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# Fiscal space for financing social protection in Albania

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# Introduction

The United Nations in Albania has been implementing a Joint Programme “Catalysing Municipal Social Protection” for the period from 1 January 2020 to 31 January 2022. The Joint Programme aims to support the municipal level ownership of the provision of social protection services and to increase the coordination between the state social protection services and the municipal authorities, with a focus on catalysing a step-change in the quantity and quality of delivery of integrated social care at the municipal level as part of an effective integrated social protection system.

Within the framework of this Joint UN Programme, the ILO, in collaboration with UNICEF and UNWOMEN, has conducted a review of the social protection system in Albania with a view to identifying gaps in coverage and financing of the existing system, and analyzing the fiscal space for building a comprehensive social protection system including national social protection floors.

This report focuses on the fiscal space analysis based on the historical data before the COVID-19 pandemic in order to provide an understanding of resource availability during normal times to finance social protection system in the country, which is non-discriminatory, gender sensitive, and economically sustainable. The purpose of this analysis also aims at providing guidance to the government, social partners, and other stakeholders on national and local capacity to mobilize resources, during normal times.

The twin shocks to the Albanian economy – the earthquake of November 2019 and COVID-19 pandemic in 2020 – have significant implications for public finance in terms of deteriorating revenue collection and rising fiscal deficits due to decrease in economic activity and emergency spending to fight the crisis. According to the International Monetary Fund (IMF), the output of the economy is expected to shrink by 7.5 per cent in 2020. Budget deficit and the public debt-to-GDP ratio are expected to rise to around 7 per cent of GDP and 80 per cent in 2020, respectively. Inflation, however, is projected to remain subdued at 1.4 per cent in 2020 in the face of depressed economic activity. The economy, according to the IMF, is expected to recover and grow moderately in 2021 assuming that the impact of the pandemic recedes and earthquake reconstruction works continue.

There is uncertainty around the economic recovery since there may be more than one wave of the COVID-19 pandemic. It is therefore also difficult to realize the full impact of the crisis at present. In view of this, the scope of the fiscal space analysis limits itself to a historical analysis avoiding the period of the pandemic.

This report has been prepared by José Francisco Pacheco Jiménez, ILO Consultant, under the supervision of Taneem Muzaffar, former Public Finance Economist, ILO Social Protection Department, with contributions from Kenichi Hirose, Senior Social Protection Specialist, ILO Office for Central and Eastern Europe. The draft report was presented at the Tripartite Validation Workshop held on 27 April 2021, where key issues and future policy were discussed by the tripartite partners from the government and from the employers’ and workers’ organizations.

The project and the report profited enormously from the assistance of Zhulieta Harasani, the ILO National Coordinator for Albania, Anisia Mandro and Fjoralba Balla, project assistants who also provided editorial assistance in finalizing this report. The collection of statistical data was conducted by Klea Ibrahimi.

This report consists of four Chapters. **Chapter 1** provides a framework of fiscal space analysis based on the Fiscal Space Handbook published by the ILO and UN Women. **Chapter 2** describes key trends in the total government revenue and ODA flows to Albania in the past decades. **Chapter 3** analyses the fiscal space options that are available both at the national and local levels including estimations of the potential resources that can be generated through different financing sources and a qualitative assessment considering each option for financing social protection. Finally, **Chapter 4** provides a summary of the potential sources of financing social protection in the country.

# 1. Framework for fiscal space analysis

Conventionally fiscal space is defined as “the gap between the current level of expenditure and the maximum level of expenditures a government can undertake without impairing its solvency” (Development Committee, 2006; p.14). This definition is however often criticized for being narrow in its scope of action. The Fiscal Space Handbook published by the ILO and UN Women (see Ortiz et al., 2019; p.9), defines fiscal space “as the resources available as a result of the active exploration and utilization of all possible revenue sources by a government.” The definition is predicated on SDG target 1.a on financing as well as international standards such the ILO Social Protection Floors Recommendation, 2012 (No. 202), both of which suggest governments to use a “variety” of options to find resources to finance social protection.

The handbook’s definition provides some critical insights into the creation of fiscal space for social spending. First, the creation of fiscal space should not be restricted to the budgetary limits but it should be conceived as a process whereby additional sources of finance can be included. In other words, fiscal space refers to both reprioritization and reallocation of spending from one sector to another and to explore additional means of domestic resource mobilization to increase revenues.

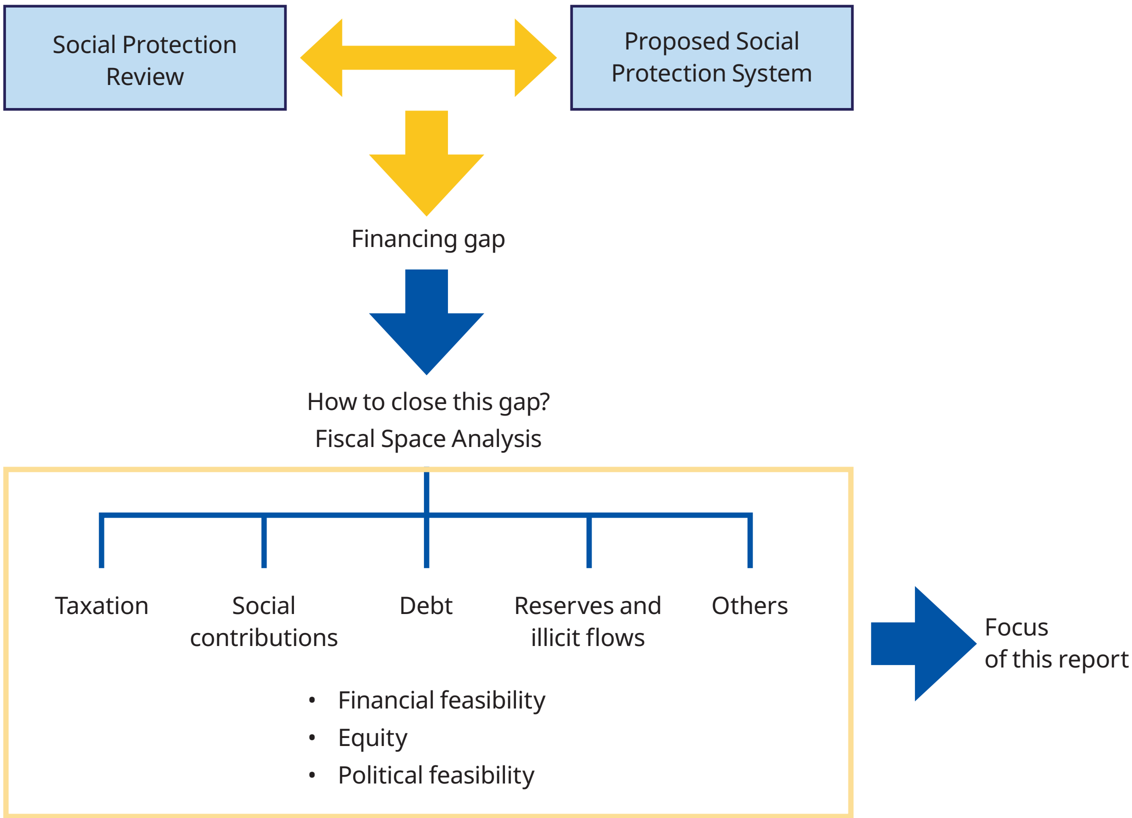
Second, policymakers should pay attention to the term “creation” so that fiscal space can be created as a result of “active exploration” of new sources of finance emerging from explicit “policy actions“ by the government. Third, fiscal space consists of both revenue mobilization and, at the same time, the establishment of the legal and institutional framework to provide sustainability and effectiveness to the newly mobilized funds. This implies paying attention to expenditure management too in order to maximize the impact of every additional *lek* on the overall wellbeing of the population.

Finally, it is important to link the creation of fiscal space with the destination of the resources (that is, referring to the term “fiscal space for social protection”), first to defend the purpose of the newly created finance and second to improve transparency in the use of public resources.

Figure 1 illustrates an overall approach taken to finance social protection in a country. It requires an assessment of the existing social protection system in the country[1]. Existing coverage and financing gaps in social protection need to be identified followed by an assessment of potential sources of finance to fill the financing gap.

1. See ILO, Review of the Social Protection System in Albania: coverage, expenditure, adequacy and financing, 2021.

**▶ Figure 1. Approach to financing social protection**




In terms of sources of finance, the handbook identifies eight potential options to create fiscal space. The options and their brief descriptions listed below are based on country practices and experiences.

1. **Expanding social security coverage and contributory revenues**: increasing coverage and therefore the collection of contributions of social security systems is a main reliable way to finance social protection; social protection benefits linked to employment-based contributions are linked to formalization of the informal economy.

2. **Increasing tax revenue**: this is another main channel for generating domestic resources and is achieved by expanding the tax base and altering different types of tax rates – e.g. on consumption, corporate profits, financial activities, personal income, property, imports or exports, natural resource extraction, etc. – and/or by strengthening the efficiency of tax collection methods and overall compliance.

3. **Eliminating illicit financial flows**: a vast amount of resources, estimated at more than ten times the total aid received, escape developing countries each year illegally. Therefore, policy-makers should crack down on money laundering, bribery, tax evasion, trade mis-invoicing and other financial crimes that are illegal and deprive governments of revenues needed for social and economic development.

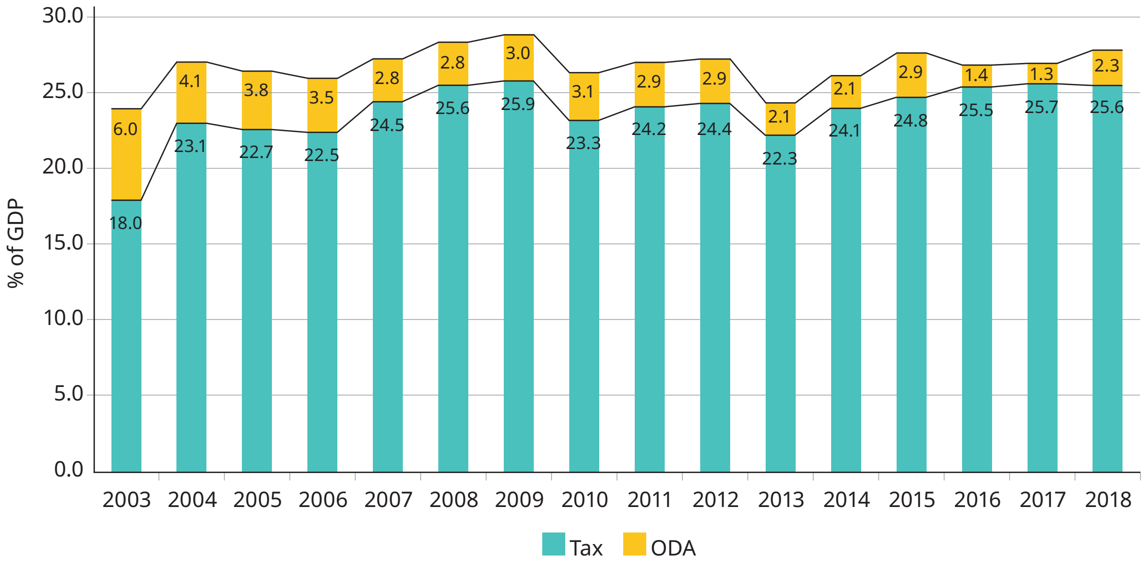
4. **Re-allocating public expenditures**: this is the most orthodox option, which includes assessing on-going budget allocations through a review of public expenditure and other types of thematic budget analyses, replacing high-cost, low-impact investments with those with larger socioeconomic impacts, eliminating spending inefficiencies and/or tackling corruption.

5. **Using fiscal and central bank foreign exchange reserves**: this includes drawing down fiscal savings and other state revenues stored in special funds, such as sovereign wealth funds, and/or using excess foreign exchange reserves in the central bank for domestic and regional development.
6. **Managing debt – borrowing or restructuring sovereign debt**: this involves an active exploration of domestic and foreign borrowing options at low cost, including concessional loans, following a careful assessment of debt sustainability. For countries under high debt distress, restructuring existing debt may be possible and justifiable if the legitimacy of the debt is questionable or the opportunity cost in terms of worsening deprivations of vulnerable groups is high.
7. **Adopting a more accommodating macroeconomic framework**: this creates an enabling macroeconomic condition to consider options 5, 6, and 8. It may also entail allowing for higher budget deficit paths and higher levels of inflation without jeopardizing macroeconomic stability.
8. **Increasing aid and transfers**: this requires either engaging with different donor governments or international organizations in order to ramp up North-South or South-South transfers.

# 2. Overview of resource availability in Albania

This Chapter provides a rapid assessment of existing revenue capacity of the government by looking at the broad picture of resource availability from domestic and external (official development assistance or ODA) sources over the period 2003–2018. Figure 2 presents the combined resource availability from two traditional sources of financing, taxes and ODA. Overall, taxes represent around 25 per cent of GDP with some increasing trend over time. In the case of ODA, it has decreased from 6 per cent of GDP in 2003 to 2.3 per cent of GDP in 2018. Albania is an upper-middle-income country, as a result donor funding tends to decrease as the country's income increases. Not only is there a declining trend in ODA to Albania over time but also the allocation of ODA to social protection is insignificant, for example amounting to only around US$ 5 million or 0.04 per cent of GDP in 2015 according to the OECD data.

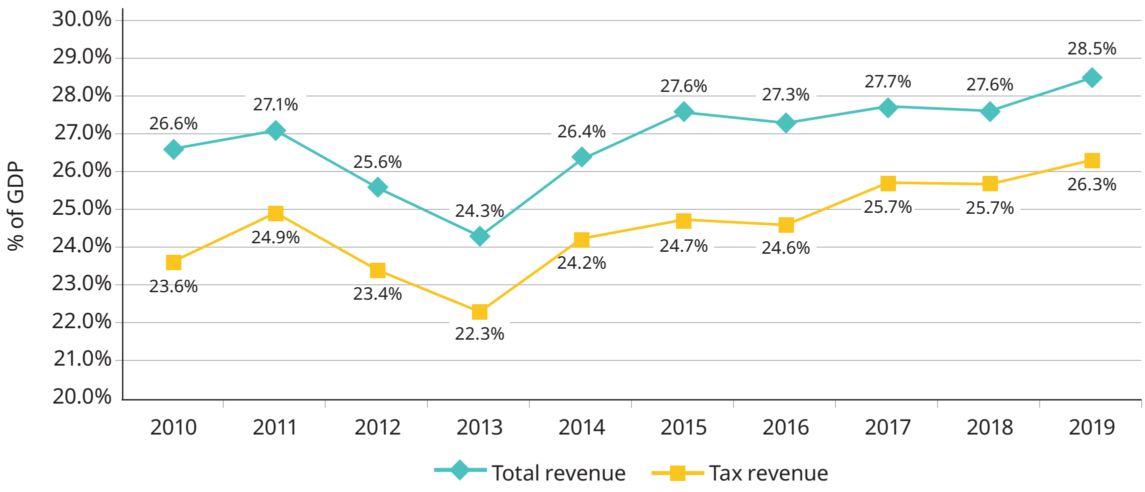
▶ **Figure 2. Combined resource availability from taxes and ODA, 2003–2018**




***Source:*** ILO staff calculations using data from the World Bank, World Development Indicators.

As shown in Figure 3, a detailed look at the total government revenue reveals that it averages around 26.9 per cent of GDP over the period 2010–2019. During this period it is at its lowest in 2013, at 24.3 per cent of GDP. Since then, in general, the total revenue shows an upward trend reaching a peak at 28.5 per cent in 2019. Taxes exhibit a similar trend representing 24.5 per cent of GDP moving from a minimum of 22.3 per cent in 2013 to a peak of 26.3 per cent in 2019. Taxes account for around 91.3 per cent of the total government revenues in Albania, with a modest increase in its share from 2017 to 2019.

▶ **Figure 3. Total revenue and tax revenue, 2010–2019**




***Source:*** Ministry of Finance, Government of Albania.

The other two broad sources of government revenue – non-tax revenue and grants – do not represent a significant share of total revenue. Non-tax revenues range between 1.3 per cent and 2.1 per cent of GDP over the period 2013–2019, with a declining trend in recent years. Grants over the same period fluctuate between 0.4 per cent and 0.9 per cent of GDP with an inverted U-shape trend till 2018 but going up in 2019.

The above description of the government revenue covers a period before COVID-19 pandemic. Although it is difficult to predict the full impact of COVID-19 pandemic on the level of government's tax revenue in Albania at present, the GDP growth forecast for 2020 (–5.0 per cent according to the IMF) indicates that overall revenues will fall significantly in 2020. Even before the pandemic, the revenue estimates for 2020 were not optimistic. The Ministry of Finance expected a 0.5 per cent of GDP decline in total government revenue in 2020 due to a 0.4 per cent reduction in taxes and 0.1 per cent cut in non-tax revenues. In addition to the tax cuts, the effects of the health and economic crisis will deepen the negative expectations and thus may lead to even lower government revenues.

In sum, the traditional sources of finance may not be enough in the upcoming years to provide sufficient resources to extend social protection to achieve universal coverage in the country. Both short-term shocks, such as the pandemic and natural disasters, and structural conditions, such as the informality, determining the capacity of domestic resource mobilization support this conclusion.

# 3. Options to create fiscal space in Albania

This Chapter provides a detailed analysis of generating potential government revenue from different options mentioned above. The analysis pays attention to the seven options to create fiscal space as listed in Chapter 2, excluding the potential revenue generation through ODA since Albania is an upper-middle-income country and therefore the extent to which it receives foreign aid is becoming limited.

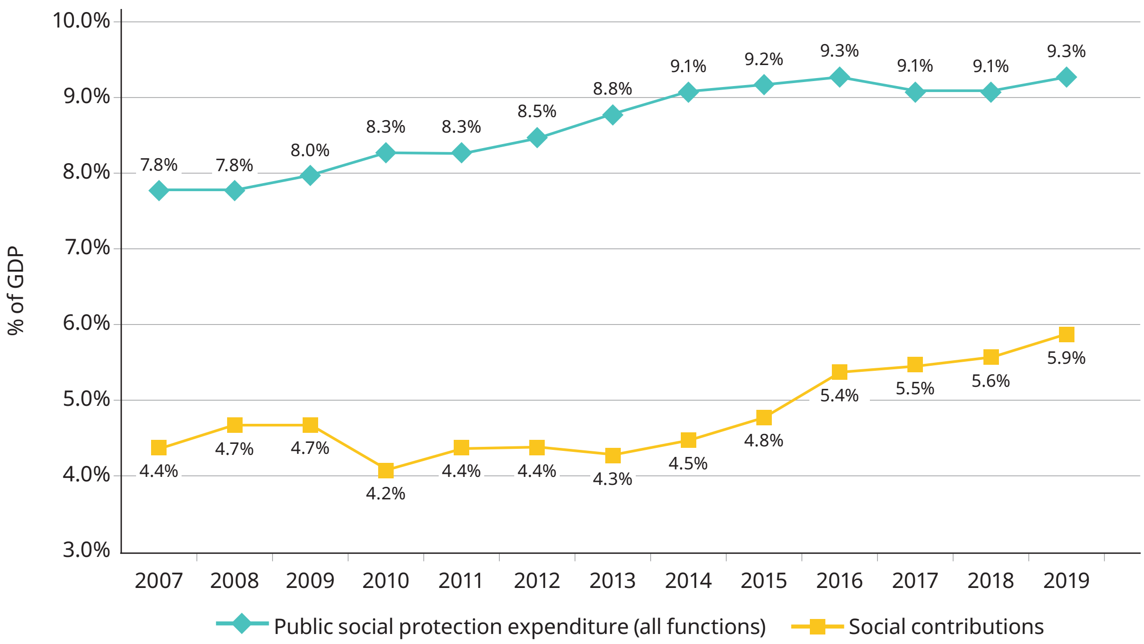
## 3.1. Expanding social security coverage and contributory revenues

Social security contributions, in conjunction with taxes, are usually considered as a key source of financing for social protection. A social security contribution is, according to ILO (2017), a prior payment that an individual makes in order to get a specific protection against certain risks through insurance mechanisms. Existence of a large informal economy in a country is a key challenge to provide social protection to the workers working in this economy. Recent developments in financing of social protection through contributions have emphasized the importance of extending coverage to independent, women and rural workers, largely working under the conditions of informality. According to Ortiz et al (2019; p.65), there are three ways to create fiscal space through social security contributions:

1. Extending legal coverage of social security schemes, through the extension of current schemes to new population groups and the creation of social security contributory programmes.
2. Extending effective coverage, which increases the contributions' collection base.
3. Adjusting social security contribution rates.

As shown in Figure 4, social protection expenditure of Albania was 9.3 per cent of GDP in 2019, demonstrating an increasing trend since 2007. The contributory revenue plays a significant role in the country, which was 5.9 per cent of GDP in 2019, representing over 60 per cent of the total social protection expenditure, rising from 50 per cent in the period 2012–2014.

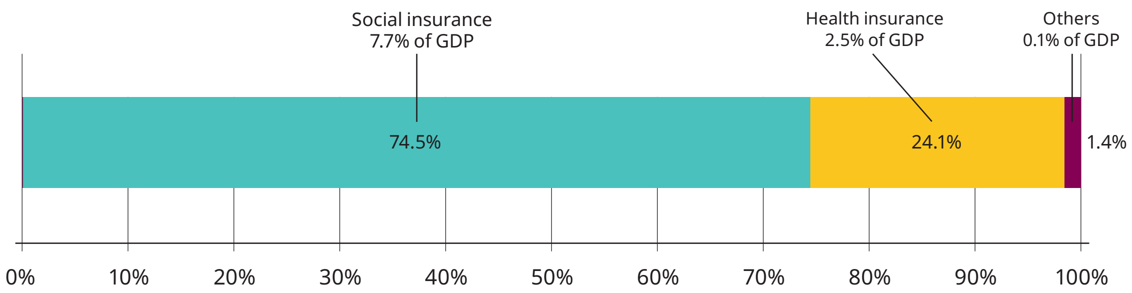
▶ **Figure 4. Social protection expenditures and social contributions, 2007–2019**




***Source:*** Ministry of Finance and Economy, Government of Albania.

As shown in Figure 5, social insurance (as a direct function) represents 7.7 per cent of GDP, about three times the allocation to health insurance. Around 74.7 per cent of the expenditures are allocated to social insurance programmes while an additional 24 per cent goes to healthcare activities. Compared to the period 2007–2009, the share of social insurance fell 6.7 percentage points due to a significant increase in health budget since 2009 when it doubled from 1 per cent in 2008 to 2.1 per cent of GDP. This increase in budget remained and helped experience some additional growth in 2019, which was 2.5 per cent of GDP.

▶ **Figure 5. Distribution of social insurance by category, average 2017–2018**



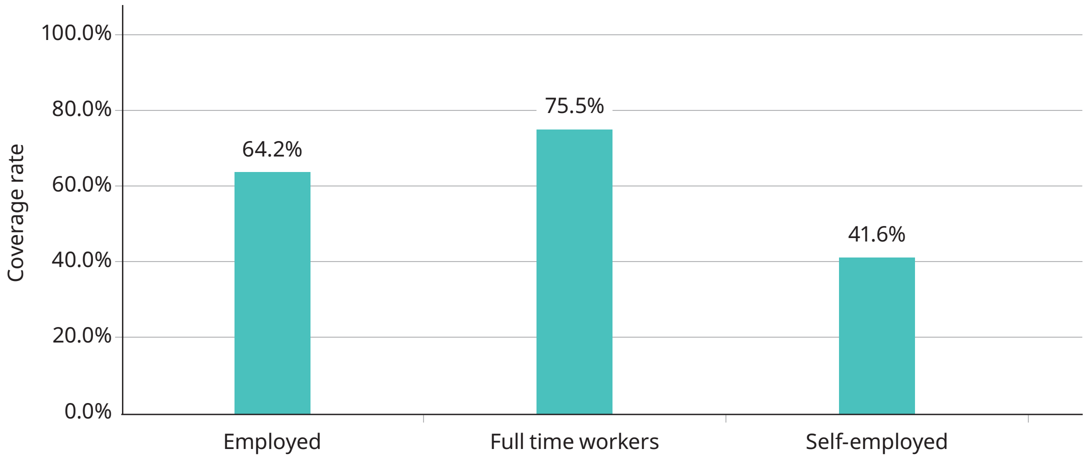

***Source:*** Ministry of Finance, Government of Albania.

Regarding informality in Albania, the 2019 composition of the labour market indicates that the level of self-employed workers represents 31.2 per cent of the total employed population. Furthermore, according to World Bank (2018), 20 per cent of the wage-employed are informally employed.

The information on informality by sector is limited in Albania. A survey conducted in Albania suggests that almost all the trades of street vending in Albania are informal with 80 per cent of them not having a license to operate (ILO, 2011). The proportion of informal employment in non-agriculture employment is 29.4 per cent, according to the Institute of Statistics (INSTAT) of Albania. By gender, the percentage is higher for males compared to females, 34.7 per cent and 21.5 per cent, respectively.

As shown in Figure 6, in terms of social protection coverage by employment status, the ILO estimates (as reported by the World Bank's World Development Indicators) that 64.2 per cent of the Albanian employed population is covered with social insurance. In 2019, the total number of employed population was estimated at 1,180,451 persons, with an estimated 1,004,564 full-time workers and 368,301 independent workers. Based on these figures, the estimated coverage rates are 64 per cent of the employed population and 41.6 per cent of the self-employed. Therefore, there exists a significant coverage gap amongst independent workers, which could be the focus of future fiscal space efforts to increase financing from social contributions.

**▶ Figure 6. Social insurance coverage rates by employment status, 2019**




***Source:*** ILO staff estimations using data from WDI, Social Insurance Institute and INSTAT.

Based on the above discussion it is possible to provide estimates of potential new resources generated from increasing coverage of self-employed workers. To do this, the exercise makes use of the previous parameters and the available information in terms of monthly earnings. It is important to note that affiliation of self-employed workers to contributory system in Albania is voluntary. This is one of the critical issues to discuss in future especially because more than half of the working population belong to this category. Other parameters used for the estimations of the fiscal space through contributions are:

- Legal monthly minimum wage: 26,000 lek.
- Contributory rate: 23.0 per cent for pensions/social security and 6.8 per cent for health.

Table 1 presents the results of the exercise. Potentially, full coverage with social insurance (including health insurance) would generate an additional 5.8 per cent of GDP. Of this, about 5 per cent would come from social security (ISSH) and 0.8 per cent from health insurance (HI). Full self-employed coverage would yield a marginal 1.2 per cent of GDP. In other words, if coverage gaps are closed by 50 per cent, the country would generate enough funding (2.9 per cent) to eliminate any pension deficit.

▶ **Table 1. Estimated additional finance from increasing social insurance coverage**

| | Category | No. of additional contributors | Additional contributions (%GDP) (ISSH+HI) | ISSH | HI |
|---|---|---|---|---|---|
| 1 | Full income declared | — | 2.2% | 1.9% | 0.3% |
| 2 | All contributing family members (informal) covered | 241,992 | 1.7% | 1.5% | 0.2% |
| 3 | Both 1 and 2 (informal also declared in full) | 241,992 | 4.7% | 4.1% | 0.6% |
| 4 | All self-employed covered | 215,009 | 1.2% | 0.9% | 0.3% |
| 5 | 1 + 2 + 4 | 457,001 | 5.8% | 5.0% | 0.8% |

***Source:*** ILO staff estimations using data from national sources.

A key challenge in this regard is to develop a coherent strategy to attract self-employed workers into the available contributory schemes. International experience from different countries around the world can help provide some guidance. One such examples which has gained popularity in Latin America is the launch of a Monotax (Monotributo) scheme that is usually defined as an institutional arrangement in which the tax collection agency and the social security institute agree on a simplified process and contribution rate to promote and include self-employed workers to the system. This simplified process includes better procedures for enrolment, payment of contributions and claim of benefits among small contributors.

Many other alternatives have emerged in the past two decades. Ginneken (2003), for instance, mentions about the importance of designing flexible and attractive packages of benefits for independent workers and to split the potential contributions and benefits by urban and rural groups. The introduction of tailor-made conditions is particularly significant for agricultural workers whose revenues experience a seasonal behaviour that differs from the traditional monthly payments that salaried workers are familiar with (Hirose and Hetteš, 2016). In some cases, self-employed programmes incorporate a component of incentives of the most diverse nature. For instance, affiliation to social security may provide access to preferential loans in some countries at reduced interest rates. In the United States, contributions as self-employed can be included as a tax relief. In other countries such as Ghana and Rwanda, premiums are subsidized either fully or partially.

The elimination of legal and institutional barriers is also an important factor to consider. Several countries still have legislations that impede certain type of workers to access social security or define specific barriers for them to enrol. At the same time, many organizational processes set up excessive number of requirements and complicated bureaucratic processes that demotivate independent workers to enrol.

Finally, it is important to build a social security system which advances gender equality. In many countries, contributory social protection schemes were designed around a "male breadwinner" model, assuming formal employment and uninterrupted and full-time careers. Gender inequality in the social security system largely reflects gender inequality in the labour market and employment, for instance, lower labour force participation for women, shorter employment career, women suffering from gender wage gaps and also facing a higher risk of working in precarious conditions in informal employment. This puts women in a disadvantaged position as they tend to struggle to accrue social security rights that are equal to their male counterparts, leaving them with lower levels of accumulated contributions and eventually lower benefit levels. This is especially the case for old-age pensions and unemployment benefits.

## 3.2. Increasing tax revenue

The total government revenue (as a percentage of GDP), as discussed in Chapter 3, shows an increasing trend since 2013. Rising tax revenue is the main driver of this upward trend. On average, taxes account for 91.3 per cent of total revenue from 2010 to 2019.

There are 12 main tax related sources of income, which are grouped into three categories – revenues from tax offices and customs, local taxes and revenues from special funds. The first category includes taxes such as VAT, income and excise tax while local and property taxes belong to the second one. Finally, social insurance and health insurance are the main components of *revenues from special funds*[2].

The macro-structure of total taxes shows that, between 2013 and 2019, income from tax offices and customs accounts for roughly three-quarters of the total taxes while an additional 20 per cent comes from special funds. Local taxes represent a low share of 4.1 per cent. Two issues about the dynamics of taxes during this period emerge. First, there are higher growth rates observed in local taxes and special funds. Between 2013–2014 and 2017–2019, the proportion of special funds increased 2.6 points while income from general taxes moved down 4.1 points. Second, in GDP terms, the proportions of all three categories show increases during this period. However, taxes from offices and customs moved up 1.9 points while special funds (+1.4 points) and local taxes (+0.7 points) lagged behind.

In relation to the micro-composition of tax revenues, the top three revenue generators are the VAT (currently at 20 per cent rate), excise taxes (on energy, tobacco, alcohol and alcoholic beverages and other products such as coffee and fireworks) and social insurance. The average contribution of the three sources was 63.3 per cent of the total taxes in 2019, almost 4 points less than in 2013. Individually, one-third of the total tax revenues come from VAT, a source that increased its share in GDP terms (from 8.4 per cent to 8.9 per cent). Social insurance contributions add 18.8 per cent to revenues, an equivalent to 4.9 per cent of GDP. Finally, excise taxes (10.8 per cent of total taxes and 2.8 per cent of GDP) could be of interest for social protection financing purposes due to the type of goods and services that feed this account. The main drawback with this source is the declining share in GDP terms, especially after 2014.

In addition to the top three sources discussed above, there are three other options that may be of interest for fiscal space analysis: personal income tax (13 per cent or 23 per cent rate, depending on the size of the taxable income), national taxes[3] and the profit tax (15 per cent rate). Two reasons back this importance. The first one is their increasing revenue collection performance in recent years. The three taxes, which accounted for 5.4% of GDP in 2013, expanded to 6.8% of GDP in 2019 (+1.4 points). Second, the progressive nature of personal and corporate taxes is essential for the betterment of equity issues and redistributive aspect of the taxation system.

2. There is an intense debate of whether social contributions should be considered or not taxes. The OECD includes them as taxes although they refer them as "...compulsory payments paid to general government that confer entitlement to receive a (contingent) future social benefit" being this the distinguished difference with taxes.

3. The National taxes include the following accounts:
- The Port tax;
- The turnover tax on gasoline;
- The Tax on used vehicles for transportation;
- The Mineral royalty;
- The Tax on Acts and stamps;
- The carbon tax on gasoline;
- The Tax on the fishing activity;
- The Tax on packaging;
- The Tax on the right to use the state land in use;
- The Tax on written premiums, excluding insurance premiums for life products, health care and travel insurance;
- The Tax on the initial registration and the annual tax on luxury vehicles.

From a tax-based perspective, the creation of fiscal space may consider four areas of analysis: a) changes in current taxes; b) creation of new taxes; c) reduction of tax evasion and d) evaluation of tax expenditures[4]. The table below summarizes the resulting additional fiscal space that may be created provided that the most important taxes experience a 1-percentage point increase in from their existing rates or, in the case of categories that groups several taxes (excise, national), a general 10 per cent increase in their rates.

### ▶ Table 2. Estimated additional finance by increasing tax rates by 1 percentage point

| Type of tax | Additional financing (% of GDP) |
|---|---|
| VAT | 0.44 |
| Profit Tax | 0.20 |
| Excise Tax | 0.28 |
| Personal Income Tax | 0.16 |
| National Taxes and others | 0.28 |
| Customs Duties | 0.06 |

***Source:*** ILO staff estimations using data from national authorities.

Despite the potential revenue outcomes recorded in Table 2, the results should be considered with caution. First, the recently approved and implemented tax reform in 2019 reduces the political space to proceed with similar reforms in the near future, either in the form of new taxes or by increasing the existing ones. Second, the exercise assumes that each additional point would collect a proportional share to what is collected today. This may not be the case. Subsequent increments in tax rates may motivate higher levels of tax evasion that will affect the expected level of revenue generation. Third, the exercise assumes that all new funding would be allocated for social protection purposes (i.e. all money is earmarked). Unless this is clearly specified in the legislation, new revenues may end-up in a common fund and distributed according to sectoral needs and political visions.

Creating new taxes or increasing the existing ones is always politically challenging. However, there is still a path to create fiscal space through at least two other channels: reduction of tax evasion and review of the tax expenditures. Regarding tax evasion, some estimates for Albania indicate that evasion represents 30 per cent of current tax collection (ICEX, 2018), something equivalent to 7.9 per cent of GDP in 2019.

In order to combat evasion both the legal and institutional capacities of the Ministry of Finance need to be strengthened to conduct anti-evasion activities. Besides, while tax elusion is legal, tax evasion is not but in practice both tend to behave in a very similar way. This may make it difficult to identify the tax evaders.

The second alternative is the review and possible reduction of tax expenditures. As Villela et al. (2010: 2) note, tax expenditures refer to "the revenue that is foregone by the application of benefits or special tax regimes". Those exemptions represent 5.6 per cent of GDP (Ministry of Finance and Economy, 2019) and perhaps the most important feature is the strong presence it has in VAT. Given the tax expenditure structure, any changes must impact exemptions in the VAT and therefore it must be carefully assessed in view of any negative effect on poorer families. The report's estimates reveal that a 10 per cent reduction of all tax expenditures would yield 0.56 per cent of GDP.

4. Tax expenditures are defined as "…those government expenditures carried out through tax legislation, regulations, and practices that reduce or defer taxes for some taxpayers" (Villela, Lemgruber and Jorratt, 2010: 1).

Finally, any intervention in tax policy needs to ensure that it does not adversely affect the desired outcomes of sustainable development goals (SDGs), particularly SDG Goal 5.C, aim of which is to achieve gender equality and empower all women and girls. For example, indirect taxes can increase gender biases due to women's different consumption patterns. Women spend proportionately more on household items which attract VAT. This means that a tax policy that primarily focuses on increasing indirect taxes (e.g. VAT) can potentially be more burdensome for women. Another example is the direct tax exemption with regard to corporate and personal income tax, which tends to increase gender inequality as men are more likely to run a business and tend to benefit disproportionately from such exemptions. Thus, raising direct taxes' contribution to overall tax revenues will not only make current tax systems more equitable but indirectly also reduce the relative tax burden on women. In short, mainstreaming a gender perspective into the tax policy to create fiscal space can significantly improve the quality of public policy and help eliminate gender biases.

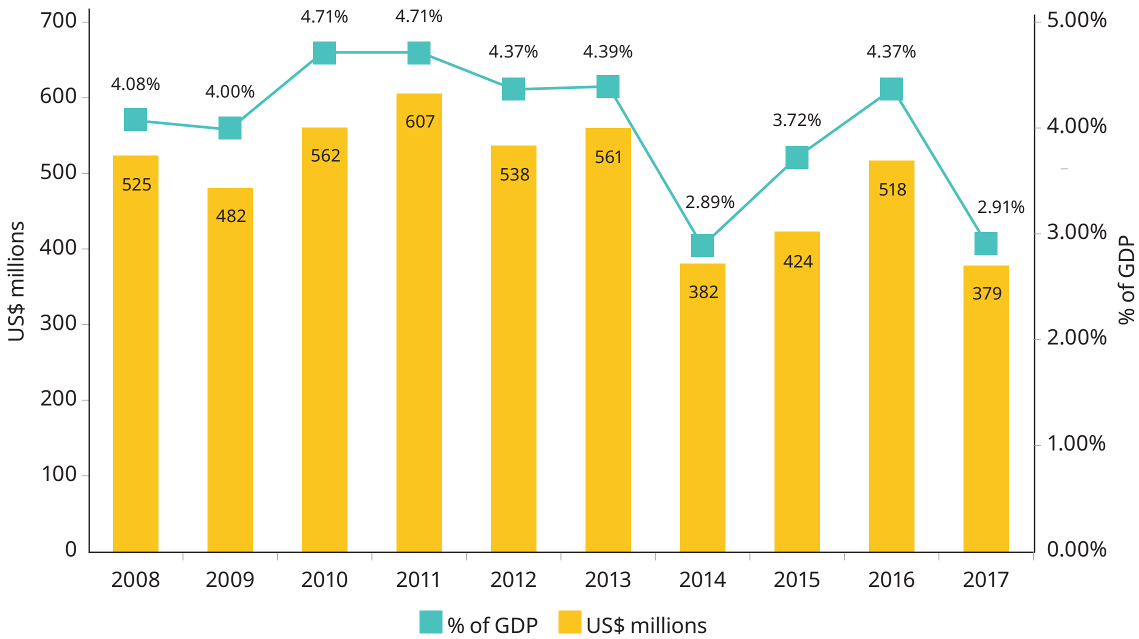
## 3.3. Eliminating illicit financial flows

Illicit financial flows (IFFs) "are generated by methods, practices and crimes aiming to transfer financial capital out of a country in contravention of national or international laws" (Ortiz et al, 2019: 102). These flows generally include practices such as money laundering, bribery by international companies, tax evasion, and trade mispricing (OECD, 2014a; OECD, 2014b, quoted in Ortiz et al, 2019). The IFFs, include cross-border financial transfers against national or international laws. These can include the following financial transfers: funds with criminal origin, funds with a criminal destination (bribery, terrorist financing or conflict financing), funds associated with tax evasion, funds related to trade mis-invoicing and mispricing, transfers by/for entities subject to financial sanctions, transfers which seek to evade anti-money/counter-terrorist financing measures or other legal requirements (Ortiz et al, 2019).

The Global Financial Integrity (GFI) calculates the trade-related illicit flows[5] in Albania for the period 2008–2017. The GFI performs a partner-country analysis to compare and contrast the differences between any set of two countries in order to identify value gaps, or mismatches, in the reported data (GFI, 2020:1). Figure 7 shows the trends in these gaps for the period 2008–2017 among Albania and their global trading partners, both in terms of US$ million and as a percentage of GDP. On average, the gap is US$ 497.8 million representing 4.01 per cent of GDP and 20 per cent of the total trade during the period. The GFI (2020) also computed the gap for the trade among Albania and 36 advanced economies (annex 1 includes the names of 36 countries). In this case, the gap reaches US$ 151 million which is 1.17 per cent of GDP in 2017, compared to US$ 379 million equivalent to 2.91 per cent of GDP in the same year but with reference to all the global trade partners of Albania.

5. According to this organization, "Trade mis-invoicing occurs when importers and exporters deliberately falsify the stated prices on the invoices for goods they are importing or exporting as a way to illicitly transfer value across international borders, evade tax and/or customs duties, launder the proceeds of criminal activity, circumvent currency controls, and hide profits offshore" (Global Financial Integrity, 2020: 1).

▶ **Figure 7. Gaps in trade between Albania and its global trading partners, 2008–2017**




***Source:*** Global Financial Integrity (2020).

Table 3 shows three scenarios of trade-related illicit flow recovery in the case of Albania. Using the gaps computed for 2017, both in the case of trade with Albania's global trading partners and 36 advanced economies, a recovery of 5 per cent of these gaps implies an additional 0.15 per cent and 0.06 per cent of GDP, respectively. If the target increases to 20 per cent, the value the recovery increases to 0.58 per cent of GDP for the overall trade and 0.23 per cent in the case of trade in relation to 36 advanced economies. Finally, a target of 30 per cent recovery of these illicit flows implies US$ 113.7 million and 0.87 per cent of GDP (US$ 45.3 million and 0.35 per cent of GDP in the case of trade among Albania and 36 advanced economies).

▶ **Table 3. Scenarios of trade-related illicit flows recovery**

| Recovery goal (% of trade-related illicit flows) | US$ million | % of GDP |
|---|---|---|
| **Global trading partners** | | |
| 5 | 19.0 | 0.15 |
| 20 | 75.8 | 0.58 |
| 30 | 113.7 | 0.87 |
| **36 advanced economies** | | |
| 5 | 7.6 | 0.06 |
| 20 | 30.2 | 0.23 |
| 30 | 45.3 | 0.35 |

***Source:*** ILO staff estimates using information from GFI, 2020.

The OECD recommends the following measures to reduce the level of illicit flows in developing countries (OECD, 2014a, quoted in Ortiz et al, 2019):

- Strengthen national inter-agency co-ordination mechanisms to combat IFFs. In order to ensure an effective response, governments need to build institutional mechanisms that assign clear responsibilities and facilitate straight-forward co-ordination and collaboration between different agencies both at the level of policy design and implementation.
- Policymakers and stakeholders should have a more strategic overview of IFFs and must assess the potential trade-offs and synergies in an inter-disciplinary manner, better inform policy making upstream, and help government actors to take more effective actions. Effective policy, therefore, will necessarily be based on an approach that emphasizes coherence – including through:
    - Identifying and raising awareness of the types, magnitudes and risks of IFFs (particularly at the political and policy making level).
    - Considering the contextual factors that allow IFFs to thrive.
    - Supporting coherence within and between national and international normative frameworks (vertical coherence).
    - Identifying critical, prioritized interactions across economic, social and environmental areas to address IFFs (horizontal coherence) (Ortiz et al, 2019: 107)

Implementing these measures to create fiscal space for social protection is clearly an equitable measure, since it implies acquiring resources from transactions that operate outside the national laws. This also seems to be a sustainable source of resources. However, the level of effort required to obtain these resources could be high, so the cost of management in this regard has to be considered.

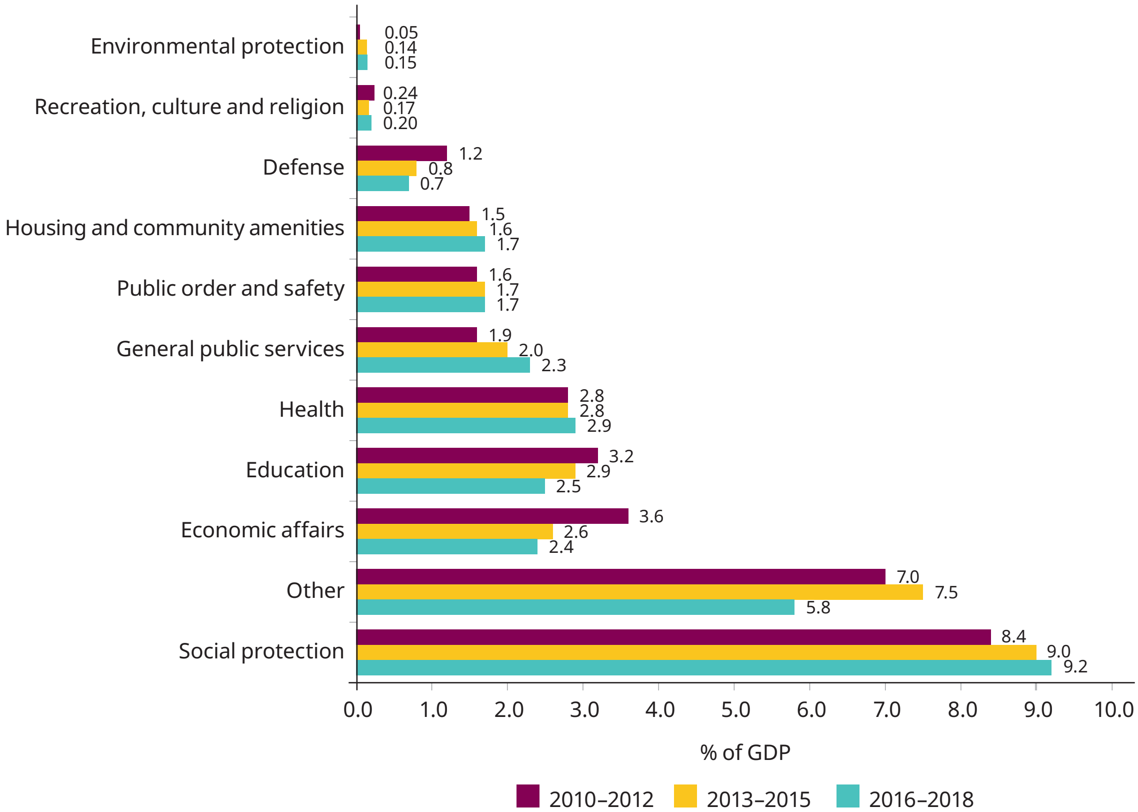
## 3.4. Public expenditure reprioritization

Development objectives and sectoral expenditures are prioritized in National Development Strategies (Ortiz et al, 2019). The public expenditure reprioritization can be understood as a "reassessment of sector-specific allocations within existing budgets" (Ortiz et al, 2019: 116). This is a measure that does not generate new fiscal space in the total budget but it can allow to obtain or secure resources for the social protection sector. The fiscal space for sectors such as social protection is obtained by reducing "less socially desirable or less relevant activities or replacing high-cost, low-impact investments with others that accrue to people" (Ortiz et al, 2019: 116).

Figure 8 presents the functional classifications of Albania's State Budget per trienniums over the period 2010–2018. The total government expenditure in Albania decreased 1.7 percentage points (p.p) in the first and the last triennium. During the period of 2010–2012 the expenditure reached on average 31.4 per cent of GDP and went down to 29.7 per cent of GDP in the period of 2016–2018. By sector, there is a clear dominance of social protection. This area represented the highest percentage of GDP, an average of 9.2 per cent in the period 2016–2018. Moreover, social protection is the sector with the highest increase in percentage points during the period (0.8 p.p). This reveals the importance of social protection both as a macro and a political priority for the Government of Albania.

Other social sectors show a constant pattern or even a decrease in terms of GDP. For instance, education decreased by 0.7 p.p from 2010–2012 to 2016–2018. Moreover, health and environmental protection just increased by 0.1 p.p during the first and the last triennium. Some sectors are viewed as a “less socially desirable sector” or a sector of “low social impact”, so they may be a potential source of budget reprioritization. Defense spending is one such example. In this particular case, however, the expenditure on this sector also declined by 0.4 p.p of GDP from 2016–2018 to 2010–2012.

### ▶ Figure 8. Functional classification of State budget, 2010–2018



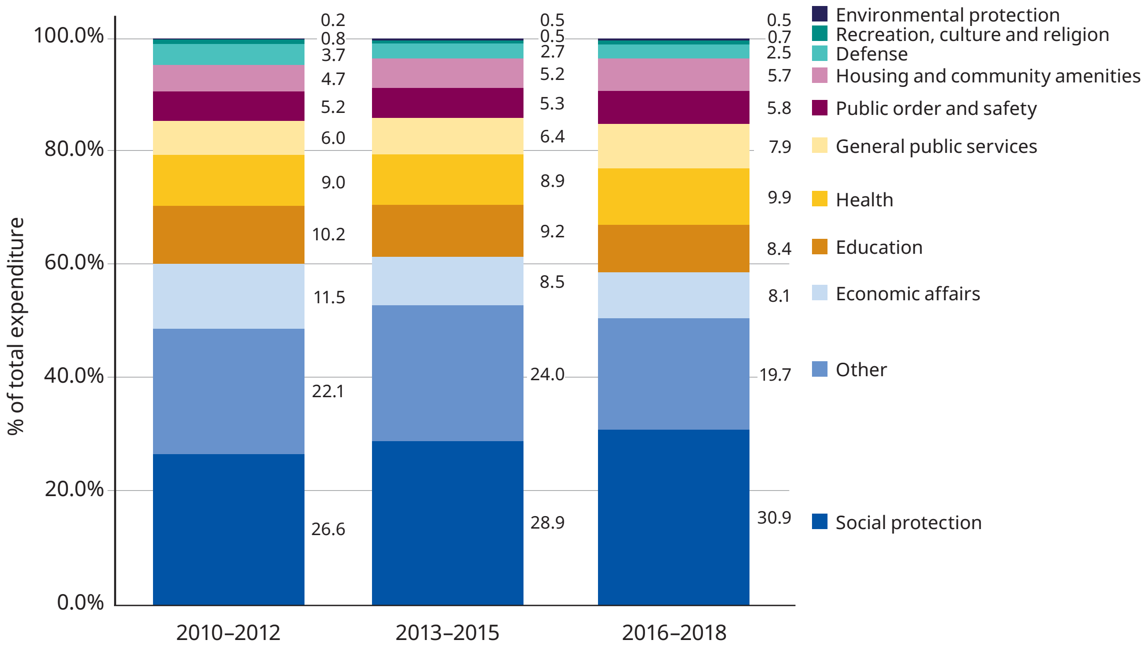

***Source:*** ILO staff estimates using data from the national authorities.

Figure 9 depicts the composition of the Albanian State Budget by functional classification. Social protection is the sector with the highest share of the total expenditure. There is an increase in the share of total expenditure that is grouped by social protection, in 2016–2018 this sector reached on average 30.9 per cent of total expenditure. The expenditure increase in the share of social protection is mainly explained by the expenditure on old age. This particular expenditure grew by 35.1 per cent from 2010–2012 to 2016–2018 and represented 87.3 per cent of the expenditure on social protection.

Besides social protection, four sectors stand out in terms of their share in total expenditure. These sectors are health, education, economic affairs, and general public services, which vary from 9.9 per cent to 7.9 per cent of the total expenditure. Conversely, two sectors (environmental protection, and recreation, culture and religion) are at the bottom with shares that do not reach 1 per cent of the total expenditure in none of the three periods analyzed.

Alongside social protection, five sectors are also increasing their share in the total expenditure from the first and the last triennium, namely general public services (1.9 p.p), housing and community amenities (1 p.p), health (0.9 p.p), public and order safety (0.5 p.p) and environmental protection (0.3 p.p). In contrast, the "losers" among the first and the last periods are economic affairs (–3.4 p.p), other (–2.4 p.p), education (–1.8 p.p), defense (–1.2 p.p), as well as recreation, culture and religion (–0.1 p.p). If any, the Government may review spending in general public services and public and order safety that gained, together, the equivalent to 0.5 per cent of GDP.

### ▶ Figure 9. Structure of State budget by functional classification, 2010–2018




***Source:*** ILO staff estimates using data from the national authorities.

In light of the previous analysis, public expenditure reprioritization seems not to be a potential financing source for social protection. The pattern shows an incremental budget allocation to social protection while other critical sectors have been falling or remain stable. In addition, the budget allocation to "less socially desirable sectors" is also declining.

Even if the analysis shifts to assess potential fiscal space from the State Budget by economic criteria, the key conclusions do not change. For instance, the top four spending categories (remunerations, fixed capital, interest, social benefits) accounted for 78 per cent of the total expenditures in 2019. Of them, only social benefits increased in terms of relative size. The other three fell in different degrees between 2003–2005 and 2017–2019: remunerations lost 0.66 points of GDP; fixed capital consumption 0.52 points; interests 0.68 points. As such it makes the search of fiscal space from this source rather difficult.

Ortiz (2018) also recommends considering the option to eliminate inefficiencies within the reallocation of public expenditures. Besides that, according to social assistance system "has been thoroughly reformed since 2012, with the aim of improving targeting and administrative efficiency, and reducing fraud" (Ymeri, 2019:4) This is evidenced in the low level of leakage observed in the NE programme, considered the main poverty-targeted social assistance scheme in Albania, where households in the top quintile receive only 4 per cent of the benefits (Dávalos et al., 2018).

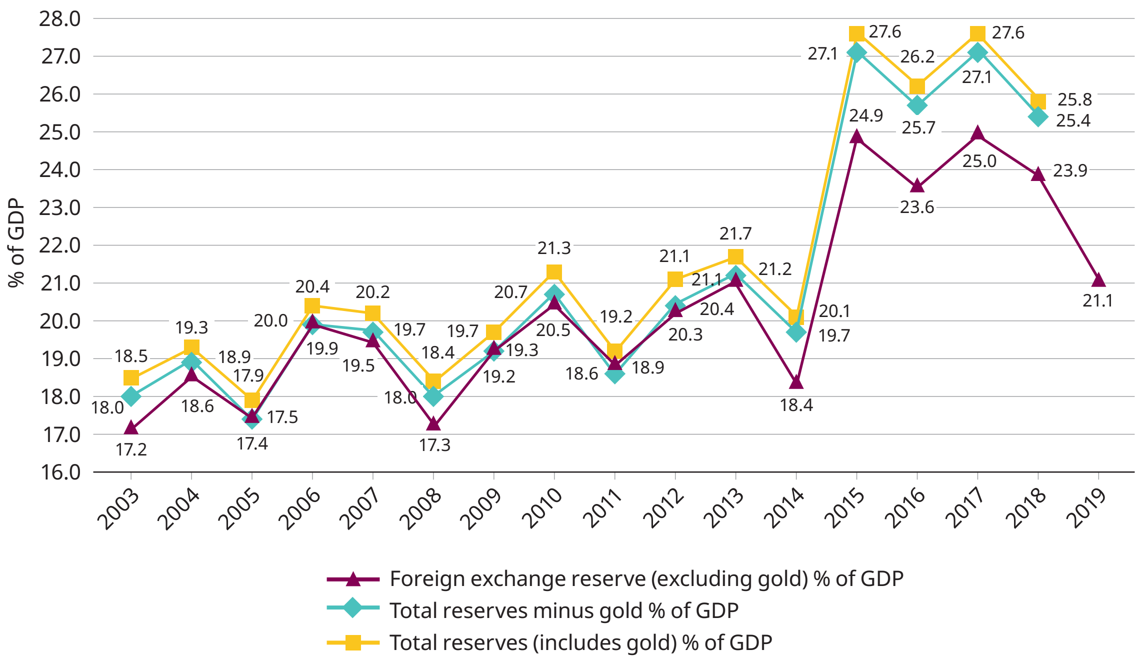
## 3.5. Use of fiscal and foreign exchange reserves

The use of fiscal and foreign exchange reserves can be a potential financing source for social protection and other social sectors. Proponents of this alternative argues for the existence of a social cost of keeping reserves (Rodrik, 2006) and the opportunity cost of holding reserves (even if they generate positive returns) vis-à-vis the cost of borrowing money for development projects. In general, it is said that if the country has reserves "in excess", there is a case to consider them as a potential source of revenue, either as a direct financing source or as a collateral to back-up loans for development purposes. However, opponents to this idea consider that reserves should be used only as an insurance mechanism against sudden stops, economic crises or to cover unexpected movements in the balance of payments, among other arguments. Given the recurrent public deficit in Albania, there is no room for fiscal reserve accumulation (i.e. no sovereign wealth funds) so the analysis focuses on foreign exchange reserves.

There are benchmarks based on which it can be decided whether foreign exchange reserves are in excess, paying due consideration to the macroeconomic stability of a country. Existing literature provides several criteria and rules of thumb (see for instance ECB, 2012; Greenspan, 1999; Moghadam, Ostry and Sheehy, 2011). Perhaps the most widely known criterion is the "*total reserves in months of imports*" that considers that the optimal stock should represents covering the payment of at least 3 months of imports. More recently, *the Greenspan-Guidotti rule* establishes that the reserves should account for 100% of the short-term debt. The first criterion focuses on the current account vulnerabilities while the second one reflects the capacity of the country to quickly refund its debt. Mbeng-Mezui and Duru (idem) add two more indicators – *the ratio of foreign exchange reserves to the total foreign debt balance* and *the ratio of foreign exchange reserves to Money & Quasi-money (M2).* In relation to the first one, the authors mention that this indicator "reflects a country's ability to repay its total foreign debt balance with foreign exchange reserves" (p. 5), being 40 per cent the optimal value. About the Money and Quasi-money coefficient, it represents a financial crisis precaution metric. Benchmark for this coefficient usually ranges between 10 per cent and 20 per cent if the country has a pegged or fixed exchange rate and 5 per cent – 10 per cent for floating exchange rate regimes. Other authors have attempted other alternatives. For instance, Jeanne and Rancière (2006) estimate the optimal level of reserves for emerging market economies at 10 per cent of GDP, given a set of assumptions about the risk preference of the country.

The historical level of reserves in Albania has been considerably high, at least for the past two decades, whichever criterion is used for the analysis. As shown in Figure 10, over the period of 2003–2019, the level of foreign exchange (including gold) reserves averaged 21.6 per cent of GDP (minimum 17.9 per cent and maximum 27.6 per cent). More restrictive indicators (foreign exchange without gold, for instance) also show averages above 20 per cent of GDP. Figure 10 shows the distance between existing reserves and the 10 per cent benchmark has been always positive averaging 13.7 per cent of GDP in the past five years.

▶ **Figure 10. Foreign exchange reserve, 2003–2019**




***Source:*** Bank of Albania and the World Bank.

Despite this significant room observed in the level of reserves, additional measures are needed to assess whether the country-specific conditions prevailing in Albania in the last few years reinforce the previous conclusion. Of the three of the four rules in Table 4, Albania shows a large share of reserves "in excess" that ranges between 9.2 and 17.5 points of GDP, depending on the benchmark criterion. Consequently, the initial evidence shows the existence of enough room to consider foreign reserves as an alternative for financing social protection initiatives. Whether the best alternative is a direct financing or as a collateral, is something that requires more analysis.

▶ **Table 4. Adequacy in reserve levels and excess reserves**

| Rule | Benchmark | Last 5 years | Reserves in excess (% of GDP) |
|---|---|---|---|
| Total reserves in months of imports | 3 months | 6.3 | 12.1 |
| Greenspan-Guidotti rule | 100% | 166.0% | 9.2 |
| Foreign exchange reserves to the total foreign debt | 40% | 35.4% | –3.0 |
| Foreign exchange reserves to M2 | 5%–10% | 30.7% | 17.5 |

***Source:*** ILO staff estimates using data from World Bank WDI and national authorities.

These initial results, however, require some complementary analysis in relation to factors that may affect the availability of funds in the near future. First, as it was mentioned before, the reserves-to-imports coefficient is a trade-related indicator that may have lost some relevance in times where capital outflows are as important as commercial flows. In spite of this, the indicator still can be used to assess reserve sufficiency in the context of the current account dynamics. After reaching a maximum of deficit of

15 per cent of GDP in 2008–2009, Albania started experiencing lower current account deficits that averaged 7.3 per cent of GDP in 2016–2018. If the tendency continued after 2018, the country would have expected a surplus in the current account in 2026. The COVID-19 pandemic, however, will severely affect the trends in trade flows. According to World Bank (2020), exports are expected to decline between 25 per cent and 30 per cent while imports would drop between 9.5 per cent and 10.6 per cent.

Next, the Greenspan-Guidotti and the reserves-to-total foreign debt indicators, mostly concerned to link reserves with debt, may require additional data to assess the trends in different debt components in the past decade. In relation to the former indicator, the short-term debt grew at a much higher pace than reserves, exports and total debt since 2005. Between 2005 and 2018, the share of short-term debt increased 2.9 times in total debt, 5.2 times in the level of reserves and 4.5 times in exports. In the particular case of reserves, while short-term liabilities represented 10.8 per cent of the reserve stock in 2005, by 2018 it jumped to 55.6 per cent. In terms of the latter indicator, the negative result warns about the need to double check reserve adequacy (in the future especially) when the analysis moves from trade to financial flows.

Finally, it is important to note that, if the Central Bank opts for a more cautious foreign reserve management policy, then the room observed in the individual metrics may change in an important way. For instance, if the optimal level of foreign reserves is set as the joint condition of the reserves-to-imports coefficient and 75 per cent of the Greenspan-Guidotti rule, then the resulting figure would be 21.9 per cent, leaving a positive gap of 2 per cent of GDP as "excess reserves".

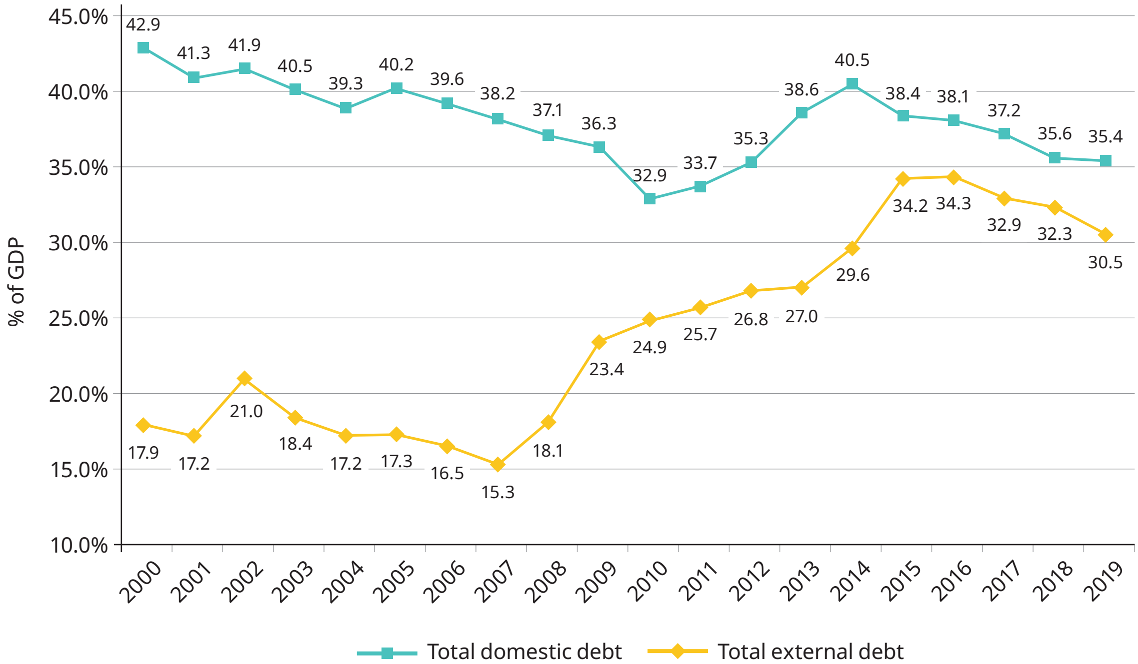
## 3.6. Debt restructuring

Financing social protection or other development through borrowing or debt restructuring involves a debate over this issue. One view is in favour of increasing debt if this will positively impact social development and country's competitiveness and the other one favours a more cautious approach to avoid future debt crises.

Since 2000, the public debt level averages at 62.1 per cent of GDP (minimum 53.5 per cent and maximum 72.7 per cent) with three periods that can be distinguished since then. The first period covers 2000–2009 and the average debt accounts for 57.9 per cent of GDP with a relative stability over the years. The second period covers 2010–2015 when the public debt continuously increases to reach the level of 64.6 per cent of GDP. In the period of 2016–2019, the level of debt starts declining and by 2019 it becomes 6.8 points lower compared to 2015, with an average of 69 per cent of GDP during the period. If this trend continues, the country may have a debt-to-GDP coefficient of 55.7 per cent in 2025. However, the effects of COVID-19 pandemic, that may last 2–3 years, may alter the path and/or may retard the effects that were initially projected.

Figure 11 depicts the domestic and external debt from 2000 to 2019. In relation to the composition, the domestic component remains as the most important segment with 53.7 per cent of the total debt, a persistent feature over the period of 2000–2019. However, this share strongly moved down from 70.6 per cent at the beginning of the century with a clear tendency to continue falling in the short-term. In other words, it is expected external debt to become the major component of the total public debt in the next few years.

▶ **Figure 11. Domestic and external debt-to-GDP ratio, 2003–2019**

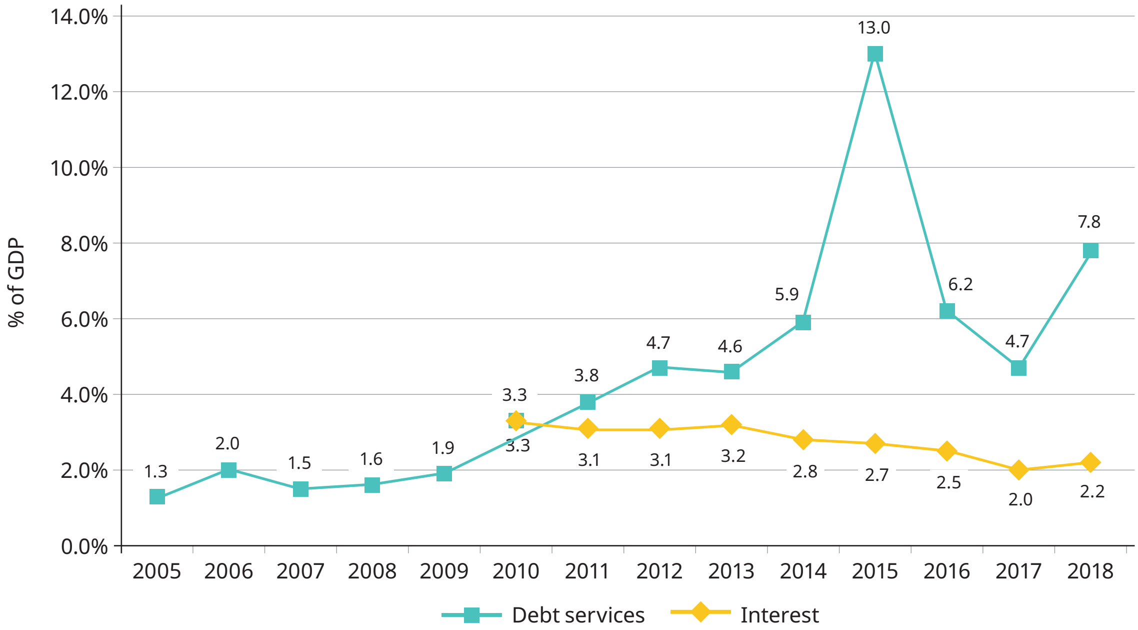



***Source:*** World Bank, World Development Indicators.

In addition to the overall behaviour of the Albanian public debt, there are a series of aspects that should be considered in this analysis. Two are of relevance for this section, one on debt servicing and the other one on the term composition of the debt.

In total, debt service accounted for 4.5 per cent of GDP since 2005 but this figure was characterized by a continuous growth over time, as shown in Figure 12. While in the period of 2005–2009 the annual burden of debt averaged 1.7 per cent of GDP, in 2014–2018 it grew to 7.5 per cent with a highest share of 13 per cent in 2015. Interest payments, once the key component of the debt service, represented 2.8 per cent of GDP in 2011–2018 but experienced a progressive decline from 3.3 per cent to 2.2 per cent of GDP. In other words, debt repayment (amortization) started gaining space so in 2018 it accounted to 71 per cent of the total debt burden (figure 12). The fast growth observed in debt payment raises concerns for both the effects on the fiscal and the external realms. During the 2010s, interests represented 11 per cent of the total public expenditures while the debt service increased by 4.6 times its equivalent share in exports (from 4.5 per cent to 20.7 per cent), putting a lot of press over the country’s reserves.

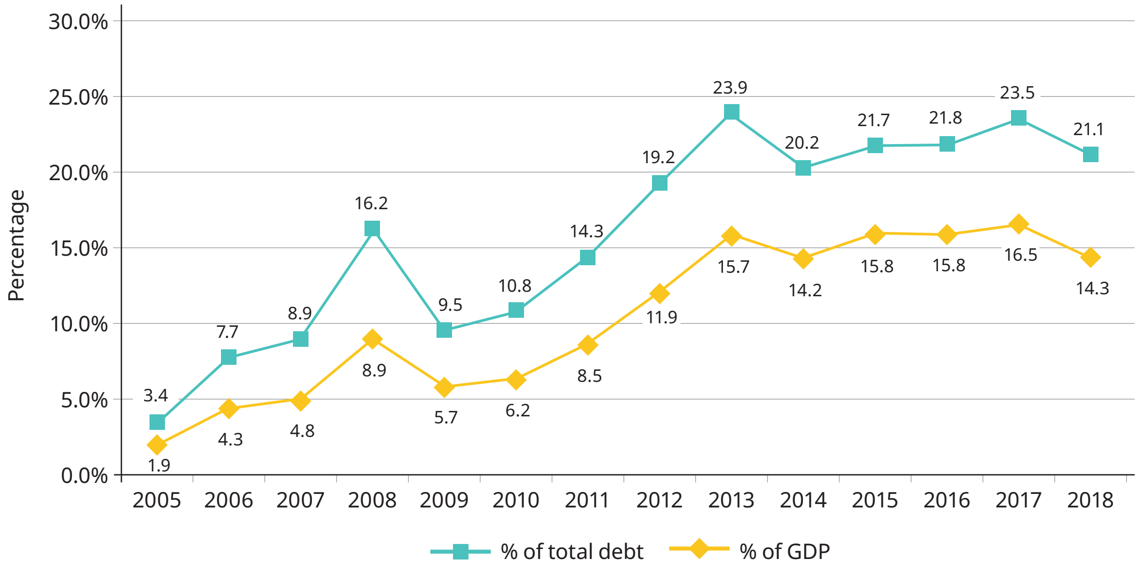
▶ **Figure 12. Debt service and interest payments, 2005–2018**




***Source:*** World Bank, World Development Indicators.

The second key aspect refers to the trends in short-term debt. Among the total debt composition, short-term obligations grew faster than the other components irrespective of indicators used to measure its dynamics, as shown in Figure 13. For instance, as a percentage of GDP, the component moved from a period lowest of 1.9 per cent in 2005 to 16.5 per cent in 2017. This led to the share of short-term debt in total debt to increase from 9.1 per cent in 2005–2009 to 21.7 per cent in 2014–2018.

▶ **Figure 13. Short-term debt indicators, 2005–2018**




***Source:*** World Bank, World Development Indicators.

Existing literature (see for example, Ito, Sekiguchi and Yamawake, 2018; Ortiz et al., 2019; Buckley, 2009; ILO, 2016) mentions about several instruments within debt financing mechanisms, which include the following:

- **Debt restructuring and debt re-negotiation**: it refers to the voluntary decision to restructure the terms of the debt with creditors
- **Debt swaps**: debt swaps are a mechanism in which the debtor, instead of paying back the debt to the creditor, allocates the corresponding money for social development purposes
- **Debt relief or forgiveness**: this alternative consists in the reduction or full cancellation of the country´s debt
- **Government bonds purchases by Central Bank**: this tool applies in those cases where the country has borrowing room to increase public debt by selling Government securities to the Central Bank

Table 5 shows contributions to sources of finance from five policy alternatives. The five policy alternatives are: a) a 1-point decline in the average cost of the Albanian debt; b) a 5 per cent reduction in the debt service; c) a 10 per cent decline in the interest payments; d) a 5 per cent reduction in the public and publicly guaranteed (PPG) loans with IDA and IBRD[6]; and, e) a 5 per cent reduction in the multilateral debt. The most effective measure would be a 1-point reduction in the average interest rate although the final impact of the rest of the measures would depend on the final policy target. One important factor to take into account is, however, the fact that not all the alternatives yield long-run savings but only one-year benefits. In some cases, such as interest payments, the reduction in the debt service may be considered "permanent" but in stock variables like the total size of the debts, this may only represent a single, one-year financing opportunity.

### ▶ Table 5. Debt-related policy targets and their financial effects

| Debt variable | Funding as % of GDP |
|---|---|
| 1 point of average interest | 0.56 |
| 5% of debt service | 0.39 |
| 10% of interest payments | 0.22 |
| 5% of IDA/IBRD loans | 0.43 |
| 5% of multilateral debt | 0.36 |

***Source:*** ILO staff estimates using data from World Bank, World Development Indicators.

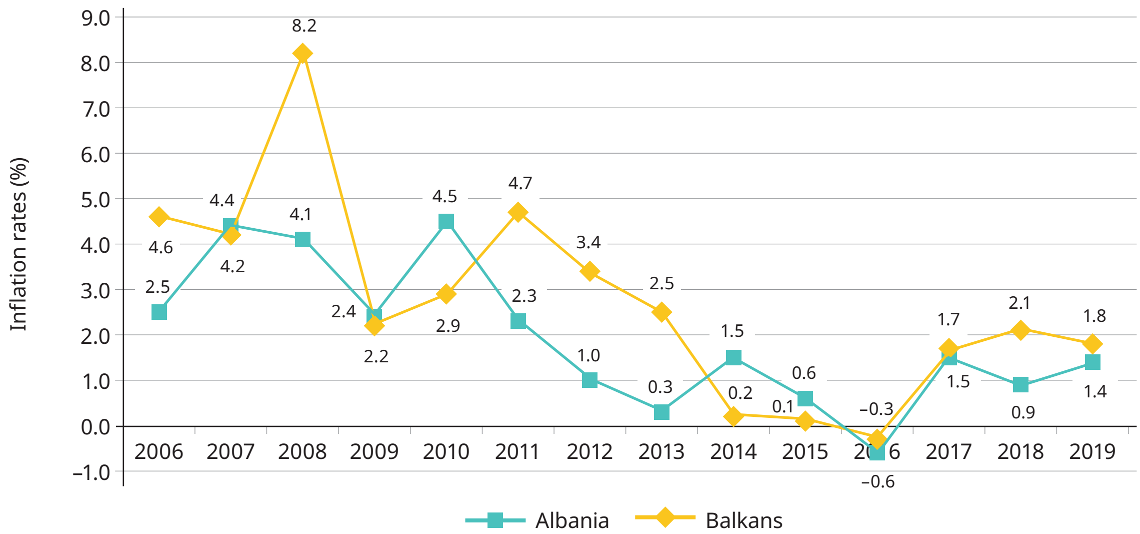
6. IDA and IBRD stands for International Development Association and International Bank for Reconstruction and Development (i.e. the World Bank).

# 3.7. Adopting a more accommodative macroeconomic policy

This alternative essentially calls for a review of existing macroeconomic policies aimed at keeping certain variables such inflation and primary budget deficits under tight control. Ortiz et al. (2019: 160) note that the predominant approach in the past 35 years is to define stability "in a narrow sense, focused only on nominal targets, such as budget deficits and inflation rates". The narrow concept of stability affects the possibility of using fiscal and monetary policies according to the business cycles and the particular conditions of the country. The search for low fiscal balances or inflation rates may play against critical investments in infrastructure, social protection, and human development, affecting in several ways the level of competitiveness of the country, economic growth, poverty, and inequality.

As shown in Figure 14, inflation in Albania since 2006 shows at least four characteristics. First, between 2006 and 2019, low average inflation rate is observed. During this period, inflation averaged 1.9 per cent per year. Furthermore, the second feature reveals low volatility of inflation (standard deviation = 1.5), an indication of the relative stability of the indicator over the years. Third, there is a downward long-run trend since the recent inflation rates are lower than the ones a decade ago. In this regard, while in 2006–2010 inflation in Albania was 3.6 per cent, in 2015–2019 it fell to 0.8 per cent. Finally, compared to the neighbouring Balkan countries' inflation rate (average = 2.7 per cent), Albania shows lower rates. Only in 5 of the 15 years during the period, the region had lower inflation rates than the country. Indeed, in 2019, inflation in Albania was 0.9 percentage points lower than the world average (2.3 per cent). Irrespective of the reference point used (regional, world or a 5 per cent parameter), inflation in Albania is low and this may support the case for a more active, expansionary monetary policy.

▶ **Figure 14. Inflation rates in Albania and the Balkan countries, 2006–2019**



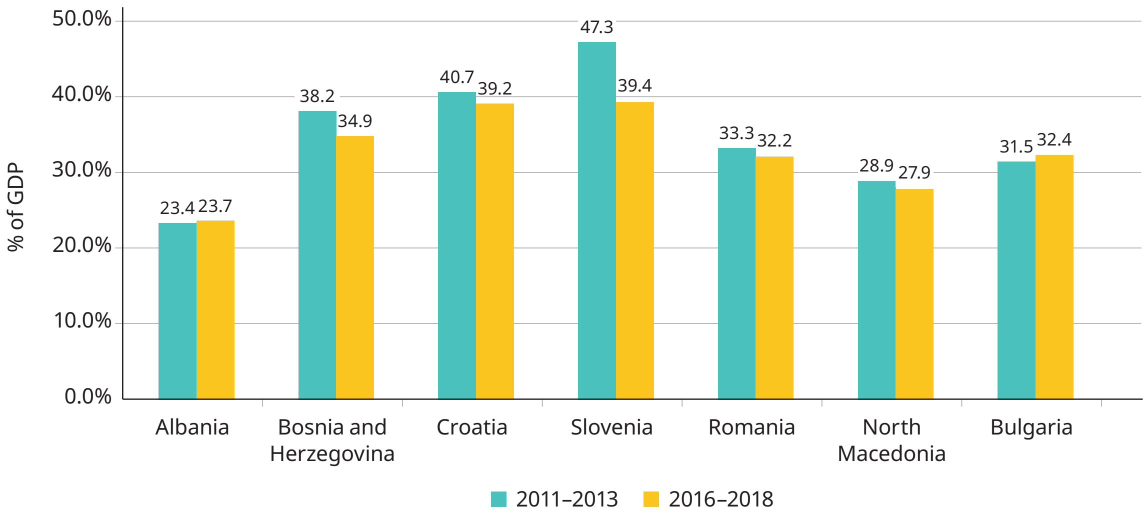

***Source:*** World Bank, World Development Indicators.

In terms of fiscal policy, two variables are selected, public expenditure and deficit/debt burdens. Expansionary fiscal policy may be a critical decision to expand public investments in strategic sectors such as social protection, conditional on the existence of institutional arrangements that allow funding to be appropriately allocated. Deficit financing through domestic debt is acceptable as long as the money is spent on productive sectors such as social protection raising productivity and leading to higher growth. Not taking care of the way countries spend (that is in the quality of the spending) may push the nation to unnecessary higher fiscal deficits and accelerated debt that may jeopardize the future macroeconomic conditions and the level of financing of social protection programmes for future generation.

The key issue is to strike a balance between increasing spending/investment while keeping debt at a manageable level. This latter number is country-specific and should not be forced to follow a particular parameter (for instance, 60 per cent of GDP) because at the end, the debt is or is not sustainable depending on other macroeconomic conditions of the country including the fiscal deficit itself, the prospect of economic growth and the capacity of the financial sector to fill the financing needs of the government.

Based on the above discussion, there are multiple ways to assess the existence of some room to create fiscal space using this strategy. A first option is the direct comparison between Albania and the Balkans in terms of public expenditures. According to World Bank World Development Indicators, Albania has the lowest level of spending among the seven countries considered in the sample being about 4 percentage points below the second lowest level (North Macedonia, 27.9 per cent).

**▶ Figure 15. Public expenditures in Balkan countries, 2011–2018**

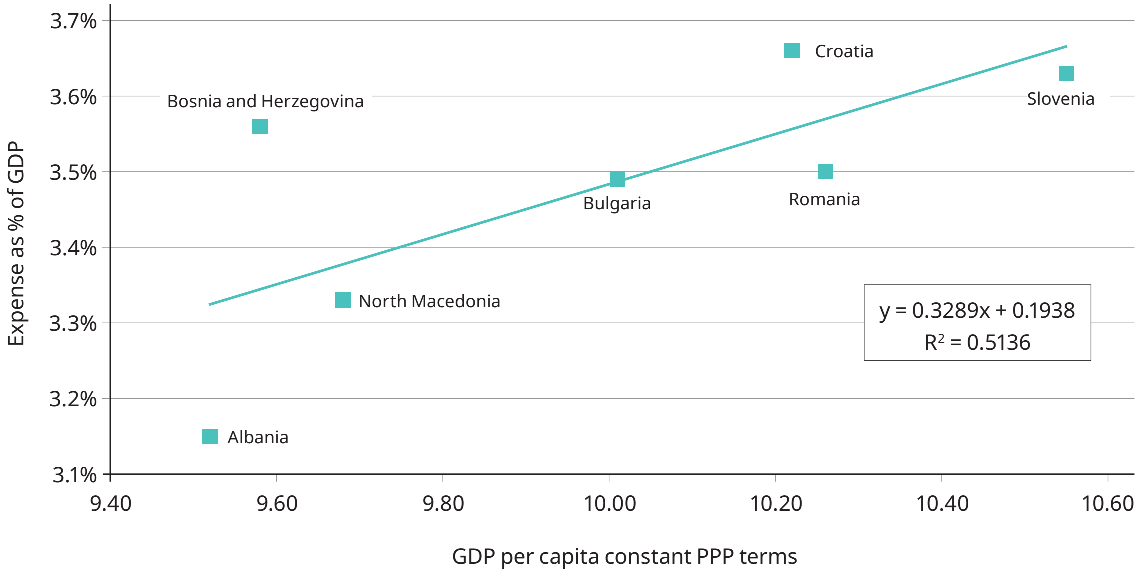



***Source:*** World Bank, World Development Indicators.

This approach does not account for differences in the level of development, as proxied by the GDP per capita. In order to consider this, a scatter-plot between the (log) levels of GDP per capita in PPP terms[7] and public expenditures is constructed. In Figure 16, the trend line reflects the estimated level of spending given a determined GDP per capita so any "dot" below the line indicates that the country is spending less given its level of development. Albania is one of such countries. According to the equation, the gap between current and expected level of spending is 4.5 points, very similar to the previous calculation.

7. The Purchasing Power Parity is a special price adjustment applied to variables in order to make them comparable across nations.

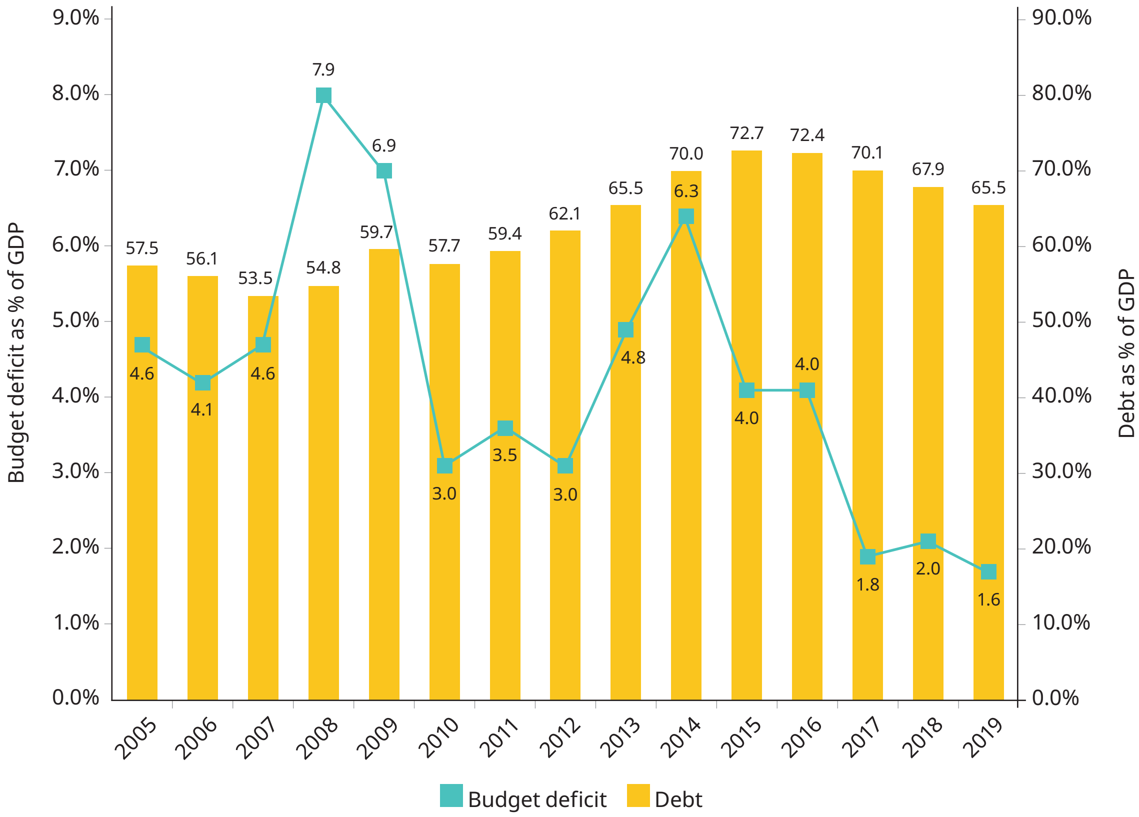
▶ **Figure 16. Correlation between GDP per capita and public expenditure in Balkan countries, 2018**




***Source:*** World Development

This analysis would not be completed if the trend in the fiscal balance and the public debt are not included. This point is critical to contextualize any spending increment given the potential limits that the current balance and the level of debt may impose. Figure 17 below shows that in the past three years, the fiscal deficits declined to an average 1.8 per cent of GDP after a decade of 4.8 per cent balance. This strong reduction is the result of the adoption of fiscal consolidation measures that are expected to continue until 2023 at least (Deloitte Albania, 2019). In parallel, the debt ratio, now at 65.5 per cent of GDP, has been falling since 2015 when it peaked at 72.7 per cent with an initially expected declining path in the upcoming years.

▶ **Figure 17. Fiscal deficits and debt-to-GDP ratio, 2005–2019**




***Source:*** Ministry of Finance and World Bank.

Several opportunities may open if the Government of Albania would like to use a more accommodative fiscal policy to increase resources to finance social protection. For example, one alternative is to calculate the difference between the historical fiscal deficits in Albania (4.1 per cent between 2005 and 2019) and the current deficit. This difference is 2.5 points. If the fiscal deficit is set at 2 per cent then it would generate resources equivalent to 0.4 per cent of GDP.

The information above suggests the existence of some fiscal space, either from the fiscal or the monetary side, to finance extension of social protection. However, there are some factors that should be considered in order to enhance the feasibility of this alternative. First, one should pay attention to the level of commitment of the country to keep inflation very low and low fiscal deficit targets. Although the country already concluded the three-year supported programme with the IMF in 2017, it seems that future policies will be addressed to keep the same path at least for the next 3–5 years.

Second, in the context of COVID-19 pandemic, multiple sectors will be fighting for additional resources for their budgets and those ones directly involved in the problem such as healthcare may have a priority in the 2020 and 2021 resource allocation. Social protection may also be part of this list but perhaps the level of required financing to move towards universal coverage by 2030 will be weakened. Depending on the prevalence of the pandemic nationwide and worldwide, the country may decide between increasing coverage or strengthening the size of the benefit.

Third, in the same context of the pandemic, while the fiscal dimension may be severely affected by the crisis (lower taxes, higher expenditures), there may be a case for an enhanced participation of central banks and their monetary policies in the financing of the protection packages. The strong contraction in the aggregate demand makes inflation targets less important at this stage.

## 3.8. Municipal financing and social protection

The above discussion provides an analysis of creating fiscal space at the country level. This Chapter looks at the opportunities available at a local level. In 2014, the Government of Albania made efforts to deepen the process of municipal decentralization by "providing local self-government with financial and economic power, rights and responsibilities, administrative, investment, regulatory and service competencies on basic functions, going one step further with the transfer of some new functions" (Haxhimali et al., 2019: 5). In terms of the fiscal decentralization reform, this component included the following issues (idem: 49):

- Transfer of national financial resources to local government;
- Transferring the responsibilities and the right to carry out the expenses;
- Increase of local government revenues;
- Full authority in determining / imposing local taxes and charges and expenditures; and
- A legal framework that enables local borrowing.

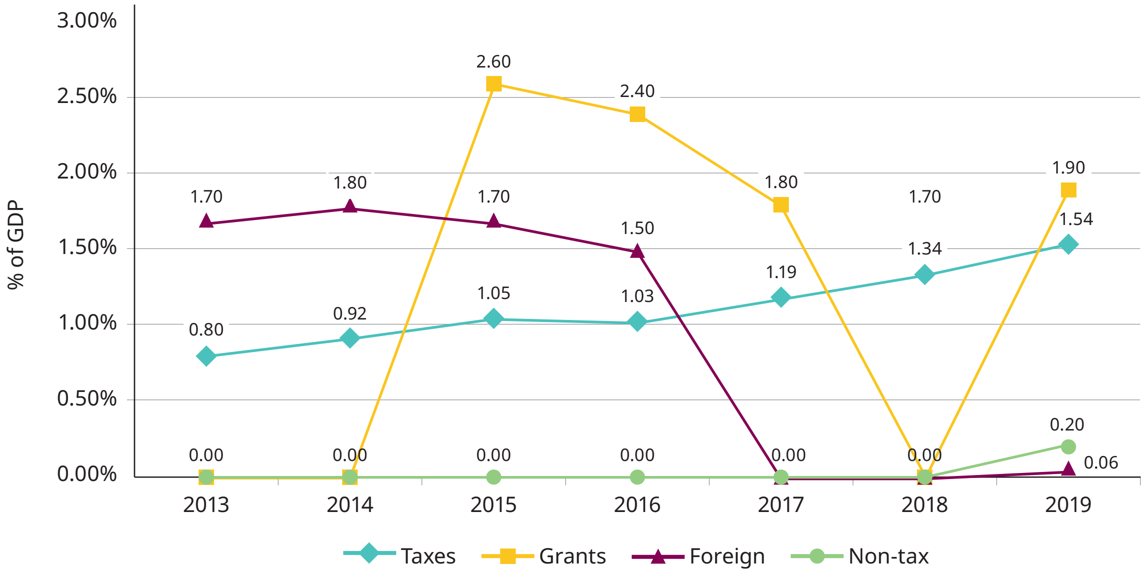
Among the most important reforms achieved during the first years since the launch of the reform, the Government was able to consolidate the number of local government units from 373 to 61 (USAID, 2016: 1) and include a 1 per cent of GDP unconditional transfer from the central government to municipalities as part of the Law on Local Government Finance. In terms of the provision of social services, there is still an unclear legal framework and severe governance and institutional gaps in such aspects such as modernization of some information systems. This is still a major area of review for future advances in the matter.

The local government law enacted in 2015 sets out the responsibility of municipalities to establish a "social fund for financing social services", in cooperation with the Ministry in charge of social affairs (UNDP, 2018). The law on social care services also elaborates upon the establishment of the social fund administered at the local level, which is composed of sources of financing from the state and local budget, ring-fenced revenues, and service fee from beneficiaries, as well as funding from non-public contributors (i.e. non-governmental organisations, development programmes or private donors). Insofar as established by the legal framework, the concept of the social fund at the local level is comparable to the notion of earmarked funding for specific functions. It does not, however, quite seem to enable the opportunities offered by a special fund established at the central level, which would pool budgetary and extra budgetary resources together to fund new, and innovative services on a competitive basis.

In terms of municipal funding, the local governments rely on two sources of resources, which are Central Government transfers (conditional and unconditional) and own income. An unconditional transfer refers to "a general budget fund distributed to the local government, on the purpose of fulfilment and management of its functions" (Kapidani, 2015: 29) while conditional transfers are addressed to finance specific projects in sectors such as social protection, roads and education, among others. The Albanian municipal system is financed from multiple taxes and fees that have been created over a long list of legislation including "the new LSGL, the Local Tax System Law (LTSL), Tax Procedures Law (TPL); the Law on National Taxes (NTL), the Law on the Management of the Budgetary System (LMBS), Local Borrowing Law, Annual Budget Laws and related Ordinance" (USAID, 2016: 3). Among others, local governments receive funding on movable and immovable property, on economic activities of small businesses category, on hotel services, on inheritances, testaments and lotteries, used vehicles and mineral rents. The country also collects funds from specific taxes such as the sin and the carbon taxes. Trying to rely on local taxes to significantly increase social protection financing does not seem to be feasible. If, for instance, all taxes included in the "Local Taxes" category increase by 20 per cent, the additional fiscal space may go up by 0.21 per cent of GDP. Similarly, a 25 per cent increase in the Property Tax rates may yield an additional 0.1 per cent of GDP with potential negative effects on construction projects.

As shown in Figure 18, four trends characterize the municipal financing structure in the past years with particular emphasis on social protection. First, the overall trend is that total municipal financing still experiences an erratic flow with the exception of local taxes. Between 2013 and 2019, total revenues (including taxes, grants, non-tax and foreign) averaged 3.4 per cent (minimum 1.3 per cent and maximum 5.3 per cent). Each component behaved in a very different way. For instance, taxes (local and shared) experienced a persistent increment and gained 0.74 points of GDP in that period. Government grants (conditional and unconditional) represented 1.24 per cent of GDP but experienced an up-and-down pattern that combined years of high level of transfers (2.6 per cent in 2015) with others of low or null transfers (2018 showed no movements). In the case of foreign funds, they account for 0.97 per cent of GDP with two clearly distinct periods, one from 2013 to 2016 (1.7 per cent of GDP) and the other from 2017 to 2019 (0.02 per cent). Non-tax revenues appeared only once, in 2019, with a low figure of 0.2 per cent of GDP.

**▶ Figure 18. Municipal revenues by source of funding, 2013–2019**




***Source:*** Ministry of Finance

In line with the former trend, the second issue shows a changing financing structure. During the whole period, taxes accounted for 41.1 per cent of the total municipal revenues followed by grants (29.9 per cent) and local foreign financing (28.3 per cent). However, in the last three years (2017–2019), taxes jumped to 60.5 per cent and grants to 37.4 per cent. External funding was reduced to a minimal share.

The third trend explores the internal composition of taxes and grants. Local taxes represented 94.7 per cent of total municipal tax revenues with a minimum share of 82.8 per cent in 2015 and 2016. In relation to transfers/grants from Central Government, the available data show no movements in 2018. For those years where transfers occurred, grants weighted 2.2 per cent of GDP with Central Government grants for local governments representing 77.2 per cent and specific grants the other 22.8 per cent. The unconditional fund/grant appears in three years since 2015, achieving in 2019 the targeted 1 per cent of GDP while the Infrastructure Funds are transferred in two years averaging 0.8 per cent of GDP per year.

The fourth characteristic refers to the internal composition of transfers by sector, in particular the importance of those ones for social purposes. As shown in Table 6, important movements are observed between 2016 and 2019 in terms of transfer composition. Three issues deserve attention. The first one is the relative decline in the unconditional transfer used for municipal management purposes. The second aspect indicates that all sectors that received transfers (with the exception of irrigation) increased their share in the overall structure, being particularly significant the increment in preschool education and in the education sector as a whole. Finally, social protection ranks at the bottom of the list with a relative share of 0.4 per cent of all the transfers received by the whole municipal sector. Although social protection doubled its share between 2016 and 2019, only 6 out of 61 municipalities received transfers for those purposes, Pukë not being one of them. In those places with social protection transfers, they account for 2.6 per cent of the total funds received.

**▶ Table 6. Structure of government transfers to municipalities, 2016 and 2019**

| Type of transfer | 2016 | 2019 |
|---|---|---|
| Unconditional transfer | 72.7% | 63.6% |
| Dorms for Preuniversity education | 1.6% | 2.1% |
| Preschool education | 12.6% | 20.4% |
| Preuniversity education | 1.1% | 1.9% |
| Protection from fire | 2.0% | 4.7% |
| Social Protection | 0.2% | 0.4% |
| Forest Administration | 0.3% | 1.3% |
| Roads | 1.6% | 2.1% |
| Irrigation and Drainage | 7.8% | 3.5% |
| **Total** | **100.0%** | **100.0%** |

***Source:*** Ministry of Finance and Economy, Government of Albania.

The brief analysis presented above is clear in showing that, despite the political priority to promote decentralization, the evidence points to the need to reinforce introduction of reforms in several dimensions relating to social protection functions. On one hand, as the literature shows, there is a lack of well-defined strategies as to which social services should be provided at the municipal level. Second, there is a poor allocation of resources for social protection. If the first issue is not resolved (this is what services to render), then the second one (this is how much resources required) may not be clarified in terms of level of resources required and potential sources of funding.

The existing literature recording different country experiences recommends multiple options to finance social protection at the local level. Revenues can come in the form of general taxation, earmarked taxes and special financing instruments. For instance, financial transaction taxes became very popular around the world in the past decades. This tax is defined as “a small tax levied on various types of financial instruments, such as shares, bonds, foreign currency transactions, derivatives and bank debits and credits”

(ILO (2016: 1)) with rates that usually vary between 0 and 2 per cent of the value of the transaction. Brazil is an example of a country that collected about US$ 20 billion per year and distributed them to health-care, social insurance, the Bolsa Família cash transfer and other social services (ILO, idem). Costa Rica has a gas tax (US$ 0.46 per litre of gasoline) that is partially distributed (21 per cent) to municipalities for road building. This tax is collected at the central level and distributed to municipalities using a special mechanism.

There are also several innovative financing instruments that have been used around the world. This report already described debt swaps as part of debt restructuring strategies. Ortiz et al. (2019) record the case of municipal bonds issued for specific social protection purposes. There are other innovative tools that can be used to raise funds for social purposes. It includes for example Social Bonds, defined as "bonds that raise funds for new and existing projects that address or mitigate a specific social issue and/or seek to achieve positive social outcomes" (International Capital Market Association, 2020: 3). In a general perspective, municipalities may explore new Impact Investment strategies, that is, funding opportunities in which private investors allocate funds in projects that generate a positive social or environmental impact. In return, they receive a profit that is usually below the market rate, conditional to the effective achievement of outcomes for the population. Although the investment can be regarded as a traditional loan, the Global Impact Investing Network (2019) defined the overall conditions of a project for being an "impact investment project" in the following terms:

- Intentionality to positively contribute to social or environmental objectives.
- Contrary to philanthropy, impact investments generate positive returns to investors that may be below market returns.
- There is a commitment of the investor to measure and report the social/environmental impact.
- Impact investments can be made across all asset categories.

# 4. Summary and conclusions

This report aims at providing a fiscal space analysis in Albania using historical data before the COVID-19 pandemic. The analysis and findings of the report are useful in understanding the resource availability during normal times to finance social protection system in the country. Moreover, it provides a guidance to the government, social and development partners, and other stakeholders on national and local capacity to mobilize resources to finance a non-discriminatory, gender sensitive, and economically sustainable social protection system. Table 7 summarizes possible options to create fiscal space at the country level.

### ▶ Table 7. Financing options and resource generation

| Macro-category | Scenario | % of GDP |
|---|---|---|
| Expanding social security coverage and contributory revenues | Universal coverage of workers | 5.8 |
| Increasing tax revenue | VAT, additional 1 %-point | 0.44 |
| | Profit Tax | 0.20 |
| | Excise Tax | 0.28 |
| | Personal Income Tax | 0.16 |
| | National Taxes and others | 0.28 |
| | Customs Duties | 0.06 |
| | 16% reduction in tax evasion | 1.10 |
| | 20% reduction in tax expenditures | 1.10 |
| Eliminating illicit financial flows | 20% reduction of illicit flows | 0.23–0.58 |
| Public expenditure reprioritization | 10% re-prioritization of general public services and order safety recent gains in the budget structure | 0.05 |
| Use of fiscal and foreign exchange reserves | 20% of the reserves in excess under the most restricted scenario | 0.4 |
| Debt restructuring | 1-point decline in the average cost of the Albanian debt | 0.56 |
| | 5% reduction in the debt service | 0.39 |
| | 10% decline in the interest payments | 0.22 |
| | 5% reduction in the public and publicly guaranteed (PPG) loans with IDA and IBRD | 0.43 |
| | 5% reduction in the multilateral debt | 0.36 |
| Adopting a more accommodative macroeconomic policy | Set fiscal deficit at 2% of GDP | 0.40 |

***Source:*** ILO staff estimates using data from the IMF, World Bank, and national authorities.

The list of financing alternatives can be grouped around 3 categories: direct revenue-generating options; improved efficiency and expenditure management; and options derived from non-traditional policy preferences. The first group comprises social contributions and taxation. As expected, taxation and social contributions are the main sources of financing. Depending on the targeted level of coverage of independent workers, social contributions may add significant levels of resources. Although social security contributions are identified as a significant source to finance social protection, their earmarked conditions limit the possibility of using them in non-contributory programmes. Taxes (not earmarked), on the other hand, can be utilized to finance extension of social protection coverage without such limitation.

The second group includes the elimination/reduction of illicit financing flows, expenditure reprioritization and debt-restructuring strategies. The recent budget performance and general allocation of public resources reduce considerably the possibility of creating significant fiscal space from spending re-allocation while illicit financial flows appear as an emergent possibility of substantial funds.

Finally, the third group requires the adoption of a more accommodative macroeconomic policy with due consideration to macroeconomic stability. The report recommends a review of existing macro perspectives that focus excessively on inflation targeting and debt control so that the country can take advantage of different targets that, without jeopardizing macroeconomic stability, can increase resources for social protection. For example, by increasing fiscal deficits to 2 per cent of GDP, the country can generate resources to cover extension of social protection to a significant number of people. Initial analysis of the use of fiscal and foreign exchange reserves provides a similar conclusion, although in this case some considerations regarding the structure of the reserves, the fulfilment of international commitments and other technical aspects should be taken into account. The high level of reserves "in excess" unlocks the potential of using it as collaterals to access development-based loans to finance social protection.

There are technical, institutional and political factors affecting the implementation of any of the above mentioned measures. For instance, the recently approved fiscal reform (2019–2020) emerges as an important barrier for the increment of existing taxes or the creation of new ones in the short and medium terms. Within this issue, reduction of tax evasion and the elimination of some tax expenditure components may be the short-term alternatives in the search of fiscal space from taxation-related measures. Two constraints, however, may appear in the horizon. The first one is that evasion control strategies may yield positive and substantial revenues only after several years of continuous efforts, perhaps one decade. The second one is that the elimination of fiscal exemptions may finally affect poorer groups as the key component of tax expenditures is the basic basket of consumption. In other cases, exemptions are legally tied as part of the package of incentives to attract Foreign Direct Investment, as in the case of Export Processing Zones. As with tax evasion, the fight against illicit financial flows requires strong legislation in terms of customs and tax administration as well as solid institutional capacities to detect such practices, including modern IT systems. Although estimations usually refer to the existence of a large amount of resources that actually exist, the challenge focuses on the identification of the exact place where the transactions take place. All this requires time.

Public expenditure reprioritization is a quite complex process in both technical and political terms as it implies moving resources from one programme/ministry/sector to another (for example social protection programmes) while keeping the total budget unaltered. Reprioritization also refers to structural changes applied to strategic sectors with important share in the total budget. Transforming these sectors with efficiency-oriented measures is one alternative to liberate resources and it is estimated that in the long-run they may save an amount between 20 per cent and 30 per cent of the existing budget.

It is also important to note that social protection is the most benefitted sector in terms of public budget allocations in Albania in recent years. In other words, there has been a strong political commitment in favour of financing social protection programmes, placing the sector at the top of the list of priorities. Trying to transfer resources from other less favoured sectors such as general public services and public and order safety (that increased their share but in a smaller proportion in relation to social protection) may affect their performance, and therefore may raise some political opposition due to the negative impact on programmes aimed at providing public safety.

Debt restructuring or any other process of debt/debt service reduction is highly desirable as they free resources that can be allocated to social protection purposes. Consequently, any effort in this connection will be politically backed up by different circles. However, there are technical aspects that may affect the decision. First, the term “debt restructuring” usually provides a negative signal to the financial markets as it is associated with the effort of last instance to avoid a debt crisis in the country. This may not be the case of Albania as the fiscal deficit is under control and the level of debt-to-GDP ratio is far from critical points. Interest payments are also low. There are other alternatives, however, that depend on the term structure of the debt so the government can negotiate lower interests in exchange for longer periods of bond maturity (especially if bondholders are public institutions). Furthermore, the portfolio of alternatives considers direct negotiation with international creditors in the form of swaps or impact investment models.

It is important to highlight the fact that the traditional approaches are also embodied in the legislations that regulate the works of institutions such as the Central Bank. In this regard, the possibility of utilizing reserves as collateral of public programmes may be regarded as a direct financing to the Government, which may be restricted in most of the legislations. In addition, it may face a strong political opposition from certain quarters of the economy. In spite of this, fiscal policy usually enjoys a higher level of political discretion, setting higher fiscal deficit levels (financed with debt) can be easier for the overall purposes of fiscal space for social protection.

In sum, Albania may require a combination of strategies if it wants to achieve universal social protection coverage progressively over a period of time. We conclude this report by emphasizing the issues of great importance to generate resources to finance social protection:

1. Recognizing the importance of extending social protection to the workers in the informal economy through social security contributions, paying attention to the issues of gender biases.
2. Balance between directing the sources that generate direct revenues (taxes) and others that reflect the capacity of the government to work with efficiency (budget reprioritization, evasion reduction, control of illicit flows, etc.).
3. Consider that strategies may require a long period to consolidate and produce the desired results. In financing, this may imply planning a phased implementation of such measures such as taxes and social security contributions. If the Government aims at approving all sources simultaneously, most probably the strategy will fail as incomes for the Ministry of Finance will compete against revenues for the Social Insurance Institute. They should be regarded as complements.
4. Keep the strategy following a parsimonious principle: the lowest the number of elements, the better the strategy is so to avoid opening many fronts at the same time with the consequent political opposition.
5. Social dialogue so as to be clear with the citizens and all stakeholders about the destination and expected results of the new funding.
6. Think outside the box: there is no magic and single number in the management of public finances as every country and its context are different. References to public debt ratios are approximations, not extreme truths.

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This report, carried out by the ILO in collaboration with UNICEF and UNWOMEN in the framework of the Joint UN Programme “Catalysing Municipal Social Protection”, presents the analysis of creating fiscal space for financing social protection in Albania, which is non-discriminatory, gender-sensitive, and economically sustainable.

Based on good country practices around the world, the report identifies possible options to create fiscal space as well as the corresponding resource availability in Albania. The report recommends that these different alternatives should be discussed in a national dialogue. Moreover, the country needs to address issues such as tax evasion and the informal economy to raise more government revenues and to further expand and strengthen its contributory schemes.

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