

# FDI and its Impact on the Economic Growth: Evidences from Albania

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## 要 旨

本論文は、アルバニアにおける外国直接投資（以下「FDI」）についての研究である。アルバニアの FDI に関する法的規制の調査・研究に重点を置いている。FDI は国内投資総額の拡大に大きく貢献し経済成長にも著しく影響を及ぼすため、アルバニアの政策立案者は当然ながら FDI の増大を望んでいる。しかしながら、アルバニアへの FDI は低迷している。そこで、アルバニアへの FDI に対して存在する障害を多面的に分析し、アルバニアが抱える法律上・政策上の問題を明らかにし、その解決方法を提案するものである。

**Keywords:** foreign direct investment, Albania

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## Introduction

Foreign Direct Investment (FDI) is an imported component of private sector development and a prerequisite for the economic development of Albania. The importance of private sector development and the benefits of a good investment climate are widely recognized.

The Government of Albania seeks to attract foreign investment and understands that such investment will be indispensable to sustained growth. Since the beginning of transition and the opening up process of the country, attracting FDI in Albania has been considered as critical importance to achieve the main growth, development and transition goals<sup>1</sup>. Although the government is taking various measures to attract the FDI,

the level of foreign investment remains the lowest in the region. GoA leadership appears to recognize this problem but implementation of laws and development of infrastructure designed to spur investment is in many cases moving more slowly than could be hoped<sup>2</sup>.

Albania faces a number of major problems such as economic and political instability, transition process and underdevelopment. Furthermore, to varying degrees, Albania lacks market institutions and related regulatory framework, and has many difficulties in implementing existing laws and regulations. These factors have served to reduce Albanian attractiveness as investment location.

However, the foreign investment climate has kept improving in following two directions:

- 1) There is increased security of investors as a result of strengthening the security and public order measures;
- 2) Investments in infrastructure projects, especially roads.

From a dynamic, future point of view, there are a number of perspectives that should be considered as attractive factors for FDI in Albania. Resource-seeking, efficiency-seeking as well as market-seeking investors can all find good reason to invest in Albania.

Albania offers to foreign investors:

- a) geographical proximity to major regional and European markets;
- b) access to Adriatic and Mediterranean seas;
- c) rich natural and tourist attractions, with an ideal climate and a coastline which stretches for over 450 km;
- d) rich mineral resources endowment;
- e) strong work-culture, with a high percentage of young population;
- f) investment permissive legal environment;
- g) low-cost and relatively skilled labor.

In investing in Albania, foreign investors take into consideration all the strengths and opportunities the country gives to them. Being asked about their motivation for investing in Albania, almost all of them interviewed answered that they tried to have a dynamic evaluation of the country's advantages and disadvantages<sup>3</sup>. They think that the advantages are becoming stronger. Also they believe that the process of

stabilization and association with Europe and implementation of free trade agreements will improve the situation considerably. But why the FDI inflow in Albania has been low. In spite of positive trends in FDI inflows in the last years, the as yet low level of FDI inflows and stock in the country points that serious barriers to investment exist<sup>4</sup>. Although, barriers like small size of the domestic market and backwardness inherited from the past or poor initial conditions of reforms cannot be considered as the main sources of problems for foreign investors. The main barriers to FDI in Albania relate to insufficient progress made in the transition process and structural reforms as well as to the overall political and security developments in the country. While some considerable improvements have been made in recent years, there are many barriers for doing business in Albania.

So, this paper will analyze the FDI inflow in Albania as well as its legal framework and investment climate. Also, it will treat the main problems, which are barriers toward the FDI and will try to give some solutions.

## **Chapter I. FDI Inflow in Albania**

### **1. Foreign Direct Investment Statistics**

FDI inflows in Albania have been relatively low. At the end of 2002, FDI stock was US\$ 945 million. Annual FDI inflows in 1997, 1998 and 1999 were US\$ 47.5 million, US\$ 45 million and US\$ 41.2 million, respectively. This is a considerable smaller compared to 1996, when the inflows were close to double this amount. The decline of FDI inflows since 1997 was due to the series of crises which affected the country; the first being the 1997 civil disturbances that followed the collapse of the pyramid financial schemes<sup>5</sup>; followed by the coup attempt in September 1998 and the Kosovo crisis in 1999. The Bank of Albania reported the following figures for foreign direct investment in Albania, in millions of U.S. dollars: 2000 (143); 2001 (207); 2002 (213), 2003 (156).

**Table 1** Annual FDI Inflows in Million of US Dollars and in Percent of GDP. 1993-2003

Years	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Net inflows	58	53	70	90	48	45	41	143	207	213	156
As percent of GDP	4.7	2.7	2.9	3.4	2.1	1.5	1.1	3.8	5.0	4.5	2.5

Source: World Bank, World Bank Development Indicators and IMF

For 2004 (341) and for the first nine months of 2005, FDI inflow amounted to USD 180 million or USD 100 million less compared to the same period of 2004. Sixty percent of FDI has come via the privatization process. The main sectors of the foreign investment in Albania are telecommunications, industry and agro processing. The amount of FDI per capita is among the lowest in the region. There are no reliable estimates of Albanian investment abroad, but it is believed to be significantly less than foreign investment here.

Albania has not fared poorly in attracting FDI if one considers its level of economic development, the absence of attractive assets and two episodes of social unrest in 1997 and 1999, which contributed to the perception of the country among international investors as an unstable place in a highly volatile region<sup>6</sup>. The total value of FDI for the period 1990-2000 of US\$ 352 per capita is higher than in BiH or FRY but significantly lower than in Bulgaria (US\$ 652), Croatia (US\$ 2057) or in Romania (US\$ 441)<sup>7</sup>. With the total inflows between 1993-2002 amounting to 26 percent of the 2001 GNI, Albania's performance was similar to that of Romania and above BiH and Serbia and Montenegro (Table 1).

**Table 2** FDI inflows. Total and Total per capita over 1990-2003, Average Annual per Capita in 1993-1996, 1997-2000 and Annual per Capita in 2000-2003 (in US dollars)

Countries	Average FDI inflow, per capita		FDI inflows per capita				Total FDI 1990-03 per capita	Total 1990-03 (in mln. US\$)	Total 1993-02 in % of 2001 GNP
	1993-96	1997-00	2000	2001	2002	2003			
Albania	22	22	46	58	46	65	352	1,091	26.0
BiH	0	19	38	33	33	50	193	770	15.4
Macedonia	5	45	95	222	41	225	687	1,373	39.2
S and M	0	22	5	18	47	66	217	2,302	23.3
Bulgaria	12	85	119	108	77	65	652	5,477	41.5
Croatia	49	23.5	279	436	260	225	2,057	8,227	41.3
Romania	12	59	46	50	53	48	441	10,017	26.0

Note: S and M means Serbia and Montenegro

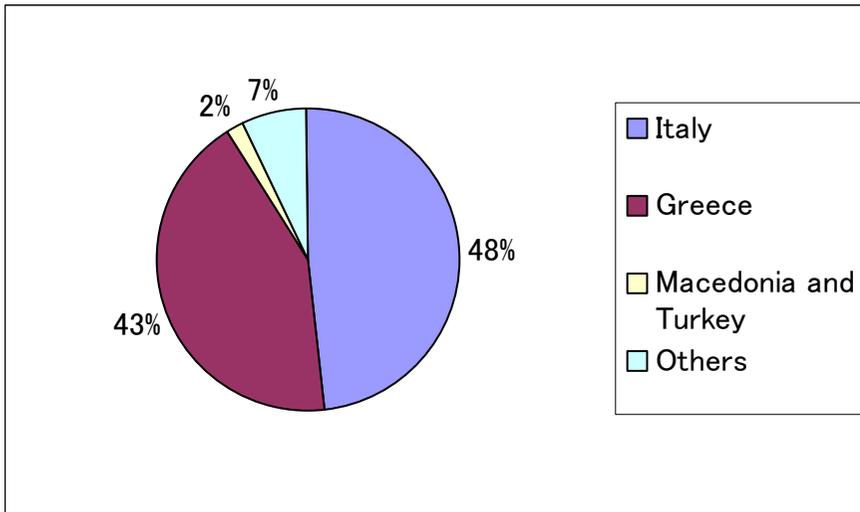
Source: UN ECE Annual Survey, various issues, United Nations, IMF balance of Payments statistics and WIIW 2004.

In Albania same as other SEE countries, FDI has been privatization driven, green field investment in manufacturing are rare. However, it should be noted that the sociopolitical disruptions followed by the collapse of pyramid scheme in 1997 had a major impact on Albania's FDI performance. Albania has recently gained more stability but the transformation to a market economy is still incomplete and foreign investors rarely take the risk to come. Investments come in through privatization or green field only to serve the local market. Export oriented investors are rarely interested.

The price paid in terms of lost FDI inflows was significant, demonstrating vulnerability of FDI inflows to political stability<sup>8</sup>. FDI fell almost 50 percent, from US\$ 90 million in 1996 to US\$ 48 million in 1997. It fell further to US\$ 45 million in 1998 and US\$ 41 million in 1999. Taking the 1996 level as a benchmark and assuming that the FDI would be in 1998-1999 at the 1996 level, the total loss was US\$ 136 million over three years, or almost 14 percent of total inflows for the 1993-2002 period.

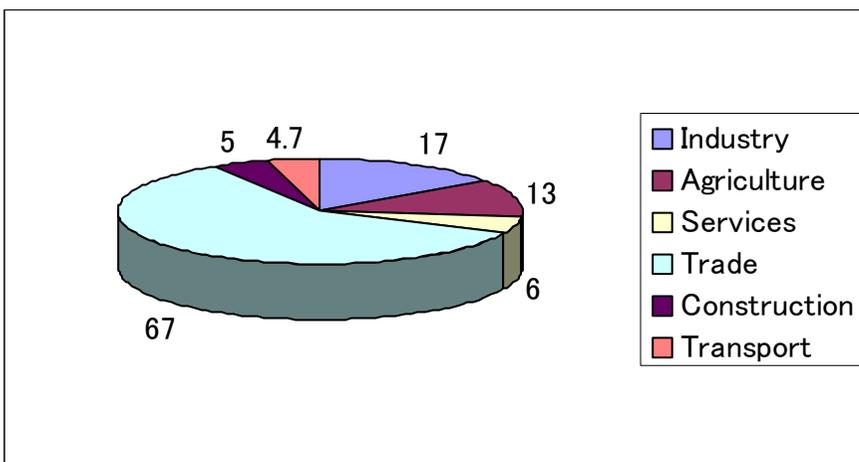
Still, the general investment environment is considered risky thus foreign investment cannot be a major vehicle of an economic take-of.

**Figure 1** FDI by country of origin



The total amount of FDI for the period 1995-2005 amounts to USD 1.48 billion<sup>9</sup>. In contrast to the other countries in Central and Eastern Europe, FDI in Albania comes mainly from neighboring countries such as Italy and Greece. Data indicates that the sources of FDI are as follows: 48 percent from Italy; 43 percent from Greece; 2.2 percent from Macedonia and Turkey, and less than 7 percent from other countries in Europe and from the United States<sup>10</sup>.

**Figure 2** FDI by Sector, 2001 (percent of total)



Italian investments are concentrated in the west of the country, close to the Adriatic Sea. Most Italian investments are small and medium enterprises, mainly involved in construction (35 percent), textile and footwear manufacturing (21 percent), trade and services (16 percent) and the agro-food industry (8 percent).

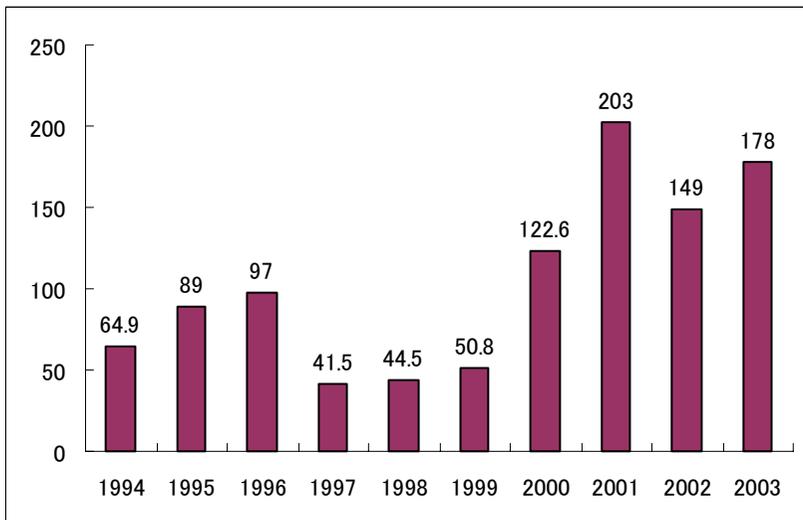
Greek investments are mainly concentrated in the south and southeast of the country close to the border with Greece. Greek investors are involved in trade, with less than 2 percent in the other industries such as textiles, garments, the manufacturing of leather products and tobacco.

FDI is concentrated in two largest cities of Albania, Tirana and Durres. These two cities alone attract approximately 67 percent of the companies with foreign participation. Tirana is the capital of Albania and Durres is the biggest port in the country. While such concentration is justified on economic grounds, it reinforces internal migration from the poorest rural regions to the large cities.

FDI inflows reached US\$ 123 million in 2000, three times higher than 1999 level. In 2001, the inflows reached US\$ 206 million (Figure). This because the result of privatization process of AMC (Albanian Mobile Communication), Vodafone (Mobile Communication Company) and the concession taken by the Italian firm DARFO in Albkrom (Chrome-ore Albanian Industry)<sup>11</sup>.

As the privatization of Telecom, the Savings Bank and INSIG<sup>12</sup> were delayed, the 2002 FDI flow decreased to US\$ 149 million. According to the Bank of Albania, the upward trend resumed in 2003 with FDI reaching US\$ 178 million ore 16.3 percent above the 2002 level. A major event was the finalization of the privatization of the Savings Bank, sold to well-known Austrian bank (Raiffaisen Bank) for US\$ 126 million<sup>13</sup>.

**Figure 3** FDI in Albania, in millions of US\$ (1994-2003)Source: Bank of Albania



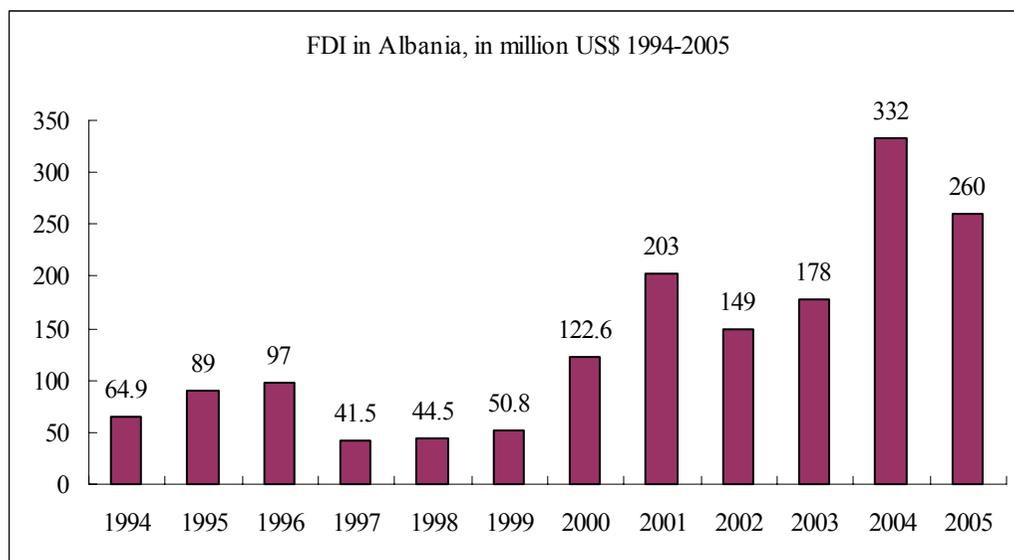
**Table 4** Annual FDI Inflows in Million of US Dollars 2004-05

Years	2004	2005
Net inflow	332	260

Source: Bank Of Albania

The Table 4 shows that the FDI inflow for the 2004- and 2005 year increased considerably compared with the previous years as the result of structural reforms and the improvement of the political stability. However, lack of a proactive investment promotion approach results into a weaker image of Albania, limited contact with potential investors and limited linkages between FDI and domestic enterprises. More emphasis should be put on targeted sector specific marketing campaigns and providing on-the-ground services to potential existing investors<sup>14</sup>. Also, the persistence of high level of corruption discourage investment, competition as well as economic and social development.

**Figure 4** FDI in Albania, in millions of US\$ (1994-2005)



Source: Bank of Albania

The Investors Targeting Strategy for Albania pointed out some of the directions to be focused on in order to

increase FDI levels in the country. These points may consist in:

- 1) Privatization of large enterprises
- 2) Implementation of law
- 3) Efficient infrastructure for export oriented FDI and tourism
- 4) Tax administration, especially related to income-tax, value-added-tax (VAT) and customs
- 5) Development of financial sector
- 6) Legal and administrative framework to record and protect property rights<sup>15</sup>.

More effort needs to be put into enforcing laws and implementing and monitoring strategies and action plans. Sensitive areas such as customs and public procurement should receive particular attention<sup>16</sup>.

## **Chapter II. Legal Framework of FDI**

Officially, a legal framework to encourage investment already exists. Law No. 7764, dated November 2, 1993, and titled “On Foreign Investment”, was designed to create a favorable investment climate for foreign investors in the country. The Law offers considerable guaranties to all foreigners (either physical or legal persons) willing to invest in business in Albania. Such provisions include:

- No prior government authorization is needed and no sector is closed to foreign investment.
- There is no limitation on the percentage share of foreign participation in companies 100 percent foreign ownership is possible.
- Foreign investment may not be expropriated or nationalized directly or indirectly, except for special cases, in the interest of public use, defined by law.
- Foreign investors have the right to expatriate all funds and contribution in kind of investments.
- Most favorable treatment according to international agreements is also provided.

There are limited exceptions to this liberal investment regime, most of which apply to broadcasting, health services and legal services. Restrictions on the purchase of real estate are also notable: agricultural land cannot be purchased by foreigners, but may be rented for up to 99 years; commercial property may be purchased, but only if the proposed investment is worth three times the price of the land. There are no restrictions on the purchase of private residential property<sup>17</sup>.

Other legislation addresses investments made through acquisition-mergers, takeovers and green-field

investment. Law 7638, dated November 19, 1992, "On Commercial Companies" regulates the activities of companies and establishes the type of legal structure under which companies may form. No distinction is made between foreign and domestic investors in this law. Albania's tax system also does not discriminate against foreign investors. Likewise, legislation concerning the public procurement process makes little distinction between foreign and domestic firms. Many activities in Albania require licensing. Before engaging in an economic activity a company should inquire if a license is required for the exercise of such activity. The procedures for getting a license are, however, the same for national and foreign companies.

Investors in Albania are entitled to judicial protection of the rights related to their investments. Parties to a dispute may agree to submit claims for consideration by an arbitration institution. Foreign investors have the right also to submit disputes to an Albanian court. Provisions on domestic and international commercial arbitration are incorporated in the Code of Civil Procedure. As a practical matter, however, corruption remains a problem in the judicial system, and some foreign investors have experienced delays and losses as a result<sup>18</sup>.

Albania offers considerable natural resources, including oil, gas, and coal, iron, copper, chrome, water and hydroelectric potential. An on-going privatization process presents opportunities in strategic sectors, mining, energy generation, oil and gas, telecommunications, finance. This process has attracted foreign investors, mainly from Greece, Italy and Turkey. The privatization strategy for sectors of primary importance explicitly seeks to attract qualified foreign firms as strategic investors for these key sectors. The bidding process appears to be more transparent for high value assets than for lower value assets.

### **Conversion and Transfer policies**

The Albanian currency, lek, is freely convertible at banks and exchange bureaus and foreign exchange is easily found at a legal market clearing rate. Most transactions are carried out in cash and the dollar and euro are legally and commonly used. The lek floats freely and has appreciated over the last 24 months by 20 percent against the dollar and remained stable against the euro. The average exchange rate for 2005 was \$1=102 lek while currently the exchange rate is 103 lek per dollar<sup>19</sup>.

To combat the flow of illegal assets, new anti-money laundering legislation was passed in July 2003 that requires reporting of all transactions over USD 20,000. Transfers abroad of funds and other financial assets are unrestricted as long as tax obligations, debts, and reporting requirements have been met. In the past, this legal freedom was not always respected, but in recent times it appears to be respected.

Since 2004, in an attempt to reduce cash transactions, the maximum limit accepted for transactions executed in cash was reduced from Lek 1 million to Lek 500,000 for transactions effected during 2004, and to Lek 300,000 for any subsequent year. For cash transactions over these limits, buyer and the seller are subject to a penalty of five percent of the transaction value<sup>20</sup>.

### **Expropriation and Compensation**

In the post-communist period, expropriation has been limited to land needed for infrastructure projects, such as roads and airports. Compensation has generally been below market value and some owners have complained at the low real amount of payments. Several U.S. citizens and residents have on-going disputes with the government regarding restitution for property expropriated during the communist regime.

The property registration process has been completed in approximately 85 percent of the total land area, almost entirely in the rural areas but very little in high value urban and coastal areas. Many of the unregistered properties are in the south coastal area, which is more valuable for its tourism potential, and where disputes are more frequent<sup>21</sup>.

The Albanian Parliament approved in July 2004 a new law on property compensation and restitution that is expected to resolve competing land ownership claims resulting from communist-era expropriation of land.

The GoA has presented three methods of compensation for expropriation claims:

- 1) restitution,
- 2) compensation of property with similar valued land in a different location,
- 3) cash settlement.

The law remains in the implementation stage and all compensation claims are not expected to be resolved until 2014. The legal entity charged with deciding claims, the National Committee for the Compensation and Restitution of Properties commenced its operation in the summer of 2005 when the GoA established a fund of USD 2 million for compensation. In December 2005, because the claims were far larger than the fund, a lottery was organized and 32 owners were compensated. The 2006 fund has been increased to USD 3 million, which is still very small in comparison to the large number of compensation requests<sup>22</sup>.

## **Dispute Settlement**

Albania has a civil law system similar to that of most other European countries. Legislation distinguishes arbitration of international disputes from arbitration of domestic disputes in that the parties involved in an international dispute may agree to settle through either a domestic or foreign arbitration tribunal. In Albania, ratified international agreements have legal superiority over domestic legislation. Albania is a member of the International Court for Settlement of Investment Disputes (ICSID) and it is in the process of acceding to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards and the European Convention on International Commercial Arbitration. Under government regulations, international arbitration is recognized and accepted as valid<sup>23</sup>. The government accepts binding International Arbitration on Investment Disputes and has over 40 internationally accredited arbiters on the country arbitration list. The arbitrators will use the appropriate law based on issues determined by the parties. If the parties cannot agree on the issues involved in the case, the arbitrators will make the appropriate assessment. That said, the judicial system continues to suffer from corruption and unreliability. The GoA has taken steps to address this issue, establishing High Council of Justice to investigate claims of judicial misconduct, but the process remains in its early stages. Although the situation is improving, investors cannot yet fully rely on the enforceability of contracts. Foreign firms and institutions have also been subject to nuisance lawsuits aimed at receiving cash settlements. Recent investment disputes appear focused on the ownership of lands considered ideal for tourism, mostly along the southern coast<sup>24</sup>.

The Albanian government, with World Bank financing, has established the Albanian Guarantee Agency (AGA), which provides political risk insurance for foreign and local investors in Albania. AGA administers the Political Risk Guarantee Facility (PRGF) and, with the exception of the production of tobacco products, alcohol and armaments, investors can apply for political risk coverage. Specific categories of risk covered by PRGF are:

- Inability to convert and transfer currency
- Expropriation
- Seizure of goods, prevention of sales or prevention of exports/imports
- War or civil disturbances
- Cancellation of licenses and restrictions on import and export
- Imposition or increases of import or export taxes as consequence of war and civil unrest

- Interference in the transport of goods
- Diversion of voyage

New provisions to Law no. 8560, dated December 22, 1999, titled “On Tax Procedures” introduced the establishment of a new body within the General Tax Directorate, the Tax Discipline Commission<sup>25</sup>. The Commission is vested with the authority to review the claims of tax violations. The Tax Discipline Commission quantifies the violation and proposes to the General Tax Director the relevant penalty. Activities of this Commission will be subject to forthcoming instructions from the Ministry of Finance.

Bankruptcy is governed by Law no. 8901, dated May 23, 2002, titled “On Bankruptcy”. According to the law, a creditor has the right to request the opening of an insolvency proceeding in order to be resolving debts. If the Court repeals this request, the creditor has the right to appeal<sup>26</sup>.

The Bankruptcy law distinguishes the right of creditors as follows:

- a) Insolvency Creditors have an unsecured claim that is provable against the debtor at the date the proceedings are opened;
- b) Subordinated Insolvency Creditors are creditors whose claims are satisfied once after the claims of regular insolvency creditors' claims are satisfied;
- c) Estate Creditors are creditors who have given credit to the insolvency administrator. They are paid out of the estate in priority to insolvency creditors. They need not file claims in order to obtain payment;
- d) Creditors with a right of set-off can obtain satisfaction to the extent of the set-off; and
- e) Creditors with a right of separate satisfaction are secured creditors, who have a legal right to rely on specific items or kinds of property (collateral) of the debtor to obtain payment of part or all of an obligation owing to them by the debtor. The Law on bankruptcy does not contain any provision regarding bank transfers<sup>27</sup>.

### **Investment Incentives**

Albanian law generally does not establish performance requirements or very detailed incentives for foreign investors. Legal incentives include:

- Equal treatment of foreign and domestic investors.
- Full profit and dividend repatriation (after taxation).

- Funds from the liquidation of a company may be repatriated.
- Bilateral agreements on the promotion and protection of reciprocal investments.
- Double taxation treaties.

One important exception concerning performance requirements is the investment requirement relating to foreign persons' purchase of commercial property, such a purchase can be made only if the investor plans to improve the value of the property by three times the purchase price<sup>28</sup>. Some foreign firms operating in Albania have also complained that capital goods and raw materials, on occasion, have been subjected to the same taxes as consumer goods. The GoA has said that it is not official policy to subject capital investments to consumer taxes. To the extent there have been problems concerning this issue, they appear to result largely from corruption or misunderstandings on the local level.

There is an incentive program for investment in the tourism sector. The investor can, pursuant to a law entitled, "For development of the areas with tourist priorities", obtain the title of "stimulated person" and would be entitled to profit from a tax exemption for the first five years of activity and for the following five years would pay only 50 percent of the profit tax. Such persons would also be excluded from custom taxes on imported goods used for capital investment. Another law, "On Free Zones" No. 8636 dated July 6, 2000, regulates the establishment of free trade zones and related matters. There are no requirements for foreign investors to purchase from local sources or to export a certain percentage of the output<sup>29</sup>. There are currently no approved free trade zones. The government does, however, appear willing to offer incentives on a case-by-case basis for concessions (either in the form of very long concession periods or in the form of temporary and localized monopolistic arrangements).

Any person or entity, which receives land as owner or tenant for purposes of construction or for other economic activities, is required to respect the term of the completion of the project according to the prior agreement. Failure to perform in the required time frame obligates the person to pay an amount equal to the average annual rent of the land.

### **Right to private ownership and establishment**

Albanian law permits private ownership and establishment of enterprises and property. Foreign persons intending to invest in Albania do not need any additional permission or authorization to do so over and above that required of domestic investors. Practically no progress can be reported on improving company registration procedures. In particular the business-licensing regime continues to be characterized by

disorganization involving a variety of authorities applying complicated and overlapping regulations. The absence of an administrative registration and licensing process, undertaken without court involvement and following transparent and simple procedures, inhibits enterprise creation. In 2005, one of the few improvements was the abolition of the requirement for annual registration with the Tax office. To start a business in Albania it takes 10 procedures and an average of 42 days while the associated costs are approx. USD 800. Businesses have complained that, in some instances, bureaucracy and corruption made obtaining a business license a lengthy and costly process. Government is currently exploring the establishment of a “one stop shop” for investors to reduce the cost and start up time for business as well as to create a check against potential corruption.

The following documents are required for registration of a company:

- Request to the district court
- Articles of incorporation
- Constitutive act signed in the presence of a public notary
- Documents reflecting capital disbursement

The articles the incorporation should contain:

- Name of the company
- Initial capital
- Seat (location) of the company
- Administrators or directors of the company
- Objective of the company
- Duration of its activity

Activities requiring a business license include:

- Tourism
- Construction
- Fuel trading
- Pharmaceutical and medical product trading

A significant portion of economic activity, estimated to be between 35 to 60 percent of total GDP, remains outside formal legal structures and fiscal evasion is still very high<sup>30</sup>. This seriously damages fair competition and also boosts the establishment of economic monopolies in different sectors.

## **Protection of Property Right**

Enforcement of property rights in Albania remains an evolving issue. Immovable property rights are still far from being well defined especially in the coastal areas where there is potential for tourism development. Currently, enforcement of property rights is left to the claimants in the civil court system. To address this issue, and relieve an increasingly burdened court system, the GoA, with USG (United State Government) and other donor assistance, is implementing an immovable properties registration system to establish proper title to private claims to land ownership. Recently the GoA ended the privatization process for small and medium size companies in order to comply with the restitution and compensation program. The Cadastral Office in each district handles land registration information requests but they are still considered highly corrupt and susceptible to bribery<sup>31</sup>.

Additionally, Albania is a signatory to the following international agreements on Intellectual Property Rights:

- Convention implementing World Intellectual Property Organization
- Paris Convention on Protection of Industrial Property
- Bern Convention on Literary and Artistic Works
- Patent Cooperation Treaty
- Madrid Agreement
- Madrid Protocol
- European Patent Convention
- Budapest Treaty on Biodiversity
- Nice Agreement concerning the International Classification of Goods and Services for the purposes of the Registration of Marks<sup>32</sup>.

Intellectual property rights are established under Albanian law. In 2000, Albania ratified the Marrakesh Agreement and became signatory to the World Trade Organization's Trade Related Intellectual Property Rights (TRIPS) agreement. Albanian law protects copyrights, patents, trademarks, stamps, mark of origin, and industrial designs. Enforcement of these laws remains incomplete and violations of copyright, trademark, and other intellectual property rights are common.

### **Transparency of Regulatory System**

The regulatory system is not yet fully transparent. Businesses have difficulty in obtaining copies of laws and regulations. Laws and regulations are sometimes inconsistent, leading to unreliability of interpretation. Proposed laws and regulations are often not published in draft form for public comment (although there has been recent improvement in this area). Some ministries have recently undertaken campaigns in order to consult with business, civil society and affected groups about issues in proposed laws and regulations<sup>33</sup>.

### **Efficient Capital Markets and Portfolio Investment**

The performance of the financial sector in channeling savings towards productive investment has recently been improving but still remains weak in comparison to western standards. Banks represent the main institutions of Albanian financial system. The total volume of their activity constitutes about 50 percent of GDP in the country. Currently, 17 banks are operating, 3 domestically owned banks and 14 foreign owned or joint ventures. The most recent bank, Union Bank, owned by Albanian shareholders, began operations in November of 2005. These banks offer their clients similar services, deposit accounts, foreign transfers, trade finance and, increasingly, mortgages. However, only half of them are active in lending. Market competition has overwhelmingly strengthened and the service quality provided to the public has significantly improved. The banking network has extended to most parts of Albania and developments in this respect are still robust. The American Bank of Albania was one of the first banks to introduce credit and debit card service (in 2004) and other banks are following. The number of ATMs is rapidly growing, now exceeding 120 with the majority in Tirana. Since 2005 the majority of state employees receive their salaries through electronic transfers and have been offered debit cards for all their transactions<sup>34</sup>.

The role of the banking system as an engine of the economy is manifested in the amount of loans issued to private and commercial interests. At the end of June 2005, loans constituted around 21 percent of the total assets in the banking system, compared to 14.5 percent at the end of 2004 and 12.5 percent at the end of 2003. Moreover, the volume of deposits in the banking system has increased, representing the main source of growth in the banking system activity. The banking system continues to represent a profitable investment sector.

Privately owned banks hold 98% of the banking system total assets and the government aims to have the sector fully privatized soon. Competition and consolidation are expected to increase given the acquisition of Savings Bank by Raiffeisen and the recent acquisition of the Italian Albanian Bank by an Italian Financial

Group, San Paolo Imi. In addition to banks, lending through microfinance institutions and Savings and Credit Associations is effective in serving those segments of the populations that do not have easy access to bank financing.

The low level of financial intermediation remains an impediment to the development of the private sector, particularly to small and medium enterprises (SME's). According to the banks and many SME's the following issues affect access to credit in Albania:

- A low level of domestic savings
- High interest rates
- Distrust of the banking system
- High operating costs of banks
- Poor business/project proposals

Credit lines can be obtained on the local market, but interest rates can be high under some circumstances, often from 10 to 18 percent. To obtain credit, applicants usually need to fulfill the following criteria, which varies from bank to bank:

- Satisfactory business plan
- Credit security (usually by mortgage)
- One's own contribution in the investment project (about 40 percent of the value)
- Export-oriented and profitable project
- The entity requesting credit needs to be at least 51 percent privatized.

The insurance industry has also experienced high rates of growth over the last seven years and, relative to neighboring countries, the market for insurance in Albania remains largely untapped. The sector is expanding, in the fall of 2004 five new insurance companies received licenses for general and life insurance, doubling the number of companies in this sector to ten. Insurance supervision and regulation are poorly performed by the Government and need to further strengthen.

Total assets for banks in October 2005 amounted to USD 3.12 billion<sup>35</sup>. Raiffeisen Bank still has the dominant position in the market with 57% of bank deposits and 70% of the treasury bills market. National Commercial Bank, American Bank of Albania, Tirana Bank, Alpha and Pro-credit are the other leading banks regarding assets and bank deposits.

Non-performing loans in June 2005 were 3.8 percent comparable to 4.6 percent of the total amount of loans in 2004 and 5.6 percent in 2002. The decrease is mainly explained by the upward trend of the loan portfolio

versus the downward trend of the non-performing loan portfolio.

The Tirana Stock Exchange remains in its infancy. No companies are publicly traded, but three have undertaken procedures to be listed. Domestic companies are financed primarily by cash flow. There are no bonds or securities to act as other credit instruments. Albania's Central Bank has recently introduced an electronic system for large and small payments, which may reduce administrative operations in banks. Cross-shareholding, stable shareholding and measures to prevent hostile takeovers are not well developed in Albania.

### **Political violence**

Albania achieved a peaceful rotation of power after parliamentary elections on July 3rd 2005. The new government, led by the Democratic Party, took office in September. The two month interim was marked by legal challenges to voting results but not by any political violence. Crime, specifically extortion, theft and robbery are of concern to the business community. Relations with neighboring countries are friendly.

### **Corruption**

Corruption remains an issue of concern in Albania. According to recent polls that gauge public perceptions, the institutions most affected are public administration, Customs, tax offices, political parties and the judiciary. To combat corruption, the GoA established the High Inspectorate for Financial Disclosure, which is charged with collecting declaration of asset information from 5,000 state employees, including all high-ranking officials. The first declarations of assets were made in 2004. In early 2005 a law on conflicts of interest was passed, but the new government plans to amend the law to make it tougher. The major amendment addresses conflicts of interest posed by business interests owned by family members of government officials.

Bribery is illegal in Albania. Under the Albanian Penal Code (Law 7895, dated January 27, 1995, articles 245 and 260), giving and/or accepting a bribe constitute criminal acts. These provisions were amended in September 2004 in accordance with the civil and criminal convention of the European Union. Giving a bribe is punished by fine or imprisonment up to five years, while public officials accepting a bribe can be punished by imprisonment from three to ten years. A code of ethics for public administration was also passed in September 2004 and it, too, is designed to counter bribery.

Albania signed, on December 18, 2003, the UN Anti-corruption Convention while on December 2005 the GoA approved it and forwarded to the Parliament for ratification, which is expected to happen during the first

months of 2006. Albania is not a signatory country of the OECD Convention on Combating Bribery. Albania participates in two different regional anti-corruption initiatives. The first is GRECO (Group of States against Corruption), an initiative of the Council of Europe, which seeks to improve its members' capacity to fight corruption through the monitoring of compliance of specific anti-corruption undertakings. The second is SPAI (Stability Pact Anticorruption Initiative), an initiative of the Stability Pact for South Eastern Europe.

Elected on a campaign pledge to govern with clean hands, Prime Minister Berisha has declared that the fight against corruption is a top priority for his government<sup>36</sup>. The GoA has restructured the agencies responsible for combating corruption. The highest authority is the Task Force of the Fight Against Corruption, an inter-ministerial group bringing together the highest officials of the GoA. In the technical level there is the Department for Internal Audit and Anti Corruption, which operates in the framework of the Council of Ministers. Police authorities and the General Prosecutor's Office are in charge of investigation and law enforcement while the State Audit Commission and internal auditing units within the different institutions of the GoA inspect, assess and report alleged cases of corruption.

Civil society organizations are very active in fighting corruption through increasing public awareness. The Albanian Coalition Against Corruption, an umbrella organization of over 300 organizations, is the primary civil society entity addressing the issue. One of the most active organizations within ACAC is the Citizen's Advocacy Office (CAO), which has emerged as a high-profile anti-corruption watchdog and advocacy organization in Albania since its establishment in 2001. In 2005, CAO carried out a survey on the corruption in the justice system and especially in the courts with the system stakeholders; citizens, judges and lawyers. The survey outcome confirmed the perception that corruption in the judicial system remains prevalent<sup>37</sup>.

Transparency International (TI) and CAO signed, in December 2004, a partnership agreement. The purpose of the partnership is to strengthen anti-corruption efforts in Southeast Europe in general and in Albania in particular. The latest annual TI Corruption Perceptions Index 2005, published in October 2005, Albania ranked 126th out of 159 countries surveyed, down from 108th out of 149 countries in 2004 and 92nd in 2003.

### **Bilateral investment agreements**

A bilateral investment treaty between the United States and Albania was signed in 1995 and entered into force on January 3, 1998. This treaty, inter-alia, ensures that U.S. investors receive national or most-favored-nation treatment and provides for dispute settlement. Albania also has concluded bilateral investment protection agreements with the following countries, in chronological order: Greece, Turkey,

Romania, Bulgaria, Macedonia, Germany, Italy, France, Austria, Switzerland, Finland, Denmark, Sweden, the Netherlands, Great Britain, Slovenia, Croatia, Hungary, the Czech Republic, Poland, Russia, Israel, Tunisia, Egypt, China, and Malaysia.

### **Investment insurance programs**

The Overseas Private Investment Corporation (OPIC), a USG sponsored entity, can make available insurance and project finance resources to U.S. investors in Albania. OPIC's three main activities are risk insurance, project finance and investment funds. Albania has also signed the Convention of Multilateral Investment Guarantees Agency (MIGA). MIGA provides investment guarantees against certain non-commercial risks (i.e., political risk insurance) to eligible foreign investors for qualified investments in developing member countries. MIGA's coverage is against the following risks: currency transfer restriction, expropriation, breach of contract, and war and civil disturbance. It provides insurance against risks similar to that offered by OPIC; MIGA and OPIC can work together on projects. MIGA offers long-term (up to 20 years) political risk insurance coverage to eligible investors for qualified investments.

### **Labor**

Labor relations between employee and employer are regulated by individual employment contracts pursuant to Law no. 8549, dated 11.11.1999, and the labor code, which was updated on July 2003. The GoA has established the National Council of Labor, composed of the GoA, Trade Unions and Employers Association, and which has completed the drafting of a Social Understanding Pact. The major goal of the Pact is to improve social dialogue between government, management and employees.

Albania's young, literate work force has a surplus of labor, reflected in an official unemployment rate of 14.3 percent (other estimates go as high as 25 percent), the presence of a large informal sector may distort the real figure. Many workers have emigrated, particularly to Greece and Italy. While some members of the labor force are highly skilled, many work in inefficient industries with outdated technology. Albanians are rapidly learning market economic practices and often display impressive entrepreneurship.

Albania adheres to all basic international labor organization conventions protecting worker rights. However, given the desperation of many Albanians for work and the weakness of government institutions, compliance cannot be assured. For example, child labor laws are poorly enforced; children sell cigarettes, candy, and other goods on the street.

### **Foreign-trade zones and free ports**

The Law on Free Zones anticipates the establishment of free trade zones near ports, airports or at the crossroads of international transport. The Council of Ministers is charged with determining the areas and boundaries of the free zones on a case-by-case basis. It approves the creation and the economic activities to be performed in the free zones. A free trade zone is defined as a protected area of land or other immovable property of both private and public ownership.

The National Authority for Free Zones is in charge of administration of the free zones and issues the licenses for those wishing to establish or carry out any activities within the free zones.

### **Challenges Ahead**

Albania is well poised to continue its strong economic performance and to advance towards its goal of European integration. However, the country's growth and competitiveness remain constrained by pervasive poverty, weak governance, and structural bottlenecks in the infrastructure sectors. To sustain high GDP growth and to improve standards of living, the agenda for reform needs to focus on the following priorities:

a) Maintaining stability and forging consensus on a vision of long-term development is key to implementing far-reaching economic and institutional structural reforms and for achieving growth that can widely benefit the population;

b) Improving governance and strengthening institutions to ensure managerial integrity within the public administration; reliable, predictable and fair enforcement of the rule of law; and a stronger role for citizens who want a greater say in how public services are delivered;

c) Maintaining a stable macroeconomic framework, notably through fiscal discipline, reducing debt stock aimed at raising public savings and the quality of public investment, and further mobilizing revenues;

d) Fostering human resource development by improving health, education, and training systems; facilitating the movement of labor to more productive and higher-paying jobs; and systematically revising the curriculum and changing teaching materials and classroom practices;

e) Improving the business environment, boosting trade, and accelerating regional integration to create a more favorable environment for domestic and foreign investment and ensuring progress towards EU integration;

f) Upgrading public infrastructure to raise productivity, contribute to regional cooperation, and ensure progress on the country's Stabilization and Association Process. This would require prioritization and

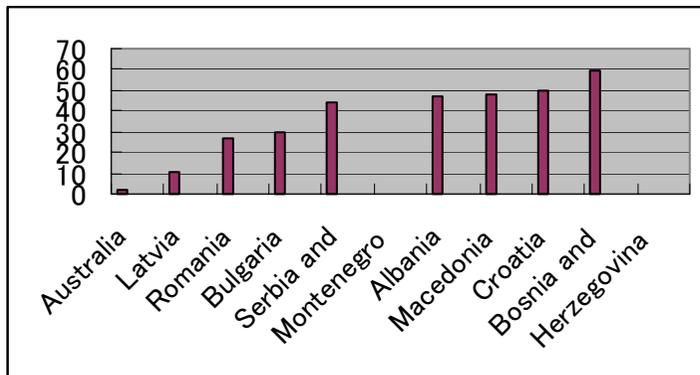
economic analysis of infrastructure investment projects, setting pricing to ensure cost recovery for public infrastructure services, sustained implementation of the Power Sector Action Plan, and implementation of the water sector strategy.

**Problems**

Slow progress with market reforms is one of the causes of the very poor investment climate. Enterprise entry and development are fraught with difficulties and the private sector generally is facing considerable obstacles in doing business. During the past ten years a large number of enterprise surveys has been carrying out with the purpose of reaching a better understanding of the difficulties met by the enterprises in their day-to-day operations and during growth.

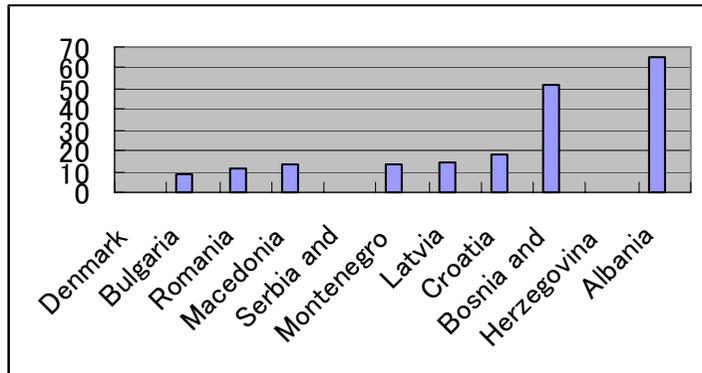
Policy instability is considered the most important obstacle to expansion by SMEs (whereas in the whole range of transition economies the main obstacle is considered to be taxes and regulations). Taxes and regulations (and in particular business licensing) are considered the second most important obstacle to doing business. The third most severe constraint is considered to be the lack of access to finance, and lastly, corruption (and slow bureaucratic procedures), one of the main factor contributing to keeping enterprises in the grey economy.

**Figure 5** Cost to Start a Business (% of income per capita)



Source: World Bank CoDB, 2004.

**Figure 6** Time to Start a Business

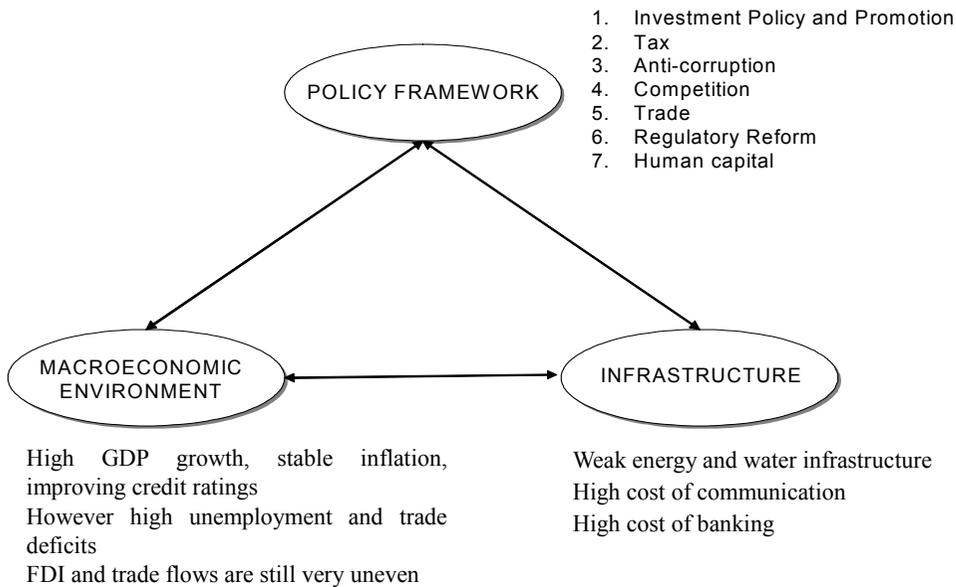


Source: World Bank CoDB, 2004.

The business registration is highly bureaucratic and time consuming. Numerous forms and documents are required for the various pre-determined steps toward registration. On average it takes several steps to register a company (from getting a bank account and registering at the court, to licensing at the tax office) and payment of several sets of fees for various licensing (e.g. health and safety).

### Chapter III. Investment Climate

The business climate depends on the policy framework, the macroeconomic environment and infrastructure support which are all interdependent<sup>38</sup>.



#### Policy Framework

National Treatment of foreign investment is guaranteed by law and internationally accepted mechanism for state-investor dispute settlement are generally in place. Also guarantees against unfair expropriation of property are set in the Constitution and the foreign investment law. Transfer of funds (current and capital) by foreign investors is guaranteed.

Note: for more details refer to Chapter II.

#### More advanced Policy Framework in Albania are:

Investment Policy;

Trade Policy<sup>39</sup>.

#### Less advanced Policy are:

Anti-corruption and business integrity;

Regulatory reform;

Tax policy;

Human capital;

Investment promotion and facilitation;

Competition policy<sup>40</sup>.

### **Investment policy and promotion**

Lack of proactive investment promotion approach results in a weaker image of Albania, limited contact with potential investors and limited linkages between FDI and domestic enterprises.

More emphasis should be put on targeted sector specific marketing campaigns and providing on-the-ground services to potential and existing investors. For example, assisting investors in dealing with licenses and permits for greenfield investment, supporting cluster and SME linkage development.

### **Tax**

Albania has made significant progress in aligning the corporate tax regime with international standards. However, transfer-pricing rules are not well enforced. According to World Bank estimates, the total number of tax payments and time to comply are both higher than the SEE average<sup>41</sup>. VAT reimbursements are not monitored and often delayed, and corruption, especially by tax inspectors, is still considered a problem by the private sector.

### **Anti-corruption**

Like most SEE countries, Albania has signed and ratified key international conventions related to corruption and has adopted laws which criminalize corrupt acts such as active and passive bribery, money laundering and trading influence<sup>42</sup>.

### **Competition**

Albania has taken important legislative and administrative steps in establishing structures to regulate competition and state aid. However, in a country where competition culture is still in its infancy, much more need to be done to increase the overall understanding of the principles of competition, as a tool to protect the market and consumer's interests. Despite progress in adopting a legislative framework, legislation in this area needs to be further improved to make competition control effective<sup>43</sup>. Efforts are needed to ensure that state

aid and competition issues are covered by consistent and complementary legislation and that an operationally independent State Aid Authority is established.

## **Energy**

Electricity losses have been reduced from 39 percent in 2003 to 36 percent in 2004. Electricity production has increased significantly thanks to a favorable hydrological situation. Revenue collection has increased slightly from 92 percent in 2003 to 94 percent in 2004.

However, the crisis in the energy sector has not been yet overcome. Companies and households continue to suffer frequent power cuts. Electricity losses and illegal connections are still high, and also collection rates need to be further improved<sup>44</sup>. Thus, continued and successful implementation of Albania's energy action plan and strategy is needed. Administrative capacities need to be further strengthened<sup>45</sup>.

## **Conclusion.**

Future FDI trends in Albania will to a great extent depend on the progress of structural reforms, aiming at the creation of a friendly environment for business and investment. These trends will be related to the protection of ownership rights, enforcing contracts, reduction of the administration power over the private sector and its transparent use, and the reduction of the involvement of public administration in general. Specifically, FDI will depend on the progress made in addressing the most persistent administrative barriers, faced by private investors<sup>46</sup>. The main transition challenges for Albania are:

i) to encourage private sector development, particularly of SMEs, and bring much of the large informal sector into the formal economy. This will require increased access to finance, but most importantly, further improvements of the investment climate through a stronger and better enforced legal framework, sustained efforts to fight corruption and tackle organized crime, and strengthened institutional and administrative capacity;

ii) to continue to pursue commercialization and privatization in utilities and in the financial sector in order to increase competition, improve services and bring new management skills; and

iii) to undertake essential investments in the country's dilapidated infrastructure, including further work to resolve the energy crisis, improve provision of municipal services and strengthen local and international transport networks.

The perception of business climate in Albania has improved, however, private enterprises and particularly SMEs still encounter many obstacles. The perceived hurdles, as measured by the 2002 Business Environment and Enterprise Performance Survey (BEEPS) study, decreased in several categories, though little improvement was achieved in reducing corruption and improving standards of the judiciary<sup>47</sup>.

Private sector development and foreign direct investment is hindered not only by crumbling infrastructure and chronic energy problems, but also by a weak administration and prevalent corruption, which lead to a poor law enforcement and unfair competition from the informal economy, as well as from illegal practices of registered companies (smuggling, tax evasion and illegal imports, counterfeit and unlicensed production). Weak corporate governance, both at the macro and at the enterprise levels, and lack of management skills as well as an underdeveloped banking system are other major impediments to the development of private economy and foreign direct investments. Reforming the judicial system, strengthening the rule of law and public order, fighting corruption and deepening public administration reform remain key challenges for the government in the medium term.

Institutional improvements are necessary both to improve efficiency of government operations and to achieve the implementation capacity needed to finalize negotiations on the Stabilization and Association Agreements with EU.

As the attraction of Foreign Direct Investments (FDI) is being seen as one important component of private sector development and also as a prerequisite for the economic development of the country, the Government, alongside with the recent achievements, has had and continues to have the promotion of FDI as a strategic objective and, within this framework pursued:

- 1) the creation of an incentive legal and regulatory framework for foreign investors;
- 2) the minimization of investment risk;
- 3) the improvement and enhancement of the Albanian image as a country with potential investors;
- 4) the establishment of an independent and credible appealing institution for the taxpayers and;
- 5) the improvement of physical infrastructure (energy, transport, telecommunication) and social one also related to investments (education, training, management).

*Also the Government pursues measures with legislative character, such as:*

- a) ratification of the agreements that relate to the arbitrage;
- b) increase the transparency and co-operation with business community regarding the fiscal regulations and procedures;

- c) improvement of the reimbursement procedures for the taxpayers (VAT reimbursement) and
- d) increase of the level of access and security related to land (through the settlement of the problems related to its identification) registration and its restitution.

In Albania, bureaucratic bottlenecks, compounded by weak law enforcement and strong corruption, are major impediments to the growth of private investment<sup>48</sup>. Administrative barriers are a substantial impediment to investors, but can be removed by a more aggressive government reform.

In the short term, an important possibility to increase FDI in Albania will be the privatization of state-owned enterprises in the strategic sectors. Involvement of foreign investments in the sector of infrastructure services is another potential source of FDI. On a medium to a long term basis, Albanian resource endowments can be a particular attraction for foreign investors, providing that process in structural and administrative reforms will be adequate<sup>49</sup>.

## Endnotes.

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- 3 National Treatment of International Investment in SEE Countries-OECD, p. 51
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- 5 For more information of the phenomenon of pyramid scheme in Albania see, *"An Overview of Albanian Transition Economy after 1992: Focusing on the Main Problems and Future Challenges"*, The Journal of the Study of Modern Society and Culture, Graduate School of Niigata University, p. 83-p86.
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- 16 *"Regional Priorities to Improve the Business Climate in SEE"*, Regional Reality Check on Progress in Policy Reforms and Implementation in South East Europe, Vienna, Austria, 26 June 2006, p.20
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- 19 *Ibid.*
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- 24 *Ibid.p.6*
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