36. Salvatore Schiavo-Campos, ed. *Institutional Change and the Public Sector in Transitional Economies*, Discussion Series, No. 241, Washington, D.C: World bank, 1994.

37. This finding has been corroborated by numerous evaluative studies on technical assistance lending by the Bank. See Heather Baser et al, "Perspectives on Technical Assistance Loans," OPRDR Working Paper, World Bank, 1997.

38. For a fuller discussion of the current thinking on legal reform and governance see Andrew N. Vorkink, "The World Bank and Legal Technical Assistance: Current Issues," Washington, D.C., Legal Department, World Bank, March 1997.

5.36 To be fair IDA, other members of the donor community and the Government faced a difficult dilemma in 1992. There was a trade-off between short and medium run measures to address institutional weaknesses, with the longer run measures having a much longer gestation period. At the time, there were strong pressures to realize sector reforms, and IDA was extended across a large number of sectors. Given its sense of urgency, the Bank resolved to build institutional capacities outside the State apparatus. While this broke the monopoly of the center in the provision of public services, it did not address the question of reshaping State institutions appropriate to a market economy.

Aid Coordination

5.37 With such a large assistance program covering such a broad spectrum, the need for good aid coordination in Albania was crucial. At the outset, this aid coordination was weak but it became much stronger thereafter. Initially it took the form of an annual donors group meeting which outlined each donor's intentions. There was informal interaction, normally between groups represented in Albania, on sector issues and project progress but this was ad hoc. What was missing was a fully integrated development agenda, with agreement between donors on the components of sector involvement and a timetable for completion of a particular task that was consistent with the planned completion of other tasks. The overall assistance program seems to have been strongly "supply driven," with each donor focusing on areas it felt were most important. This had a number of repercussions.

5.38 Sequencing of assistance efforts was sometimes poor. Examples include the array of activities to strengthen the central bank where development of a unified bank system chart of accounts lagged or rehabilitation of the physical primary health centers was completed but they were not operational because of a lack of basic furniture or equipment. There has been duplication of efforts, particularly in TA to the core public sector. And, there has sometimes been a lack of a critical mass of effort because various components of a Government objective have been spread across multiple donors resulting in severe coordination problems and reduced accountability.

5.39 As noted, this coordination has improved in 1997, with much more frequent meetings of the donor group. Furthermore, sector group meetings in the country have started to meet more frequently in a formal sense with the goal of agreeing upon a common sector strategy, individual donor responsibilities and accountabilities, timetables and project sequencing. In this latter regard, IDA's role in providing comprehensive ESW is a crucial ingredient for improving donor coordination.

The Efficiency of IDA's Assistance Program

5.40 Table 5.1 provides an indication of the overall efficiency of IDA's assistance program for Albania. The primary measure is staffyears (SYs) spent per approved project. Albania compares very favorably to Bankwide outcomes for total SYs per US\$ committed. However, the low ratio of staffyears to \$US committed is more likely a result of the extraordinarily high numbers of operations the Board has approved for the country. Lending required nearly half of total SYs allocated to Albania, which is significantly higher than the Bank average of 30 percent.

Table 5.1. Comparative Data on the Efficiency of Bank Assistance Programs from FY92–96

Country	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Total SYs	Lending SYs	No. of projects	Commitment	(2)/(1)%	(1)/(3)	(2)/(3)	(1)/(4) (%)
Slovenia	9.8	6.5	2	104	66.3	4.9	3.3	9.4
Albania	74.7	34	22	272	45.5	3.4	1.5	27.5
Lithuania	37.5	20.1	7	160	53.6	5.4	2.9	23.4
Croatia	24.2	15.7	6	280	64.9	4.0	2.6	8.6
Slovak Republic	19.3	11	2	135	57.0	9.7	5.5	14.3
Azerbaijan	23.3	11.8	4	165	50.6	5.8	3.0	14.1
Hungary	68.7	31.6	8	780	46.0	8.6	4.0	8.8
Czech	6.3	1.7	2	326	27.0	3.2	0.9	1.9
Zimbabwe	74.3	25.4	6	340	34.2	12.4	4.2	21.9
Poland	110.2	42.8	11	1833	38.8	10.0	3.9	6.0
Vietnam	71.4	40.7	11	1242	57.0	6.5	3.7	5.7
All Countries	14568.0	4309.3	1422	110112	29.6	10.2	3.0	13.2

- Notes:
1. Countries are ranked according to population size.
 2. ESW SYs (Economic and Sector Work Staffyears) are yearly averages, based on data for FY92–96. SY data include borrower country-identified staffyears only. Commitments are in US\$ millions.
 3. Lending SYs is project development from identification to Board presentation; the other two main categories in the Total SYs are supervision and ESW.
 4. Column (5) is lending SYs as a percentage of total SYs.
 5. Column (6) is Total SYs per project; column (7) is Lending SYs per project.

Source: PBD, World Development Indicators Database

As in the case of ESW, supervision effort in staffyears fell well below the Bankwide average for the period in question. In general, the efficiency of IDA's program was dependent on its ability to resolve the trade-off between the breadth and depth (or intensity) of its lending program. The considerable breadth of lending with 22 projects across multiple sectors perhaps had a price in terms of the depth or intensity of staff effort for each operation in terms of ESW prior to lending or supervision during a project's life. The Region believes that the supervision effort was not underfunded because of the small country characteristics of Albania—repeated projects; annual portfolio review exercises; intensive procurement assistance; and single Ministries with multiple project responsibilities.

Conclusion

5.41 Excellent country relations were nurtured between IDA and Albania. Very good progress was made in agriculture, external debt management, small and medium scale privatization, tax reform, price and trade liberalization and a contribution was made in the rehabilitation of infrastructure. But lack of progress in some key areas detracted from these positive achievements. There were weaknesses in IDA's prioritization of assistance efforts and the depth and focus of assistance efforts in the financial sector, and also in health and education. The Bank's concerns about the need for stricter scrutiny and regulation of the investment funds/pyramid schemes was not expressed forcefully enough.

5.42 The pyramid schemes were symptoms of a far deeper set of problems and it is possible that factors other than the collapse of the pyramid schemes could have triggered the breakdown in civil order. Development of public administration and state institutions along lines suitable for a liberal market economy proceeded all too slowly. The lack of an effective focus on governance, social development and institutional reform is similar to the Bank's reconstruction record in post-conflict countries. It is not too late to remedy these weaknesses in the Bank's strategy in consultation with the Bank's partners.

6. Lessons for the Future

General Lessons

6.1 To improve the effectiveness of IDA assistance in Albania in the future and accelerate the pace of economic development, two key principles will need to be followed:

- More thought needs to be given to prioritization and sequencing of IDA's focus and interventions in light of Albania's institutional weaknesses.
- Greater care needs to be paid to the "balance" in IDA's program of lending, supervision and non-lending activities. Where detailed sector strategies are absent then ESW should be devoted to overcoming this. Where sector strategies have been developed, stronger efforts should be made in the policy dialogue and in aid coordination to create a consensus and shared vision between the Government and donors as to the goals, the overall policy framework, and monitorable progress indicators.

6.2 *Develop a System of Graduated Response for Crucial Issues.* It is clear from the experience in Albania, that individual project indicators or conventional macroeconomic parameters are not enough to evaluate the performance and sustainability of a country assistance program. The Region and the Bank should develop a system that ensures that crucial issues or policy slippage are brought to the attention of senior management expeditiously. In addition, these special concerns could also be brought to the early attention of Albania's authorities and the entire donor community. Perhaps, the Region could develop a "watch list" of key reforms envisaged over the next twelve or twenty four months, as well other as potentially negative economic and social issues (the reemergence of investment funds and pyramid schemes or the failure of a private bank to name two examples) and report periodically to senior management on the status of the items on the watch list.

6.3 *Social Balance in Project Interventions.* The situation is still politically fragile, and society is polarized, in part on a regional basis. Given the World Bank's high profile in the country, special care and attention must be given to ensuring that IDA project activity is adequately balanced throughout the country. Public awareness of the principles guiding IDA's choice of project activity should be nurtured.

6.4 *Increase Emphasis on the Accountability of Systems.* Future project design must seek to improve the accountability of those responsible to provide a service or complete a project. Therefore project design must involve all stakeholders, if only to define the parameters of this accountability. The value of participatory techniques for enhancing accountability was clearly manifest in the Rural Poverty Alleviation Pilot Project's reliance on civic traditions of mutual trust among villagers to ensure good repayment performance. By contrast, the top down, supply-driven approach of the Education and Health Rehabilitation projects provided little by way of stakeholder ownership and therefore, accountability.

6.5 *Aid Coordination Needs Greater Attention.* Experience suggests that aid coordination needs to be conducted on two levels. First, is the formal consultative/donor group type meetings. Second, is more intensive sector level coordination that encompasses each individual donor's

progress in project implementation, identification of problems encountered and sequencing of complementary efforts. Greater accountability on the part of donors to each other is a necessary objective at this second level of aid coordination. This has been undertaken in other IDA countries. For example in Bangladesh, IDA, in conjunction with the Government of Bangladesh, has organized a Local Consultations Group (with 18 sub-groups) which meets on a regular basis to deal with common implementation issues with more immediacy. The assistance efforts in Albania would be enhanced by such an activity.

Sector Lessons

6.6 *Agriculture.* Most of the lessons from IDA's assistance to the agriculture sector in Albania are positive—timely ESW, participatory approach in project design, creation of community based institutions, simple project design, and strong Government ownership. The challenge for the future will be how to build on this success. The incentive frameworks are in place and good progress has been made in rehabilitating the supporting infrastructure, with the possible exception of rural roads in the more remote areas. Discussed below are not so much lessons for the future but rather key items for the next phase of assistance.

- a) Land holdings are small and fragmented. This will be a constraint to the transition from the current, largely subsistence farming to a market oriented, commercial agriculture. An active land market needs to develop to facilitate consolidation. The basic legal framework is in place, but the titling and registration process is still underway with assistance from USAID. Recent changes to regulations on the registration of land and planned changes to the law on land sales will accelerate the development of a land market. Progress needs to be monitored carefully and IDA support in parallel with USAID might accelerate the process.
- b) Rural credit will also be a constraint. IDA recognizes this and is seeking to transform some of the VCFs into more self sustaining rural credit union type financial institutions. The approach is cautious (on a pilot basis) which is good and the effort needs to be monitored closely.
- c) Further efforts are needed to strengthen the organizational sustainability of the WUAs in the irrigation system. A key element in this will be institutional development of the district water enterprises and improving their financial viability.
- d) Future growth in the agriculture sector will mainly come from improved technology and input use. Agricultural research and extension services will be a critical component in this. Progress has been made in establishing a national public extension service, but the approaches and quality vary quite markedly across districts. A variety of donors are involved, however coordination guided by a national extension conceptual framework, that encapsulates a role for the private sector in the national extension service plan is absent.³⁹

39. Private sector extension services have already evolved in association with private sector marketing of inputs. Some 450 farm input dealers belonging to the Albanian Fertilizer and Agrobusiness Dealers Association are currently engaged in extension activities such as demonstration plots and field days, along with the use of mass media techniques such as newsletters, videos and television programs.

6.7 *Health.* The fundamental deficiency in IDA's assistance to this sector is that there has not been a shared vision with the Government of Albania as to how the sector should be a decade from now. Without this vision, assistance will really only address sector problems at the periphery. Comprehensive sector work is needed, as a vehicle for policy dialogue and agreement on a prioritized sector strategy. There needs to be definition of an appropriate role for the Ministry of Health, district level administrations, the training establishments and the private sector. Institutional development is a high priority, with a strong need to improve the incentives and accountability of those providing health care services. Further assistance to rehabilitate primary health centers, or other higher level facilities, should only proceed when their is agreement on a sector policy framework.

6.8 *Education.* Much of what was said above in respect to the health sector and the lessons from the past six years are applicable to the education sector. A sector strategy is absent, and appropriate institutional roles for those involved in education have yet to be defined. There is little or no parent involvement at local and district levels, with the result that accountability for the quality of service delivery is poor. The scope for beneficiary participation in project implementation in this sector is high, as has been demonstrated by others involved in the country's education system (e.g., the Soros Foundation), and the results have been very positive. IDA should follow this lead. Furthermore there is much scope for greater partnership in this sector, particularly with active members of the NGO community.

6.9 *Infrastructure.* As with privatization, many of the lessons learned over the past six years of IDA assistance for infrastructure development have been discovered in other transition economies. Seeking to work with dysfunctional public utilities, without a fundamental change in management and employee incentive and accountability structures, does little to improve the quality of essential services such as power and water. Attempts at institutional development often fail because the entrenched vested interests in maintaining the status quo are too strong. Another crucial lesson is that by not pursuing early full cost recovery, most notably for water in Albania's case, sector development is retarded and their inevitably occur negative spillover effects into other infrastructure sectors. Short term concerns about household income and ability to pay are often exaggerated, and where real hardship may be encountered this is better dealt with by income supplements under a well targeted social safety net system.

6.10 Given these experiences in Albania and elsewhere, IDA should focus more intensively on working with the Government in setting up an infrastructure privatization program and the related regulatory framework. Furthermore, experience in other countries has shown, that far greater beneficiary participation in the provision of power and water is possible. This is replicable in Albania. For example, rural power distribution networks can be structured on a cooperative basis (this has occurred in both the industrialized countries such as the United States and some of the poorest such as Bangladesh), water provision can be decentralized to units with real autonomy and responsibility for rural roads maintenance can be community based.

6.11 *State Owned Enterprises and Privatization.* The lessons gleaned from IDA's assistance to Albania are similar to those learned in other transition economies. Endeavoring to restructure large SOEs without strategic investor involvement rarely works. Mass privatization, to be fully effective, needs to proceed in parallel with capital market development to allow consolidation of control shareholdings by investment groups and funds in the affected companies. This requires securities legislation and an oversight regulatory body for share transactions. Small, and in certain cases medium level, firm privatization can be rapid and can include cash auctions and past management/employee involvement with payments being made on a deferred basis. The

important issue is to have managerial oversight that is focused on profit generation. As many studies have shown, ownership matters.

6.12 For the future, IDA and the Government of Albania must be somewhat more vigorous in seeking private involvement in the larger so called "strategic" SOEs. IFC can play a major role here. To be successful, potential private sector investors and participants in these SOEs should be granted the maximum flexibility to effect changes in firm organization and operations. Artificially imposed constraints will only reduce investor interest, and ultimately benefit neither the firm's workforce nor the country. Finally, given the array of new Bank instruments such as guarantees and MIGA, scope exists for a proactive role for IDA in working in partnership with the Government to attract private investment in the larger SOEs.

6.13 *Finance.* The major lesson here is that trying to restructure state owned banks in the transition economies has rarely proved successful. Key objectives in the future should be to continue to strengthen the central bank, particularly in bank supervision, and ensure its freedom to act to enforce sound prudential and bank licensing regulations. The Government is planning to liquidate or privatize RCB and NCB and this needs to be strongly supported by IDA and the other donors. IDA should also take a more proactive role in seeking to encourage the development of the nascent private banking system in the country, as well as encouraging other members of the donor community (such as IFC and EBRD) to be active in the sector.

6.14 *State Institution and Public Administration Reform.* Improving governance and the quality of public administration and public perceptions of State institutions should receive a high priority in IDA's future assistance strategy. From the past experience in Albania certain key directions and principles are manifest.

- a) A sound conceptual framework for the core public sector and public management must be articulated. This should encompass all layers of State institutions, including service delivery entities, and should take advantage of contemporary paradigms of public management.⁴⁰ Given that the present system of public administration is in such a state of disarray, this represents a very good opportunity to develop a core public sector that is suitable to the Albanian environment and consistent with the key requirements of transparency, accountability and nonpoliticization.
- b) Very comprehensive sector work is necessary, both to articulate the conceptual framework and to be used as a means of reaching consensus and a shared vision with the Government of Albania of the reform path. A Public Expenditure Review is long overdue and should cover operational efficiency of budgetary resources expended. This will be an indispensable aid to the authorities as they seek to progressively downsize public employment. Further work also needs to be done on the tax system, including social insurance and welfare assistance. Cumulative payroll taxes are very high at present, and represent a disincentive to formal sector employment generation.
- c) Past experience in Albania has shown that a strong participatory approach in service delivery and governance builds ownership and has had a very positive effect on outcomes and sustainability. Furthermore past experience has shown that beneficiaries are eager and willing to participate in the delivery of services. Participation enables

40. See for example, Organization for Economic Cooperation and Development. *Governance in Transition: Public Management Reforms in OECD Countries*. Paris: OECD, 1995.

stakeholders to agree to new and emerging rules of the game. It is therefore an important ingredient of any legal, regulatory or anti-corruption initiative.

- d) Local government will have an important role to play in the future, both in terms of the evolving political system, as well as in service delivery. Therefore, in developing in partnership with the Government of Albania the conceptual framework for a new public administration, appropriate roles for local government must be articulated, together with fiscal issues.

July 27, 1998

CODE98-46

Report from CODE

Committee on Development Effectiveness

Albania: Country Assistance Review

On July 15, 1998 the Committee on Development Effectiveness (CODE) discussed *Albania Country Assistance Review* (CAR) prepared by OED (IDA/SecM98-341), together with a draft management response (CODE98-45). The Committee welcomed the opportunity to review the CAR in advance of the Board discussion of the Albania CAS on July 30.

The CAR evaluates the efficacy of the Bank's assistance to Albania and provides lessons for IDA's future involvement. It concludes that until the collapse of many pyramid schemes and the breakdown in civil order in early 1997, Albania's macroeconomic performance and the pace of structural reform were commendable. Many IDA projects were successful and rapid progress was made in several areas including agriculture, external debt management, small and medium scale privatization, tax reform, price and trade liberalization and the rehabilitation of infrastructure. Much of this progress endured despite the breakdown in civil order, but the unfinished development agenda remains large and includes in particular the strengthening of the state, institutional capacity building, and financial sector reform.

Some of the key lessons emerging from the CAR were: the need for greater attention to the prioritization and sequencing of IDA's interventions, with an appropriate balance of lending, supervision and nonlending activities; the importance of involving all stakeholders in the project design process; and the need to emphasize institutional reform. Management said that it accepted OED's overall assessment.

The Committee commended the CAR for its quality and welcomed the management's response and the close and fruitful cooperation between OED and Bank staff in the preparation of the CAR. It was pleased that the lessons emerging from this review were incorporated into the CAS.

The Committee suggested that the Bank's past agenda in Albania had perhaps been too broad, and it should concentrate on doing more in fewer areas and place more emphasis on economic and sector work. The Region responded that the previous Bank strategy had been appropriate for the circumstances of the early transition period, but a worsening domestic political crisis derailed the development process in 1997. For the future, the new CAS proposes a somewhat narrower strategy, focusing on the key issues highlighted in the CAR as deserving special attention.

The Committee was pleased that the coordination between the Bank and the IMF was satisfactory in Albania, although the division of labor on the financial sector between the two institutions could be clarified further. It also pointed to the importance of focusing on the Bank's comparative advantage vis-à-vis other donors in the country.

July 27, 1998

CODE98-46

The Committee observed that there is a need to take into account the capacity of the country to absorb aid effectively .

Other issues raised during the discussion included: the need for a World Bank strategy for public administration reform; the importance of public perception of World Bank interventions and of seeking the Albanian authorities' views on the CAR; the challenge of attracting workers' remittances to productive sectors; obstacles to strategic investments in large enterprises; and the effects of cost recovery of public utilities on the household income.

Leonard Good
Vice Chairman, CODE

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