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This advisory project was conducted at the request of the Ministry of Privatization and Public Economy. A team from the Foreign Investment Advisory Service (FIAS), a joint facility of the International Finance Corporation and the World Bank, visited Albania to conduct the field study in May 2000. The FIAS team met with private sector investors, representatives of the government, members of the international donor community, non-governmental organizations and other private sector facilitators (consultants, lawyers).

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EXECUTIVE SUMMARY

I. Introduction

i. In the past eight years since the collapse of the communist regime, Albania has made impressive progress on several fronts. Macroeconomic stabilization has been a success and the country has privatized or liquidated assets of nearly all 520 state-owned SMEs. Progress has also begun on the privatization of the 'strategic' sectors, which has been marked by the success of recent privatizations in mobile telecoms and banking. Albania has also put much effort into the adoption of a market-oriented legal and regulatory framework.

ii. However, badly needed FDI inflows have been minimal. In a period when FDI flows on a global basis have been increasing dramatically, and when a number of neighboring transition countries are attracting annual flows amounting to three or more percent of their GDP, FDI to Albania is currently closer to one percent of GDP.

iii. Improved prospects for peace and stability in southeastern Europe are likely to encourage more investment in the entire region, including Albania. However, if Albania wants to get a share of this potential FDI, key issues in the investment climate will need to be addressed.

iv. A combined set of uncertainties and disincentives in Albania increases risks and costs to the investor, thereby reducing expected profits. Such a high risk environment increases the required rate of return by investors, which in turn, results in fewer investments in that location. Meanwhile, several neighboring countries that compete with Albania for FDI have improved their investment climates, and offer more attractive alternatives to potential investors.

v. Attracting foreign investors to a country is analogous to selling a product to consumers in a market. Albania, as a host country, possesses certain assets to offer foreign investors, including proximity to the EU market and access to the Mediterranean sea, low cost of relatively well educated workers, and rich natural resources and minerals. If major weaknesses in the current investment environment could be eliminated or at least mitigated, resulting in an improvement of the 'product' of Albania as an investor destination, the potential to increase current levels of FDI by several times exists.

II. The Overarching Issue of Weak Governance

vi. The most important problems for foreign investors are linked to the difficult, overarching problem of poor governance in Albania. The top problems cited by foreign investors—inadequate implementation and enforcement of law; and corruption—are directly related to weak institutions and a lack of accountability of authorities regarding their decisions and actions. Such systemic deterrents to FDI keep economic prospects limited and investment risk high. Poor governance capacity also contributes to the incidence of political instability, which further increases risks. In the absence of respect for the rule of law—especially among government officials themselves—foreign investors know that their investment will carry a higher risk, and that the hidden costs of doing business (e.g. the cost of bribes, inability to enforce contracts and property rights, losses incurred by vandals and criminals who are not deterred by a respected police force) will be greater.

- *Lack of consistent and transparent implementation of law*. The most significant obstacle to achieving higher levels of FDI is Albania's failure to implement laws, regulations and procedures in a consistent and reliable manner. Investors repeated frequently that government officials routinely ignore their own laws and regulations or apply them capriciously and selectively. The government therefore needs to take urgent measures to ensure that all officials apply and enforce existing laws in a consistent and even-handed manner. Until the government is able and/or willing to implement laws consistently and fairly, there is little incentive in the current culture for others to follow rules and laws.

- *Corruption.* Discussions with foreign investors indicate that corruption is so pervasive that it raises the cost of doing business in Albania substantially. Corruption is therefore one of the leading disincentives for investors seeking to establish businesses in Albania.

- *Poor enforcement of law and contracts.* Almost all foreign investors cited the unreliability of the judicial system as a major factor in deterring investment. Foreign investors need to have their legal rights protected and their disputes fairly adjudicated. This is not currently the case in Albania.

III. Specific Issues that deter FDI

vii. Other issues cited by investors are more specific and apply to policies or practices in a more narrow sense, such as inadequate physical infrastructure, access to land and construction permits, tax and customs administration and business regulations. However, problems in these areas often share links to the problem of Albania's poor governance.

- *Tax and customs administration.* Foreign investors note with a very high degree of consistency that tax laws and procedures are inconsistently applied and interpreted by authorities, resulting in unfair and arbitrary treatment. Investors also cited inconsistent application of procedures in the customs administration. Investors also cited a high level of corruption in these administrations. Tax and duty reimbursement mechanisms are reported to be ineffective.

- *Deficient infrastructure.* Almost all foreign investors cited lack of reliable infrastructure as a constraint to investment. The lack of sufficient and reliable power, water and transport also causes investors to face higher cost structures.

- *Access to land and construction permits.* Investors spend a lot of time and money dealing with land-related issues. The most difficult problems are related to access to land and construction permits; registration and title records, property expropriation and a weak court system for enforcement of property rights. Several investors expressed frustration with the inability to access finance because of an inability to prove a secure title to land.

- *Business regulations*. In addition to an ambiguous operations licensing process, investors complained of lengthy procedures that are time-consuming and confusing.

viii. Due to the wide range of issues and recommendations presented in the body of this report, a matrix of priority recommendations is presented at the end of this section. An attempt was made to place initiatives within a timeframe—immediate or medium term (after one year)—and may serve as a basis for discussion with the government in a forthcoming workshop in Tirana. In addition, the matrix cites the paragraphs of the main text where more specific findings and detailed recommendations are presented.

IV. Investment promotion

ix. Focus should be placed on improving the investment climate (the ‘product’) before large amounts of resources are dedicated to promoting FDI (marketing the ‘product’). There is no point in promoting a poor investment environment. Therefore, limited resources should be spent on a selective investment promotion strategy that best suits the country’s current promotional needs.

x. FIAS recommends developing a two-phase investment promotion strategy. In the first phase, the key areas of a suitable strategy for Albania include:

- <u>Promoting Privatization</u>. Privatization offers the most potential for FDI in the near term and the bulk of promotional efforts should be focused here.

- <u>Investor servicing</u> of existing and potential investors. Investor facilitation is the most basic, most important part of promotion and should always be high priority.

  - *Existing investors* are often the most important source for future FDI through project expansions or reinvestments. Once these investors are satisfied, they will also have a substantial impact by sending positive signals to potential investors.

  - *New investor facilitation*. Although the level of new greenfield investor interest per year is relatively low, the agency can focus on being more proactive at converting interested investors into actual investments by offering much needed information (on laws, procedures, costs of factor inputs, etc) and assistance at each step of the investment process.

- Policy advocacy and focusing on improving the 'product' of Albania as an investment destination. Through their contact with private investors investment promoters will be come familiar with investor perspectives and problems. This valuable information should be fed back to policy makers to improve the investment climate.

xi. In the second phase, once improvements are made in the investment climate to the point when Albania becomes more attractive to greenfield FDI, the investment promotion strategy should expand to include suitable image building and more targeted investment promotion activities. The phasing in of these functions in the future should be carefully evaluated. For example, image building, which is very expensive, can be highly wasteful and even counterproductive if conducted too early and when the country in reality offers a relatively insufficient "product" to investors and does not have substantial improvements in the business environment to show case.

xii. The importance of defining a sensible, practical and competitive investment promotion strategy is an essential prerequisite to establishing an investment promotion agency. An investment promotion agency is an organizational tool to implement the strategy. When such a strategy is defined, crucial issues which impact on the effectiveness of the agency can be defined, including:

- its legal basis and mandate;
- its links with government and the private sector;
- the composition and operations of its governing board;
- its internal structures and staffing; and
- how it is to be funded.

xiii. Major problems and challenges under each of these headings exist in Albania, and these need to be resolved before any effective promotion agency can be established. The three previous failed efforts to establish an institution since 1991, ought to provide excellent lessons to learn from, as there is little point in rushing into a fourth unsuccessful venture. The authorities in Albania need to consider the issues involved in each of these topics and not dash into establishing another ineffective structure. Careful consideration is called for so that proper decisions are made, and an appropriate institution established.

xiv. Strong views exist in Albania as to which part of the government the new investment promotion agency should report to, and good reasons exist for the different options put forward. But FIAS is of the view that the dominant consideration right now is that any new promotional agency established should be given the best possible chance of surviving and of being effective. In view of this, FIAS suggests that two options be carefully considered in phase one of the two-phase approaches outlined above.

- Option 1: Broaden the institution being established to promote privatization into a foreign investment promotion agency under the Minister of Privatization.

- Option 2: Establish a smaller Investment Promotion Unit under the Prime Minister.

xv. Each option has its pros and cons, which are discussed in the report, and the government will ultimately have to weigh the trade-offs in line with their objectives and special circumstances.

Summary of Top Priorities to Promote Higher Levels of FDI

Activity priorities	Measures to be initiated immediately	Medium term measures (after one year)
1. Reduce investor uncertainty and increase government credibility by strengthening governance capacities	a. Implementation of laws and procedures. There needs to be a concentrated effort and donor support to focus on the implementation of existing laws, regulations and procedures, especially in the areas of taxation, customs, and bankruptcy; honor legal and financial obligations; disburse retroactive payments for unpaid tax reimbursements; set up training programs for public officials and legal professionals on new laws and regulations and how to implement them. Text: pages 14-17. b. Accountability of public officials. Create incentives for civil servants to follow procedures; encourage the use of appeals mechanisms and Office of the Ombudsman to hear charges by the public who have been treated unfairly by government officials; impose severe penalties for abuses; take concrete measures to increase effective private sector participation in the formulation of economic policies, laws, and procedures that affect them. Text: pages 11-21. c. Reduce opportunities for corruption by identifying administrative procedures that serve little or no public purpose, and eliminating them completely. For the remaining procedures that do serve a purpose, streamline them and make them as business-friendly as possible. FIAS has wide experience in this area and would be glad to assist the government. Text: pages 18-21 and 37-40.	d. Reduce bureaucratic discretion. Review new legislation and consider amending laws to eliminate discretionary power in legislation; and increase transparency and clarity in definitions and procedures. Text: pages 14-17. e. Public administration/civil servant's reform. Deepen the anti-corruption program in the areas of government accountability; civil servants' performance, incentives and pay; and government policy credibility. Text: pages 18-21. f. Enforcement of law and judicial reform. Reform in this area is priority. Continue work with the World Bank to improve the legal and justice system and the rule of law. An effort should be made to provide judicial training on the corporate laws of Albania, with a special emphasis on intellectual property, banking, companies, bankruptcy, tax secured lending and comparative law. Efforts should also be made to establish clear ethical standards by which judges will be evaluated. Text: pages 22-23.
2. Privatization and private participation in infrastructure	a. Privatization. Take actions to create the necessary conditions to transfer assets and contract services out to the private sector, such as cost covering tariffs and taking legal measures against delinquent accounts. Text: pages 5-7 and 23-27. b. Risk mitigation. Develop a strategy to identify sector-specific risks for investors and take actions to reduce or mitigate these risks. Text: pages 23-27.	c. Private investment in infrastructure. As part of the country's strategic plan to rebuild infrastructure, the government should expand the private sector's role in investing in and delivering infrastructure services. Text: pages 23-27.

Activity priorities	Measures to be initiated immediately	Medium term measures (after one year)
3. Tax and customs administration reform	a. Reform tax administration. Continue work to eliminate the misapplication of tax laws and procedures; train tax officials in the new law, procedures and financial accounting; solicit private sector input for subsequent amendments made to tax laws; ensure speedy reimbursement mechanisms for duties and VAT. Text: pages 31-36. b. Reform customs administration. Focus on reducing the administrative time and cost of customs transactions to investors; make sure procedures are clear to all and implemented in a consistent manner. Through an administrative barriers to investment study, if requested by the government, FIAS could advise the government on reducing procedures in customs transactions. Text: pages 36-37 and 40.	c. Accountability of tax and customs officials. Create an administrative appeals procedure to resolve disputed decisions by the tax authorities and customs agents. Objectively enforce disciplinary measures against tax and customs officials who arbitrarily misapply the laws, regulations and procedures. There should be strong disciplinary penalties against tax and customs officers who violate the law. Text: pages 31-37.
4. Land	a. Continue efforts to create a modern, unified and comprehensive land registration system to record urban land, display and protect property rights; pay awards of compensation to former landowners or land shareholders, as stated by law. Text: pages 27-31. b. Eliminate unnecessary approvals for foreign investor access to land and streamline and make more transparent construction approvals. Through an administrative barriers to investment study, if requested by the government, FIAS could advise the government in this area. Text: pages 27-31 and 40.	c. Land speculation. Address land speculation problems by reducing the economic incentives for it rather than through administrative mechanisms that intervene in private transactions. Text: pages 27-31. d. Support local law enforcement in its ability to protect the rights of landowners from squatters and trespassers; and achieve land registration and restitution program objectives.

PART ONE

STRENGTHS AND WEAKNESSES IN ALBANIA'S FDI CLIMATE

CHAPTER I

INTRODUCTION

1. This report was prepared by a Foreign Investment Advisory Service (FIAS) team at the request of the Government of Albania, Ministry of Privatization and Public Economy, which wanted advisory assistance on strengthening (i) the business climate for foreign direct investment (FDI) and (ii) the country's FDI promotion strategy and institution. In preparation for this general diagnostic review of the FDI environment, FIAS interviewed 40 investors that had investments in Albania or had at one time considered investing in Albania across many sectors, including banking, construction, assembly industries, agriculture, transport, trade, natural resources and other services. The FIAS team also interviewed several investors who after considering investing in Albania decided not to come. Investors interviewed were asked open-ended questions about what in their view were the top obstacles of investing in Albania. Investors were asked to describe the major problems in broad terms so that they could set the agenda. Further, FIAS consulted representatives of the government, international donor community, non-governmental organizations and private sector facilitators.

2. The objective of this report is to provide an overview of perceptions of the FDI climate, including opportunities that investors see in Albania and an analysis of the obstacles investors face, along with recommendations to address them. Assets and strengths will be presented in Chapter 1 and weaknesses of the investment climate will be discussed in Chapter 2. In Chapter 3, FIAS presents recommendations for an investment promotion strategy, and options regarding suitable institutional arrangements to carry out that strategy.

A. Macroeconomic Overview

3. Since the communist regime ended in 1992, Albania has made important progress in stabilizing the economy and introducing market-oriented reforms. Virtually all price controls have been removed, and the exchange rate was unified and is now market determined. Trade and payments regimes were liberalized, and Albania joined the WTO in July 2000.[1] Cautious monetary and fiscal policies have helped to reduce inflation from 240% in 1992, to virtually 0 in 1999 and achieve exchange rate stabilization. Working with the IMF and World Bank Group, nearly all of the country's 520 state-owned SMEs have been privatized or

[1] The maximum tariff level is expected to decline from the current 18% to 15% by 2001, after being cut from a top rate of 30% in 1998.

liquidated and progress has begun on the privatization of the 'strategic' sectors[2] and the banking sector.

4. The economy's response to macroeconomic stabilization and reform was impressive. After GDP contracted by nearly 40 percent between 1990 and 1992, it expanded by an annual average of over 9 percent from 1993 to 1996 and 8 percent in 1998 and 1999. This makes Albania one of the fastest growing economies in eastern Europe, although coming from a low income base of $850 per capita[3]. Strong growth has been led by the private sector, primarily in agriculture and construction sectors, which have been bolstered by efficiencies made in allocation of agricultural land and large inflows of foreign aid into building infrastructure.

5. However, weak governing institutions and political instability have kept Albania from achieving solid, sustainable progress. The collapse of the pyramid scheme revealed the fundamental problems in Albania's economic governance capacities.[4] The resulting financial crisis leads in turn to a serious social crisis, during which the government lost control of entire parts of the country and significant damage was inflicted on public and private sector property. In the wake of the crisis in 1997, GDP fell by 7%, and it is estimated that 21,000 enterprises closed during, or as a result of, the crisis. According to the Ministry of Economic Cooperation and Trade, unemployment increased since then to 18% and the informal economy has grown, now representing an estimated 60% of GDP.

B. The Role of FDI in Albania

6. The benefits of FDI are well known and well documented and do not need to be elaborated upon here. FDI brings more than finance: it brings new technologies, management techniques, market access, job creation, revenue enhancement and can have strong demonstration effects. It can provide an operational like between an enterprise and a foreign partner. A foreign partner that has investment expertise, technology or market access not available in the host economy can raise the productivity of the enterprise. The host economy benefits from the additional economic activity, creating employment and tax revenue. Entry by foreign firms can also increase competition in domestic markets, reduce monopoly profits and stimulate quality upgrades of products and services by all firms in the sector.

7. Albania attracts very little FDI. Albania receives one of the lowest levels of FDI in the Central and Southern European region (see Table 1). According the World Investment Report 2000, FDI inflows to the Central and Eastern Europe region reached 3% of GDP in

[2] The 'strategic' sectors owned by the state include nearly 80% of the overall assets of the economy in the sectors of fuel and gas, electric power, telecommunications, transport infrastructure, water resources, and mining.
[3] Private consumption per capita in PPP terms for 1998 is $2,156.
[4] World Bank, "Albania, Beyond the Crisis: A Strategy for Recovery and Growth." Report No. 18658-ALB.

1998, in line with the annual overall average ratio for all developing countries in that year,[5] while FDI inflows to Albania in 1998 and 1999 were closer to one percent of GDP.

8. There are about 1,470 foreign companies registered in Albania and over 2,100 joint ventures. From 1992 to 1996, the number of foreign firms registered in Albania grew dramatically from 125 to 1206, as many investors came to benefit from the country's comparative advantages or to get in early to establish a position in a new, growing market. Reflecting strong trade linkages and geographical proximity, the majority of FDI is from Italy and Greece, with investors from Turkey ranking in third place.

9. FDI in Albania is dominated by small and medium-sized enterprises (companies with less than 500 employees world-wide). Over 60% of all foreign companies operate in the trade sector, which is similar to the percentage of local companies in this sector.[6] The high concentration in trade reflects a high reliance on imports and low levels of local industrial production.[7] Several investors in the trade sector told FIAS that they were taking a wait-and-see approach before initiating local production facilities, as the overall difficult environment coupled with unfair competition from 'illegal' goods, (for which taxes and duties are largely unpaid), dampened profitability prospects.

Table 1. Regional FDI flows and Comparative Information for 1999

	FDI flows in US$ millions	**FDI per capita in US$**	**FDI/GDP**	**TOP FDI SOURCE**	**SECOND SOURCE**
Albania	41	13	1%	Italy	Greece
Bulgaria	770	93	6%	Benelux	Germany
Czech Rep	5,091	492	9%	Germany	Netherlands
Croatia	1,347	299	6%	USA	Austria
Estonia	305	218	5%	Sweden	Finland
Hungary	1,951	193	4%	Germany	USA
Latvia	366	153	6%	Denmark	USA
Lithuania	486	131	6%	Sweden	Finland
Macedonia	117 *	59*	4%	Greece	Germany
Moldova	34	8	1%	Russian Fed.	USA
Romania	961	43	4%	Netherlands	Germany
Slovakia	332	66	2%	Austria	Germany

Source: World Development Indicators, World Bank; International Financial Statistics, IMF; and World Investment Report, UNCTAD.
*1998 figure

10. The most dynamic growth pocket in industry has been in manufactured goods, that sector's share of total exports grew from 54% in 1994, to 69% in 1998. A large portion of these goods is in apparel and footwear by Italian and Greek investors. These investors often work with Albanian factories under subcontracting arrangements. This production demonstrates the comparative advantage of Albania's low cost labor and it also shows the potential for attracting export-oriented FDI to serve the European market. On the other hand, the use of subcontracting arrangement reveals some reluctance on behalf of foreign investors

[5] World Investment Report 2000, UNCTAD.
[6] Source: Albanian Institute of Statistics.
[7] The country's industrial capital stock has been drawn down due in part to reduced activity of state enterprises and also to mob destruction and looting in 1992 and 1997. Accordingly, total local industrial production in Albania fell from 47% of GDP in 1990, to 12% in 1998.

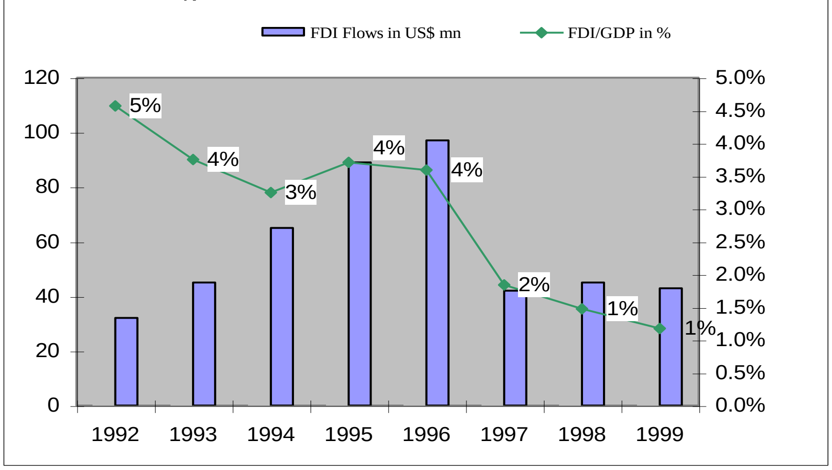
to be more directly involved in the Albanian economy. They prefer to provide the inputs and subcontract the work to local producers and, for fear that orders will not be completed on time, are able to severe contracts in times of civil unrest.

11. About 11% of foreign companies are in the services sectors. This is low relative to comparable transition economies that saw an increase in services after the collapse of public enterprise production. However, increasing investment opportunities in financial services and telecom will position the services sector to grow over the next few years.

12. There was a marked decline in the annual levels of FDI inflows from 1997 to 1999. In fact, the level of annual inflow in 1995 and 1996 was nearly twice as large as that in the period from 1997 to 1999 (see Figure 1). In 1999, only 51 foreign companies registered, 28 of which were in trade, 8 in industry, 7 each in construction and services and 1 in transport. Moreover, FDI fell in per capita terms, and in relation to the level of GDP. Conversely, the trend in most other countries in the region during the same period was upward.

13. The decline in FDI to Albania is undoubtedly due in large part to the series of crises which affected the country, starting with the 1997 rioting following the collapse of the pyramid funds; the coup attempt in September 1998 and rioting that broke out after the assassination of a parliamentarian; and the Kosovo crisis in 1999. Some investors, overwhelmed by the high cost of damage and looting during the riots in 1997, left the country.[8] Others greatly reduced the size of their activities, and many have taken a wait-and-see approach regarding decisions to remain, expand operations in Albania, or locate elsewhere. Those who have remained told FIAS that their experience in Albania has been much more difficult than they had initially expected, and, as a result, they are quite frustrated and many are pessimistic.

Figure 1. FDI Flows into Albania



Source: World Bank World Development Indicators, and IMF International Finance

14. Yet, the low level of FDI in Albania persists for reasons beyond the recent events of political instability. According to investors surveyed, there are major underlying problems, which increase uncertainty and costs, and reduced profit expectations. The most important problems cited by investors are:

- lack of application and enforcement of law (including property security);

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[8] According to the Italian Businessman Association, there were 700 Italian investors in Albania in 1996 compared to 530 in 1999.

- a harassing and corrupt public administration (especially in customs and tax administration);
- lack of even the most basic infrastructure services (roads, power, water, communication); and
- problems in accessing land and construction permits.

15. It is hoped that a pick-up in the privatization process will induce a boost of inward FDI in 2000 to 2002, as interesting investment opportunities tempt some investors to take on the related risks associated with investing in Albania. In 2000, thanks primarily to two very successful privatization transactions (discussed in more detail below), FDI inflows are forecast to be over $120 million, which represents 3% of projected GDP, and is the highest nominal amount of FDI inflows to date in Albania.[9] However, the challenge for Albania will be to sustain higher levels, as the difficult business environment is expected to have a dampening effect on FDI flows outside of the strategic sectors, particularly in greenfield investments for some time to come.

C. Assets and the Potential to Increase FDI

16. Despite the difficult investment climate, Albania, as a host country, does possess several assets, or strengths, to offer investors. Having said this, if major weaknesses in the current investment environment could be modified or, at best, eliminated, which could improve the 'product' of Albania as an investor destination, then there may exist the potential to increase levels of FDI by several times. For example, if Albania were able to attract similar ratios of FDI as other countries in Eastern and Central Europe, Albania could achieve annual levels in the $250-300 million range.

17. The most obvious assets Albania has to offer include proximity to the EU market; low cost of relatively well educated workers; rich natural resources and minerals; fertile and arable land; and an ideal climate and a coastline for the development of tourism. With a small domestic market and low per capita income, most FDI outside the strategic and infrastructure sectors would be cost-minimizing for export-oriented activities, particularly in natural resources and light manufacturing. Small foreign investors may also be interested in the new and emerging local market and establishing a presence to grow with the market. The potential in agriculture and tourism will take more time to develop, as various obstacles that impede FDI expansion there will need to be removed.

1. Privatization

18. In the short and medium term, if privatization in Albania is successful it will be the reason for the lion's share of FDI flows. The experience of FDI and privatization in the central and eastern Europe region has been impressive: about $31 billion in foreign

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[9] According to IMF estimates.

investment went into privatization programs from 1990 to 1998.[10] Privatization can also serve an important signaling function to foreign investors through a raising expectations of future positive developments in the investment climate. For example, a FIAS study found that across 36 different countries undergoing privatization, every dollar of privatization revenue attracted an additional 88 cents of FDI.[11] Foreign investors consider the privatization of infrastructure even more important, and infrastructure sales among all other privatizations have the strongest impact on attracting additional FDI into a country. Not only does it attract investment to specific projects related to transport, roads, power, water, etc., but also it improves the condition of infrastructure services which is an important attraction for FDI in other sectors of the economy.

19. Albania's potential to attract greater levels of FDI through privatization is demonstrated through the recent sales of state assets in mobile telecom and banking. In May 2000, a Greek-Norwegian consortium offered \$85.6 million to purchase 85% of the country's only mobile telecom provider and the contract was swiftly passed into law by the parliament in September 2000. This figure alone represents nearly twice the average annual amount of FDI inflows to Albania in 1999. In June 2000, in the country's first bank privatization, National Commercial Bank was sold to foreign investors Kentbank (Turkey), EBRD, and IFC, attracted nearly \$10 million.[12] The country's SME privatization program, which sold or liquidated assets of nearly 500 enterprises, has been far less successful at attracting FDI; however, a Lebanese-English cement consortium participated in purchasing state assets and an Italian brewery has expressed interest.

20. Other projects slotted for privatization need foreign strategic investors. A tender for a second mobile license is expected by the end of the year 2000. This is to be followed by the privatization of TELECOM, the fixed public telephones network in Albania, through majority stake sale to a strategic investor. The sale of Savings Bank is also scheduled for 2000-01. The government is working on privatization of Rinas Airport, and the oil and gas industry (Albpetrol) is part of the strategic sector privatization program in 2001-2002. The privatization of Servecom, service company which is part of the Albpetrol holding company, is already in motion and may be completed soon. In mining, the government is in the

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[10] The region's total privatization programs raised \$55 billion during this period and 56% of this amount comes from foreign investors. Most of the foreign investment flows took the form of FDI.

[11] FIAS Occasional Paper 8, "Facilitating Foreign Participation in Privatization", 1996, pg. 4. Also, many countries across central and southern Europe experienced such "FDI expectation enhancements" from successful privatization programs. For example, Bulgaria's privatization program, worth a cumulative \$2 billion since 1993, helped the country increase its FDI annual inflows from \$40 million in 1993, to \$770 million in 1999, or by a factor of nearly 20. Thanks to the privatization program in Romania, that country was able to attract over \$2 billion in FDI in 1998, also up more than 20 times from the 1993 level of \$90 million. It must be noted that in addition to having successful privatization programs, these countries also took important steps to improve their investment climates during the same period in order to receive the "FDI expectation enhancements."

[12] This transaction represents the first bank privatization in Albania, and with over 25 percent of aggregate deposits, it will be the largest private sector bank in the country. The transaction also demonstrates foreign investor interest in a sector which stands to benefit from wide-ranging developmental impacts--increased competition and significant transfer of banking technology and skills, enhancing industry standards and greater access to finance, especially for SMEs.

process of finalizing BOT concessions with foreign investors, who have expressed interest in investing in chromium, copper and phosphates. However, several negotiations in mining concessions have broken down due to the inability for foreign investors to obtain reliable electricity supply. In infrastructure, the need to upgrade the country's roads, power, water and ports will also require strategic foreign investors (see Chapter 2 for issues related to private participation in infrastructure).

21. Yet the success of privatization will also depend largely on the country's ability to attract foreign strategic investors, i.e. FDI. At present, the difficult environment poses a barrier to many foreign investors and, hence, an obstacle to the privatization that needs to be done. The circular relationship between privatization and attracting FDI contributes further to the challenges faced by Albanian authorities. Nonetheless, the success of recent sales transactions certainly sends positive signals to foreign investors. If the momentum of this success can be maintained, Albania stands a chance of appearing on more important investors' radar screens and this can be excellent advertisement for the country. However, in order to capitalize on any interest the world may show Albania during its "time in the spotlight", and to tap into some of the potential "FDI expectation enhancement" which could be generated in addition to direct privatization sales, the government must take solid steps to show its commitment to FDI by making key improvements in the business climate.

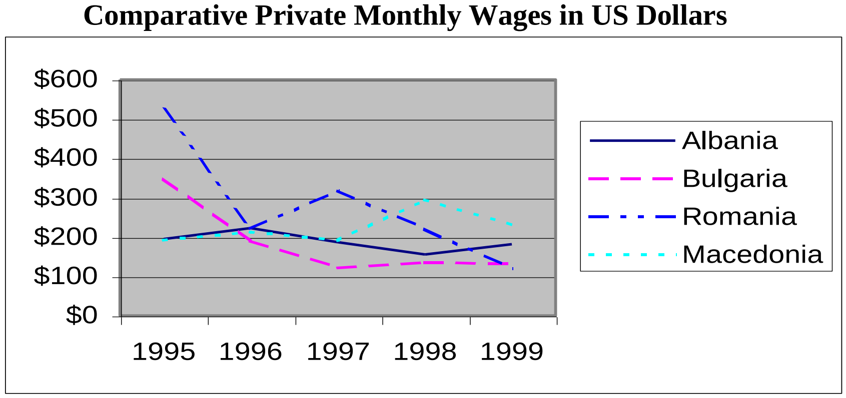
2. Export-oriented FDI

22. Globalization trends and increased competition have forced many firms to minimize costs for all the steps in their production value chains. This includes relocating steps in the production process to destinations where cost-quality improvements (e.g. lower costs, better service, and higher quality) can be obtained. Relocations may be in manufacturing, or even administrative functions (e.g. accounting operations).

23. Low wage costs, combined with a reasonably well educated labor force, is one of the few positive factors that give Albania a potential competitive edge over many other countries competing for export-oriented FDI. The proximity to their home markets and the low cost of the relatively productive labor force enticed many Italian and Greek investors to locate in Albania as the economy began to open. Albania has also benefited from this relationship through job creation, both in urban factories and in rural areas, and increasing export revenues.

24. Yet, despite this past success, several of the light manufacturing, export-oriented foreign investors that FIAS interviewed raised serious concerns about the deterioration of important cost differentials between Albania and neighboring countries. Investors pointed to three main

Figure 2:
Comparative Private Monthly Wages in US Dollars



Source: World Bank SIMA and IMF.

areas where cost advantages of locating facilities in Albania were shrinking:

- rises in costs related to the total cost of labor, including actual wage levels, taxation and other social charges on labor costs;

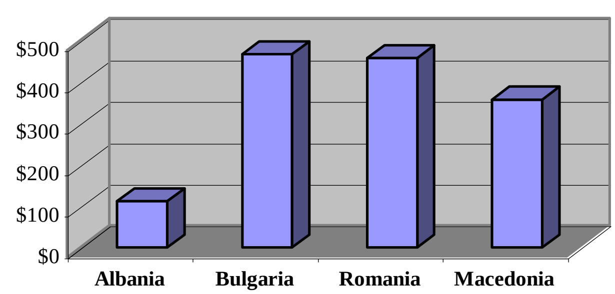
- lack of reliable access to imported inputs, including capital goods, machinery and raw materials, at international prices, due to ineffective VAT/duty reimbursement mechanisms; and[13]
- high and increasing transaction costs in terms of time and money associated with cumbersome administrative obstacles and procedures.

25. At the same time, neighboring countries have made important progress in improving their climates and removing disincentives, which has effectively lowered the cost of doing business there. Also, in US dollar terms, the cost of labor in those countries has come down (see Figure 2). Investors with a presence in one or more of these countries stress that in addition to increasing relative labor costs, Albanian worker productivity is lower. Data comparing 1998 manufacturing value added per worker in US dollars, places Albanian at much lower levels than neighboring competitors (see Figure 3). While this figure reflects lower productivity for the overall manufacturing sector, it may also capture inefficiencies associated with the remains of over-staffed state-owned enterprises.

26. Several of the investors FIAS interviewed were familiar with the investment climates of neighboring countries and had plans to expand operations in Bulgaria, Romania, and some even in FYR Macedonia. The bottom line is that important cost differentials between Albania and neighboring countries have begun to narrow and this may have an negative impact on export-oriented FDI in certain segments. This is not to say that Albania's comparative advantage of low cost, well educated labor is disappearing. It is to say, however, that Albania's competitiveness *vis-à-vis* other similar low cost destinations for cost minimizing FDI has deteriorated. Further, in view of these cost pressures to investors, it is very important that export-oriented investors have access to imported inputs at international prices.

27. Other important sources for potential export-oriented FDI is found in Albania's strategic sectors and mineral resources, including chrome, nickel, copper, oil and coal. The country has important deposits of bauxite and phosphorite, which have

Figure 3. Comparative Productivity Levels
Manufacturing Value-added per capita in US$



Source: UNIDO, Country Industrial Statistics
MVA (output per worker in the manufacturing sector at constant prices in US$)

[13] VAT is 20% and other tariffs can be up to 15%. While these levels are not high by regional standards, it can represent a sizable amount of money being caught up in the system due to ineffective reimbursement mechanisms. Recent efforts to address these problems are underway, including extensive legal redrafting of reimbursements legislation (supported by the IMF) and a planned reduction of capital goods tariffs to 2% from January 1, 2001.

not yet been exploited. As with most of Albania's industry, mining suffers from outdated equipment and technology, as well as a lack of management expertise. The government is hoping to attract foreign investment in state enterprises through concessions and management contracts to help modernize these sectors. A way of attracting more FDI, as experienced in other countries, is to privatize these assets. Direct sales of assets will also have a greater impact on overall efficiency of production and quality of output.

28. The potential for FDI in agriculture and tourism, however, has a longer-term horizon. FDI in agriculture is constrained by small land plot sizes (which limits economies of scale) and restrictions on foreign ownership of land.[14] Once efficiencies can be made through consolidation of land plots, agribusiness may offer some potential for FDI, especially in food processing and agribusiness for export to the EU. Tourism may offer some prospects for the future. Albania offers 450 kilometers of unspoiled coastline, mild climate, and unique cultural heritage sites like Butrin and Apollonia. Yet tourist arrivals have been low due to the poor security situation, the general lack of infrastructure, and the poor investment climate.

[14] There are only 13 foreign companies registered in agriculture.

CHAPTER II

EXISTING INVESTMENT ENVIRONMENT FOR FDI IN ALBANIA

A. Introduction

29. Why does Albania fail to attract FDI at a rate comparable to its neighbors? The decision to invest abroad is based on expected future profits. Such expectations are formed according to the prevailing economic and political conditions, and the existence of policies directed at growth and stability. The combined set of uncertainties and disincentives in Albania increase risks and costs to the investor, thereby reducing expected profits. The uncertainties that exist in Albania make it nearly impossible for investment decisions to be based on forward-looking business plans and financial projections. Such a high risk environment increases the required rate of return by investors, which in turn, results in less investment in that location. Higher costs coupled with "unfair" competitor pricing of final goods, mostly illegal—namely where taxes and tariffs are not paid on goods, have a further negative effect on investor profitability.[15] In addition, several neighboring countries that compete with Albania for FDI have improved their climates, and thus offer a more attractive alternative to potential investors.

30. Without significant improvements to the business climate in Albania, FDI flows outside of the 'strategic sectors' are expected to be marginal over the next few years.[16] Many of the investors interviewed by FIAS were relatively pessimistic, maintaining a 'wait-and-see' attitude regarding investment decisions in Albania. Some new investors are proceeding at a slow and cautious pace to implement already committed projects. During FIAS' mission, numerous references were made to potential investors who were deterred by existing investors from investing in Albania. For instance, one foreign investor said that he received visits from over 20 potential foreign investors, none of whom decided to invest in Albania after learning more about the poor business environment.

31. Many of the problems cited by foreign investors are linked to the difficult, overarching problem of poor governance in Albania. The most important problems for foreign investors are inadequate implementation and enforcement of laws and corruption. There is a general lack of respect for and confidence in the branches of government charged

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[15] Investors estimate that illegal goods are commonly sold at 30% less than 'legal' goods. (the difference accounts roughly for VAT 20%, other duties and other tax payments overhead).

[16] High profile investors who come into strategic sectors are subject to certain advantages over smaller investors in the wider economy. For one, many are expected to come in under concessionaire contracts, approved by Parliament. These investors typically have direct contact with high-level decision-makers throughout the course of establishing and operating a new enterprise. Smaller investors, such as new potential greenfield FDI and SME foreign investors, would have to fend for themselves in the harsh realities of a truly difficult business climate.

with implementing and enforcing laws, which is directly related to weak institutions and a lack of accountability of authorities regarding decisions and actions. Such systemic deterrents to FDI keep economic prospects limited and investment risk high. Poor governance capacity also contributes to the incidence of political instability, which, further aggravates perceived risks. In the absence of respect for the rule of law, foreign investors know that their investment will carry a higher risk, and that the hidden costs of doing business (e.g., the cost of bribes, inability to enforce contracts and property rights, losses incurred by vandals, thieves or other criminals who would not exist were there a respected police force) will be greater.

32. Other issues cited by investors are more specific and apply to policies or practices in a more narrow sense, such as inadequate physical infrastructure, access to land and construction permits, business regulations, and access to finance. However, problems in these areas often share links to the monumental problem of Albania's poor governance.

B. Overarching Issues Related to Poor Governance that Deter FDI

1. Political Instability

33. One of the most serious issues affecting the investment climate in Albania is public order and political stability. From 1996 to 1999, major political upheavals were almost annual occurrences. The infamous pyramid crisis revealed the fundamental problems in Albania's economic governance capacities. According to a World Bank report, "the inability, or unwillingness, of the government to enforce its own laws and regulations allowed the pyramid schemes to mushroom to enormous proportions."[17] Their collapse led to a massive social crisis and the government lost control of entire parts of the country. Violent social reactions resulted in disruptions in economic activity and extensive damage to property. It should come as no surprise that nearly every investor with whom FIAS spoke mentioned political stability as a key to the country's development in general, and to the expansion of FDI in particular.

34. Even in one of the least inviting regions of the world for FDI, Albania compares unfavorably to its closest Balkan neighbors in terms of political risk. For example, Dun and Bradstreet ranks Albania last in the region. Based on international investors' surveys and specific risk assessment criteria, Euro money and Institutional Investors placed Albania at nearly the lowest level of their world ranking for 1999 (See table 2).

Table 2. International Risk Ratings

Country	Euromoney (out of 180)	Institutional Investor (out of 136)
Albania	**167**	**122**
Bulgaria	**89**	**79**
Croatia	**57**	**64**
Romania	**95**	**85**
Yugoslavia	**174**	**130**

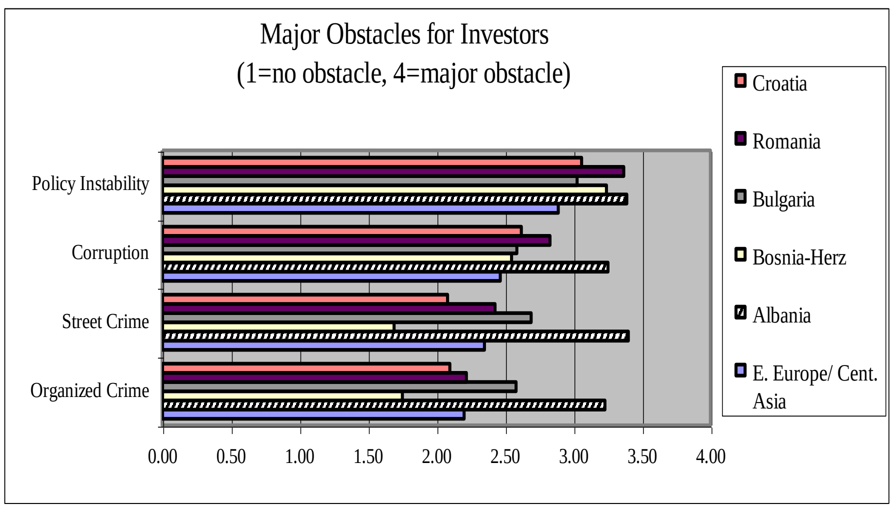
35. From the perspective of foreign investors, the persistently high perceived risks

[17] For more discussion, see World Bank, "Albania, Beyond the Crisis: A Strategy for Recovery and Growth." Report No. 18658-ALB.

associated with political instability in Albania are closely linked to the underlying fundamental problem of poor governance. In particular, investors point to a lack of confidence and credibility in government actions and policies and a lack of state control over its own institutions. Among the top ranking obstacles identified by Albanian investors (domestic and foreign) were street crime, policy stability, corruption and organized crime.[18] The effects of these weaknesses are felt through direct personal security, loss or damage of property, and additional costs generated by uncertainty. Figure 4 provides a regional comparator of this survey. A major problem underlying weak investor confidence in the government is a lack of accountability in its 'governing style'. Most investors characterized changes in the government's economic policies as "fairly" to "highly" unpredictable and said that they "never" have influence over the content of new laws, rules, regulations or policies that affect them.[19]

36. Another problem associated with political instability in Albania is frequent cabinet shuffles, which contribute to rising uncertainty, additional costs to business and disruptions in activities. For instance, the privatization of the state-run Albania Mobile Communications was delayed due to changes in government ministers. Changes in government are often accompanied by changes in administration staff who are not familiar with nor properly trained to apply laws and procedures. Another related problem is that these changes often affect government agreements and/or contacts with investors, as investors complained of having to deal with a changing array of officials and even ministers before projects can be implemented. Agreements in principle made with one minister are often not honored by his or her successor and negotiations have to start again from scratch. The costs in terms of lost resources are substantial. For example, one investor told of a case in which a high-level government official personally endorsed a land use permit for an investor. However, immediately after that official left office, the permit was revoked. Obviously, the investor lost considerable time and money due to the arbitrary nature of the decision.

Figure 4: Regional Survey on Business Constraints



Source: World Bank World Business Environment Survey

[18] World Bank, World Business Environment Survey for Albania, 1998.
[19] Ibid.

37. Recently, the Albanian government has made some progress in restoring public order. The last two years have witnessed less violence and disruption. Important test cases were the Kosovo-crisis which, contrary to expectations, did not result in destabilizing the domestic political situation. In October 1999, the transition from Prime Minister Majko to Prime Minister Meta was 'uneventful', following the former's defeat in the run for Chairman of the Socialist Party. The local election campaign in October 2000 was also relatively calm, in spite of attempts by opposition leader to stir up unrest. The outcome of general elections in June/July 2001 will be crucial events for the future of political stability in Albania.

38. The government has adopted a policy reform program to strengthen the country's weak institutional and governance capacity, including its ability to enforce its laws and regulations. The business community is also developing institutions to deal more closely with the government, including the creation of a Foreign Investors Association and a U.S. Chamber of Commerce.

Recommendations:

- The authorities should place a priority on establishing credibility in the eyes of investors. A necessary ingredient is to build a solid track record of actions and decision-making that is consistent and in line with a well articulated strategy, and government commitments and laws. The government must honor and pay financial commitments and obligations it undertakes in order to create and sustain confidence among foreign investors regarding the investment climate in Albania. Increasing the government's accountability and responsiveness to the private sector will also increase confidence and credibility. As gains in these areas are made, the government should focus on building the institutional capacity to sustain them beyond inevitable changes in elected officials and administration. (For more detail, see next section).

- Albania's priority should be risk-reducing reforms. This means that the government needs to adopt and implement liberal economic policies and laws, reduce the number of investment procedures and streamline them, and adopt measures to reduce political risks to investors. The implementation of such reforms will take some time to have an impact on the investment climate. Many investors surveyed stressed the need for some sort of political risk insurance, as an interim measure, as reforms are put in place. In the wake of disturbances of 1997 and in recognition of the deterring effect political risk has on foreign investors, a World Bank project helped the government to create the Albanian Guarantee Agency (AGA). MIGA, who recently insured its first project in Albania against expropriation,[20] also provides similar investment guarantees to protect investors against political risks of transfer restriction, expropriation, war and civil

[20] MIGA issued a guarantee for $1.6 million to Ge.Por.Tur. s.a.s. of Italy for its equity investment in Giorgi Albo Sh.p.k. Ge.Por.Tur will design, construct, and operate a tourist marina—including a lodge, restaurant, supermarket, yachting club, and moorings for leisure boats—on the southern Albanian coast.

disturbance and breach of contract. However, FIAS found that many investors did not know about products offered by AGA or MIGA.

2. Implementation of Law

39. Since multi-party elections brought democracy to Albania in 1992, Albania has engaged in an aggressive campaign to substantially revise its legal structure. Inevitably, there have been periods of regression, but Albania has maintained its momentum for legal reform. The new constitution establishes a wide range of freedoms and democratic institutions, recognized favorably by international experts.[21] During the last decade, the Albanian Parliament has put much effort into the adoption of a market-oriented legal regulatory framework. The country has adopted a host of significant legislation in areas of taxation, customs, privatization, and foreign investment. The Law on Foreign Investment eliminated most of the prior restrictions on FDI. Incorporating international standards, the Law includes a majority of the basic assurances considered important to foreign investors, such as providing a clear and broad definition of the scope of investments covered; granting national treatment to foreign investors; eliminating restrictions on the repatriation of funds; and settling disputes through the International Center for Settlement of Investment Disputes. Many experts have referred to the Law as "the most liberal FDI law in the region."

40. Bilateral investment treaties offer further evidence of Albania's strong legislative commitment to enhancing the environment for FDI. Albania has concluded bilateral investment protection agreements with 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, Malaysia and the United States.

41. Unfortunately, the most significant obstacle to achieving higher levels of FDI is Albania's failure to implement laws and regulations in a consistent and reliable manner.

42. Investors want an environment with some degree of predictability. Most importantly, they need to make investment decisions knowing that there exists a fundamental level of respect for legal regulations. The government's failure to implement its laws and regulations was identified by investors as a major impediment to investing in Albania. As one investor stated, "despite all the efforts from the international donor community to introduce new modern business laws, these laws are not being applied . . . there is no culture of law . . . not even the executive administration applies them."

43. Failure to consistently implement laws and regulations weaken the general respect for written laws and regulations, and the institutions that govern them. Investors stress that the government frequently violates the law by not following clearly presented rules and procedures that accompany the modern laws. Consequently, these actions have a severely negative effect on the credibility of the public administration and thus erode confidence in

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[21] See *Nations In Transit* 1999.

the government. Investors easily cite numerous examples of disrespect for the rule of law and capricious enforcement of the law. These include incidences where the government entered into contracts with investors only to subsequently cancel or ignore its contractual obligations;[22] failed to pay its debts and honor legal and financial obligations; and misapplied laws and procedures, especially in the area of taxation and customs.[23] In addition, many of the commercial laws affecting FDI are so new to the practitioners that they are implemented in a different manner from one time to the next. Other examples of commercial laws with implementation problems include the Bankruptcy Law and the Companies Law.

- Procedures for Bankruptcy were passed into law in 1995. As of May 2000, there had been no bankruptcy filings. The reason for this is not that there have been no insolvent companies in need an equitable division of assets among potential creditors and other claimants. According to investors and lawyers, it appears to be that there are few practitioners in Albania with any real knowledge of how to proceed in bankruptcy.

- The Company Law sets forth the basic rules of establishing a company in Albania. The law, which is written in a similar fashion to the corporate laws of other European countries, assumes a knowledge of corporate duties and obligations, but does not spell them out. The concept of a company in the sense it occupies in a free enterprise system did not exist in Albania prior to the passage of the company law. For example, it is not clear from the law what one must do in the case of malfeasance of a member of the board of directors of a corporation. While a common law country may have a cause of action to bring against the board member arising out of the parties' fiduciary relationship, in Albania, a country with a civil law tradition, the law is expected to be spelled out in the code.

44. Investors also cited non-commercial laws which are not being implemented. For example, the failure of the police to perform their function and apply the law evenhandedly directly increases the risk to a foreign investor's operation in Albania, and with it, the cost. For example, a large investor complained of inconsistent application of the law by the police, when the investor was a victim of a robbery. The police allegedly refused to file a robbery report and the robbery went without prosecution and the investor was unable to claim damages from his insurance firm.

45. In some instances, misapplication of the laws can be traced to intent to extract bribes. In many instances, however, there is a genuine lack of understanding of laws, procedures and concepts by officials. Investor problems can be also be traced to a lack of transparency in the legal system which makes it difficult for investors to gain certainty in operating their businesses. Investors cited a high level of opaque rules and discretionary powers in the

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[22] One investor interviewed discussed how, despite the fact that he secured a judgment from an international court, the Albanian government would not honor the court's judgment by compensating the investor. Other examples of government noncompliance are in the areas of tourism, land and construction—strategic investment areas particularly relevant to privatization.
[23] Taxation and customs are treated in more detail below.

application of laws and procedures as a major source of difficulty of doing business in Albania. The lack of transparency is manifested in two ways:

46. First, laws and their regulations and procedures, are either not written with clear descriptions of concepts, definitions or procedures, or they are not readily available to investors. Often, legislation is passed in a hurried fashion, with little deliberation or debate. Unclear concepts, laws, regulations, and procedures open the way for administrative discretion in interpretation, which hinders consistent implementation.

47. Based on extensive discussion, there has been a modest gain in this area. Recently, the parliament passed new parliamentary rules of procedure, which provide for greater transparency and public input, as well as improved procedural guidelines.[24] The new procedures provide greater time for parliamentary commissions to review draft laws. Recent examples of public input include the Ministry of Labor and Social Affair's public hearing on the draft NGO Law; the Ministry of Legislative Reform's initiative to create an Administrative Center for Coordination of Foreign Assistance; the Parliamentary Commission on Agriculture's public hearings on land tax law, and the Ministry of Legislative Reform's hearing on the draft Ombudsman law.[25] The new rules also make the drafting process more transparent by allowing the public and media to attend plenary sessions and permitting radio and television to broadcast these sessions.[26] Individuals, including investors, are now able to obtain information on draft laws and parliamentary reports.[27] Despite these ongoing efforts, the inability to obtain official copies of draft and final laws and regulations in English or Italian remains a complaint of foreign investors.

48. Second, newly adopted laws and regulations often specifically and directly extend discretionary power to officials. This can be a real deterrent to investment because it increases uncertainty, time and money spent on receiving approvals, and it creates opportunities for corruption. For example, the Customs Code allows for bonded warehouses. However, the General Manager of Customs has discretion over approvals. Similarly, in the Free Zones law, there are no clear rules or criteria upon which these government approval decisions are made[28] and investment approvals are subject to a high degree of discretion. Further, authorities are not required by law to provide reasons for their rejection of applications, and there is no mechanism for appealing these decisions.

49. There have been some positive developments to increase government transparency and accountability of authorities' decisions and actions. Last year the parliament adopted the Administrative Procedures Code of the Republic of Albania[29], which makes government officials accountable for their illegal acts, or even failure to act when it is their responsibility to do so. In addition, the parliament adopted the Law of the Right of Information for Official

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[24] *Nations In Transit*, 1999.
[25] Ibid.
[26] Ibid.
[27] The parliamentary commission may also hold public hearings on draft legislation and commissions are more actively seeking advice from interested parties to proposed legislation. See *Nation In Transit*, 1999
[28] Council of Ministers in the case of developers and Free Zone Authority in the case of users.
[29] Law No. 8485.

Documents[30], which grants any person the right to request official information from the state, and requires the government to publicize official information. Foreign investors can also refer problems to the constitutionally mandated national ombudsman that is empowered to "defend the rights, freedoms, and lawful interests of individuals from unlawful or improper act or failures to act of the organs of public administration."[31]

Recommendations:

- The government should apply and enforce new legislation consistently. There needs to be a concentrated effort and donor support to focus on the implementation of existing laws, regulations and procedures, especially in the areas of taxation, customs, and bankruptcy. Until the government is able and willing to implement new laws, there is little incentive in the current culture for businesses and other legal professionals to do so.
- Public officials and legal professionals, including judges and government lawyers, need training on the these new laws and regulations and how to implement them.
- The government should pay outstanding financial obligations, such as contract liabilities and unpaid tax reimbursement balances, to foreign investors and Albanian nationals, and should eliminate unreasonable payment delays.
- Laws, regulations, and procedures should be more transparent. To this end, the Assembly should review new legislation and consider amending laws to: (1) reduce the amount of discretion vested in government officials, and (2) more clearly define ambiguous procedures. In the case of free zone developers and users, specific information required for application procedures and specific and clear criteria for approval and other conditions should be included in the law and regulations. Government officials should also be required to provide specific reasons for refusal of, e.g. permits, within a specified time limit.
- As required by the Albanian Constitution, an ombudsman was recently elected. The Ombudsman's office should hear charges by members of the public who have been treated unfairly by government officials. Non-governmental agencies interested in government accountability should encourage use of this forum. Additionally, the forthcoming Albanian Investment Promotion Agency should encourage foreign investors to report government violations of established rules to the Ombudsman office.
- The government should increase its ongoing efforts to disseminate information to foreign investors in Albania. Presently investors have difficulties in obtaining official copies of laws and procedures in English or

[30] Law No. 8503.
[31] Law No. 8503; AA. 60 of the Constitution.

Italian. For example, these laws and information should be posted on the internet and hard copies sent to Chambers of Commerce in each city and libraries. The forthcoming Albanian Investment Promotion Agency should focus on getting this and other relevant information out to investors.

- There needs to be a consistent process for consultation between government, civil society, interested parties and the parliament in drafting laws and regulations.

3. Corruption

50. Corruption in Albania has been and remains a serious problem at all levels of government. Despite the anti-corruption initiative launched in 1997, nepotism, political patronage and simple bribery are still commonplace in both business and government. According to recent studies, businesses, citizens and public officials paint a consistently grim picture of the prevalence and costs of corruption in Albania. Transparency International rates Albania 2.3 on the Corruption Perceptions Index for 1999. The index is on a scale of 0 (highly corrupt) to 10 (highly clean). The overall ranking placed Albania at 84, along with Georgia and Kazakhstan, out of 99.

51. Discussions with foreign investors indicate that corruption is one of the leading disincentives for investors seeking to establish businesses in Albania. Corruption is so pervasive that it raises the cost of conducting business in Albania. A "non-compliance culture" is prevalent in both the public and private sectors. The non-compliance culture encourages corruption, which in turn rewards "cheaters"--those who are willing to pay bribes--and punishes "non-cheaters" in the private sector. This ultimately creates an unleveled playing field between "cheaters" and "non-cheaters" in the private sector, whereby those who play by the rules are punished by harassment from the administration and are subject to higher fees. Higher costs coupled with "unfair" competitor pricing of illegal goods—namely where taxes and tariffs are not paid-- have a negative effect on investor profitability.[32] According to a recent EBRD study, the number one constraint to Albanian businesses is competition from companies in the 'gray economy'.[33]

52. The Bank of Albania estimates that ninety percent of enterprises present false accounting documents. According to an enterprise survey conducted by the Albanian Center for Research and Development in 1998, 50% of enterprises surveyed admitted paying bribes to officials that were worth about 8% of their turnover. Investors in a nationwide survey conducted by the World Bank said that on average, firms pay up to 10% of total revenues in unofficial payments to public officials.[34] Investors during FIAS' interviews echoed the frequency of such payments, and several investors estimated that the cost of payments to officials added 10 to 15% of the total cost of doing business in Albania. Investors simply

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[32] Investors estimated that illegal goods are commonly sold at 30% less than 'legal' goods, which roughly accounts for evasion of VAT (20%) and other duties and tax payments and fees.

[33] EBRD, "Taxes, Competition and Finance for Albanian Enterprises: Evidence from a Field Study", working paper number 54, July 2000.

[34] World Bank, World Business Environment Survey for Albania, 1998.

look at these payments or gifts as part of the normal cost of doing business, but these costs deter investment in the first place by reducing profits.

53. Bribery appears to be so rampant as to be an acceptable way for civil servants to augment their meager salaries and the only effective method for speeding up business transactions. Many investors interviewed by FIAS made reference to the phrase “will you buy me a coffee?” The solicitous phrase, used frequently by civil servants, invites discussion about special payments of gifts to speed up services or circumvent normal procedures or fees. For example, investors told numerous stories about customs officers delaying or blocking the entry of goods into Albania, or threatening to do so, in an effort to elicit payment of a bribe from the importer. Bribery also exists on a smaller scale, and has become part of the business culture in many ways. For example, investors report that in order to have a telephone line installed in any reasonable amount of time, a bribe is mandatory.

54. Many investors, constrained by corporate codes of conduct, feel distinctly disadvantaged by the uneven competition that exists in Albania because of corruption. This practice promotes illegal and corrupt business practices and denies people equal access and opportunity based on an objective evaluation of their business project. Instead, some investors are arbitrarily denied permission while others are granted permits and licenses based on connections and bribes. According to a recent survey, more than half of the firms interviewed claimed they do not participate in government procurements because competition is unfair. Almost 50% of those who did participate said they were required to pay bribes.[35] Corruption, therefore, deters foreign investors from doing business in Albania.[36]

55. For example, due to the difficulties of developers obtaining proper zoning permits, it is not unusual for a developer of urban property to proceed with construction without the proper permit or variance for legal construction of a building. The developers claim that it is both cheaper and easier to bribe a building inspector to bend the rules once the building is built than to submit to the discretionary process of obtaining a permit before construction. For foreign investors who are unwilling to proceed with construction illegally or resort to bribery, the alternative is frustrating and discouraging.

56. Unfortunately, bribery and corruption also extend to the judiciary. Bribery in the courts varies among the cases and areas of law in direct relation to the incentive of one party or another to bribe. Bribery is also a normal occurrence in criminal and civil cases. In civil cases, the amount of a bribe is generally proportional to the amount of money being contested, and often is paid by both parties. The Albanian judicial system is so fraught with the expectation that bribes will be forthcoming that the cycle is difficult to break. Foreign investors commonly fear that without bribes, courts will be biased against them. It will take considerable time before potential foreign investors evaluate Albania’s judicial system as a legitimate and reasonable forum in which to resolve business disputes.

[35] Ibid.
[36] FIAS heard numerous examples of investors who came to Albania from Germany or the Netherlands or other countries but soon left because of the level of corruption in the government.

57. To reduce the high level of corruption among judges, the Albanian government has created the Judicial Inspector's Office under the supervision of the High Council of Justice.[37] The Office's function is to evaluate the competency of district and appeals court judges, investigate any complaints against judges, and recommend appropriate disciplinary action.[38] The government, however, has been slow to clearly define the role of the Office.[39] Even if the Office had a well-defined action plan, it would be hindered from implementing it due to lack of funds.[40]

58. Customs administration is also not immune from corruption. In such situations, the importer faces several dilemmas. If s/he does not pay the bribe, the goods—which in many cases are perishable—will go nowhere. If s/he does pay the bribe, the goods will pass inspection, but his documentation will likely be inaccurate (i.e., documentation required for reimbursement, foreign exchange remittances, etc.), causing problems later on with other parts of administration. Often, payment of the demanded bribe results in a reduction or waiver, unofficially and unlawfully, of the duty that is legally owed. However, the goods would not have come into the country by legal means. As a practical matter, the cycle and chain of bribery and extortion in the customs authority deprive the importer of the ability to calculate his costs in advance. As with other forms of bribery, the foreign investor or importer either participates in the extortion or becomes a criminal participant in a customs duty fraud scheme, or he faces a lengthy, intentional delay of the importation.

59. There are indications that the incidence of bribery in customs may be starting to decline. In a 1998 survey, investors reported that both the highest frequency of unofficial payments and highest portion of all unofficial payments made to government officials were made when dealing with customs.[41] In 1999-2000, however, efforts to improve collection and reduce corruption at the borders have helped to increase customs revenues by 30%.

60. The Albanian government is working in cooperation with World Bank and other experts to increase official accountability and generally to deepen civil service reform. The recently adopted Law on the Status of Civil Servants is an attempt to provide a program by which the government may employ the best possible persons for available positions and award those jobs to its citizens on an equal basis without nepotism, favoritism, or political reward. The civil service is the backbone of the government and is important to the foreign investor. The Law is generally clear and comprehensive, incorporating most of the traditional protections common to such laws.

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[37] Constitution Watch, East European Constitutional Review, vol. 9, no. 1/2.
[38] Constitution Watch, East European Constitutional Review, vol. 9, no. 1/2.
[39] World Bank Legal and Judicial Reform Project.
[40] Constitution Watch, East European Constitutional Review, vol. 9, no. 1/2.
[41] World Bank, World Business Environment Survey for Albania, 1998.

Recommendations:

- The government should remove opportunities for corruption by eliminating unnecessary regulations or controls and improving transparency and accountability for the ones that must remain. The private sector should also be included in the national dialogue to combat corruption. The process of implementing anti corruption work affects everyone, including private sector representatives. An identification of administrative barriers to investment with an objective of streamlining and eliminating steps can not only facilitate investment, it also serves the purpose of reducing the opportunity for corruption. FIAS has worked with countries to build private-public partnerships and design the implementation phase of regulatory reform. Box 1 describes Latvia's experience of implementing regulatory reform which helped to curb corruption. Also, Box 6 on page 40 describes FIAS Administrative Barriers to Investment projects in some more detail. Further, by having an investment promotion agency focus on facilitating investment, steps and time required can be reduced and transparency of procedures increased. Where investors experience delays, harassment or bottlenecks, the investment promotion agency can bring selected issues to the attention of the board and to representative from the ministry or agency were the problem occurs.

- Top priority should be given to deepening civil service reform and anti-corruption efforts. Some progress has been made in reducing the level of smuggling and fraud; however, increased efforts should be placed on increasing accountability of public officials and re-evaluating staffing norms for pay scales/levels, performance standards, increasing staff morale, training, incentives to resist bribery, etc.

Box 1: Public/Private Partnership in Regulatory Reform in Latvia

In 1999, FIAS completed a study of administrative barriers to investment in Latvia, on behalf of the Latvian Development Agency (LDA). Among the problems faced by investors were a large number of unaccountable "Inspectorates", some of which were allegedly harassing businesses repeatedly and looking for bribes. A World Bank survey of corruption in Latvia also indicated that many inspectorates were perceived as problematic.

In a jointly-developed Action Plan based on the recommendations of the administrative barriers study, the Government of Latvia and representatives of the business community placed reform of the Inspectorates high on their list of priorities. The Government of Latvia also suggested that this item be included in the Structural Adjustment Loan they were negotiating with the World Bank.

During the implementation phase, FIAS worked closely with the LDA and the business community, while the World Bank Public Sector Management Team worked with the Latvian Civil Service Reform Secretariat and the Inspectorates, and the two "sides" worked together to develop a detailed reform program, including a series of workshops, development of a new Government regulation governing the work of Inspectorates and establishing the rights of "inspectees", new requirements for reporting on Inspection visits, brochures to publicize the new requirements, development of performance indicators, appeals mechanisms, and training programs to encourage a "client orientation" among the inspectorates. The Labor Inspectorate and the Fire Inspectorate volunteered as pilots for the training program and rapid implementation of the reforms.

The private sector, having been included in the design of the reforms, is pleased with the progress made over the past two years. They notice the new "client orientation" and the willingness of government inspectors to cooperate in explaining government regulations and compliance and appeals procedures. The complaints about "harassment" and corruption are noticeably reduced.

4. The Judiciary

61. Strong, well-written laws are essential for structuring Albania's legal system and providing a way for innovative economic recovery. Even so, the legal system will languish without competent institutions and public trust in them. The formal legal sector, led by the Judiciary, must play the primary role in creating, promulgating, interpreting and enforcing the rule of law. The judiciary must override and ultimately replace the bureaucracy left over from the communist era; it must be rebuilt and revitalized. An independent, well functioning judiciary is a fundamental factor in building an environment that attracts and retains FDI. Foreign investors need to be assured that under the law their rights will be protected and their disputes fairly adjudicated. These assurances are not given in Albania. The problems associated with the judiciary are hindering the effective functioning of the courts and dissuading foreign investors from establishing businesses in Albania.

62. Albania's judiciary continues to struggle to achieve the independence guaranteed by the country's new Constitution. Judicial independence and impartiality among judges are essential elements in protecting rights, safeguarding the supremacy of law and ensuring against the arbitrary exercise of power. Yet, judicial independence is among the most serious of problems within the Albanian judiciary. Despite the changes since 1989, Albanian courts still fall short in terms of providing a reliable venue for impartial, educated decisions. Currently, judges in Albania are poorly trained and many are selected on the basis of their loyalty to political parties. The judiciary remains subject to the coercive influence of political parties, as well as the executive branch. Those judges who demonstrate

independence from the government are allegedly subject to intimidation by these same government authorities. As a result of the system of judicial appointments, members of the judiciary often lack meaningful training and experience in the law.

63. Another major impediment to FDI, as noted by investors, is the general lack of experience dealing with and understanding market concepts, which act as a foundation for the newly adopted law in Albania. Because this lack of knowledge is particularly acute in the judiciary, training for new magistrates must be a priority for the government.

64. Enforcement of judicial decisions in Albania also continues to be a major problem. It is commonly acknowledged throughout the country that effective, reliable enforcement of civil judgments is rare. It is estimated that fewer than 10% of civil judgments are enforced.[42] Even in situations where court decisions adequately reflect the law, the administration's ability to carry out the decision through binding enforcement is deficient. The execution of judgments is dependent on the Office of the Executors. Although branch offices are maintained in all district courts, the Office is seriously understaffed, ill equipped, and poorly organized.[43]

65. Based on a number of interviews with domestic and foreign businesses operating in Albania, the enforcement of civil judgments is handled in an almost random manner by the courts. Yet, from the standpoint of the foreign investor, the consistent enforcement of civil judgments is a key business element. One investor interviewed by FIAS reported having attempted to enforce over 6,000 judgments of collateral loans; only 16 of the judgments were actually enforced.

66. Another area where courts have failed to enforce judgments is in the area of property rights. Court decisions as to the right of ownership to real property are commonly un-enforced. Furthermore, in cases where a court orders the government to compensate a former landowner,[44] the government often fails to pay the compensation which, in turn, reduces the government's credibility in the eyes of investors.

67. The judiciary also lacks the necessary resources to function effectively. Article 144 of the Albanian constitution provides that "the courts have a special budget, which they administer themselves. They propose their budget according to law." The courts simply do not have sufficient resources.

68. The Government of Albania has adopted a policy reform program to strengthen the legal and justice system and the rule of law. The World Bank recently approved a project to provide required resources for technical assistance, training, goods, and works that are needed to implement important aspects of this agenda. The task of legal and judicial reform in Albania is enormous, and if the government truly wishes to attract FDI, a priority should be placed on implementing measures needed to improve the rule of law.

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[42] It is estimated that only 3.9% of civil judgments were enforced in 1992, and 5.5% in 1996. According to the World Bank (report # 18658-ALB), the situation became even more difficult in the wake of the 1997 crisis.
[43] *Nations In Transit*, 1999.
[44] The Law on Restitution and Compensation of Ex-owner's, Law No. 7698 (1993).

Recommendations:

- Prioritize judiciary and court reform. The World Bank project includes crucial elements needed to improve the legal and justice system and the rule of law. An effort should be made to provide judicial training on the corporate laws of Albania, with special emphasis on intellectual property, tax, banking, bankruptcy, companies, secured lending and comparative law. Efforts should also be made to establish clear ethical standards by which judges should be evaluated.
- Other priority issues that should be addressed in reform efforts include:
  (a) Improvement of judgment enforcement;
  (b) Publication and dissemination of court decisions and legislation; and
  (c) Improvement of court and case management.

C. Specific issues

1. Lack of Adequate Infrastructure

69. A major constraint to private sector growth is the inadequate infrastructure. Complaints from foreign investors about infrastructure in Albania range from medium to severe dissatisfaction. Examples are abound of cases in which the lack of sufficient and reliable power, water, or transport have caused investors to face higher cost structures or to curtail economic activity.[45]

- **Energy and water.** Power outages and water shortages are common. Investors complained of low electricity supply, which is incapable of supporting industry. This forces many investors to incur the extra cost of purchasing generators. FIAS also heard reports of frequent power surges, resulting in destroyed or damaged machinery and equipment. Poor water supply and quality also add to costs because of the need to pump, store and even purify water, as leakages from parallel sewerage pipes commonly contaminate "clean" water.

- **Transportation and roads.** Given limited port facilities and almost non-existent railway links, road transport is virtually the only way goods can be traded into and out of Albania. Unfortunately, most roads in Albania are severely dilapidated. According to investors, the main road network in Albania is in much worse condition than its neighbors. It reportedly takes a truck 7 hours (5 ½ for a car) to go on a frequently traveled route to the south that is 250 kilometers long. About one-third of the population is effectively cut off from markets because rural roads are in poor condition and it appears

[45] Lack of adequate infrastructure was also cited as a specific bottleneck in for investment in tourism.

clear that road transportation is a major impediment to expanding exports. The country's main airport and port both require rehabilitation.

- **Telecommunications.** The needs in telecoms are enormous. According to the World Bank, there are only 1.5 telephone mainlines per 100 persons in Albania, compared to the CEE average of 18.2, and a high-income country average of 46.6.

70. Within the framework of the Stability Pact's Quick Start projects, over 1 billion Euros were pledged for infrastructure projects. While there has been a lot of effort to improve vital aspects of infrastructure, particularly the wider, regional dimension through the Stability Pact, in the eyes of the foreign investors, progress has been far too slow.

71. The lack of adequate infrastructure offers opportunities for private investment. In its privatization strategy, issued in 1998, the government declared its intention to privatize various infrastructure sectors, which should improve the provision of these services. A good framework for FDI in infrastructure includes several elements: [46]

- an overarching legal framework to provide the basis for private sector activity;
- a strategy of reform for each sector, explicitly incorporating the private sector as central element;
- effective institutions, and a clear and coherent allocation of powers and responsibilities among those institutions to manage the process; and
- a strong regulatory framework.

72. Albania, with assistance from World Bank and other international experts, has made some progress establishing the policies needed to support private investment in infrastructure. The Albanian concessions law[47] allows for private sector activity in water, transport, power, telecommunications, waste and industrial zone development. There are also separate legal frameworks allowing for privatization of power, water and telecommunications. The government has also developed sector reform strategies, with an important role given to the private sector. Yet progress to implement reforms and build strong regulatory frameworks has been slow and the conditions needed to attract investment have not been fully met. As a result, with the exception of telecoms, very little FDI has entered these sectors.

73. Investment in infrastructure projects can be risky both for the investor and host country. The projects are often technically complex, as are their financing structures. Investors spend a lot time assessing project risks to determine how to mitigate them and to evaluate project feasibility. For more information, please refer to FIAS Occasional Paper 12,

[46] See FIAS Occasional Paper 12, "Attracting Foreign Direct Investment into Infrastructure: Why is it so difficult?" Frank Sader, 2000.
[47] Law No. 7973 of July 26, 1995 on Concessions and Participation of Private Sector in Public Services and Infrastructure. There are also separate sector laws for power, water, telecommunications and a draft on industrial zones and free zones.

"Attracting Foreign Direct Investment into Infrastructure: Why is it so difficult?" Frank Sader, 2000.

74. The government can also take short-term interim measures to address existing infrastructure constraints by facilitating private sector development of industrial and free trade zones. International experience indicates that private investment can play both a major role in the development of the these zones and in the provision of on-site infrastructure. However, a necessary condition for the success of such zones is government commitment to building necessary off-site infrastructure.[48] To varying degrees, utilities can be provided by the private zone developers on-site at the location of a zone and charged directly to the zone tenants. Zones typically have their own water supply, and if large enough, dedicated waste treatment plants. Similarly, electric power generating capacity can be installed on-site and charged to the zone tenants. Internal electric grids are normally part of an export processing zone's infrastructure, developed at the same time as the rest of the project.

75. In addition to providing quality infrastructure services, zones can be structured to help buffer investors from other negative aspects in the investment climate, which can reduce investor uncertainty and costs. For example, if structured properly, they can create an environment of stability and protection, easy access to land, streamlined investment procedures, and reduced bureaucracy and opportunities for corruption. Zones can also be structured so that they create the necessary conditions to attract export-oriented FDI. While zones success stories are encouraging, many have not lived up to expectations and in several cases have resulted in outright failures. A 1992 World Bank study indicates that around 30 percent of zones have failed, while only 40 to 50 percent can be considered successful. An example of an unsuccessful zone is briefly described in Box 2.

[48] Zones may find it difficult to succeed if the country lacks good transportation infrastructure (roads, air and seaports, trucking and loading facilities), efficient and competitively priced power and telecoms, along with sufficient public utilities such as water and waste processing.

Box 2: Dakar Export Processing Zone:
Example of an Unsuccessful Zone

Dakar zone became operational in 1976 but did not achieve its objectives in creating employment, foreign exchange or attracting FDI. Employment peaked at 1200 in 1986 and fell back to 600 in 1990. Roughly 10 firms exported a total 4 million of FCFA (approx. $15 million) out of the zone, despite a relatively stable political environment and advantageous financing opportunities. The tax and customs incentives were also very competitive with Senegal's neighbors and competitors, including exemption from taxes on corporate income and dividends and exemptions from customs duties on machinery, inputs, semi-finished and finished goods.

Failure of the zone is attributable to several factors:

- First, bureaucratic red tape delayed potential investors' application process.
- Second, minimum employment (150 workers) requirements and investment floors (approx. $100,000) discouraged many national and foreign entrepreneurs. (The rule was later removed)
- Third, labor market rigidities, mandated by the government, made hiring and firing of workers difficult. While the Senegalese hourly wages and salaries were competitive with other countries such as Tunisia and Egypt, the workers' productivity was much lower, putting the zone at a disadvantage. (Lower productivity was due in part to labor market rigidities and in part to low education levels of workers).
- Fourth, the government did not provide standard rental factory space. It required investors to lease and build their own factories, thus discouraging FDI through the imposition of increased business risks.
- Finally, experts claimed that utilities and transport costs were relatively high in Senegal (up to 25 percent of the cost of the final export good).

Source: World Bank

Recommendations:

- PPI. The government should place a high priority on its continued work, with the World Bank and other experts, to prepare the infrastructure sectors for privatization. In addition, if the government wishes to be more proactive in its effort to attract FDI into these sectors, it should develop a strategy, in cooperation with international experts, to: (i) identify specific risks investors face in Albania, by sector; and (ii) take actions to reduce, or develop appropriate mechanisms to mitigate, these risks.

- Industrial zones. The government should encourage the development of industrial zones in a way that best suits Albania and adheres to international standards of best practice. In developing its strategy, the government needs to consider the importance of its role to provide off-site infrastructure to ensure the success of the zones. The government should also encourage private ownership and management of the zones and private investor development of the necessary on-site infrastructure services, including independent investment projects in power and water.

  Further, in developing the legal and regulatory framework, the government should carefully consider its objectives and develop a regime that meets the needs of foreign investors. The recent law on free zones (number 8636) is a step in the right direction, however, in FIAS' view this law lacked key features important for FDI, particularly in clarity of rights, obligations and transparence in approval mechanism. Annex A provides a brief discussion of some broad principles of international best practice that the government may wish to consider. If the government chooses to proceed along this path, FIAS is prepared to help develop a strategy and appropriate legal and regulatory framework to support industrial parks and free zones.

2. Access to Land and Construction

76. In April 1998, the parliament approved a number of laws that clarified and simplified the legal framework for land transactions. Access to land is a cornerstone of a market-based economy. Real property must be accessible for the efficient development of "business infrastructure" (commercial buildings and office space), allowing for the construction and sale of buildings for both business and residences. Access to land has been stymied in the case of Albania, which in turn has dampened development of related industries and progress toward mature industries.

77. Many investors complained about spending considerable time dealing with land-related issues. The most difficult problems are related to: access to land and construction permits; registration and title records; and a weak court system for enforcement of property rights.

78. **Foreign ownership of land.** The primary objective for Albania in the area of land ownership should be full and permanent ownership of land, for both domestic and foreign persons. Such a policy would attract more investment to Albania and provide stability regarding property ownership. Currently in Albania, for both urban and rural areas, foreign investors may rent real estate or premises for long periods (from 10 to 99 years). Albania's law on property ownership is based on "eternal user rights." This is not a right of ownership, but rather the right of perpetual use. This system can work well for foreign investors if supported by a strong and appropriate legal framework that protects the rights of both leases and leasors.

79. Foreign investors in Albania are prohibited from buying rural land and may only buy urban land if the value of investment is a least three times the value of the land purchased.[49] This provision, found in the Law on the Sale/Purchase of Sites, approved in July 1995, is designed to curb land purchases by foreigners for speculative purposes.

80. However, in order to purchase land, the investor must first build while renting the land. The investment must start within the period indicated in the contract (permission), the price of the land is set by the Council of Ministers, and the investor must provide a guarantee of 3% of total value. Should this time limit not be met, the permission is revoked and the guarantee is lost. The purchase is then subject to approval by the Finance Section of the District Council (local authorities) once the investor has obtained: (i) an activity license, for whatever sector he/she is active in, and (ii) authorization from the City Planning Office,

[49] In the case of housing construction, construction companies "buy" the land from the legitimate owners by giving them 18-23% of the building, including flats, shops on the first floor etc.

testifying that the actual investment on the property is indeed three times higher than the value of the land.

81. The current administrative procedure in place– i.e. minimum investment and government approval requirements for private transactions involving foreigners--is not an effective way to deal with the problem of land price speculation. If investors truly wish to speculate, they can surely find a way to do it. If the government's concern is indeed speculation, then this issue should be dealt with directly. Further, private land sales transactions reflect the 'market value', which should actually minimize opportunities for speculation. (Speculation opportunities usually arise in situations where the market value is not fully reflected in the sales price.) In other countries governments have resorted to a number of measures to limit or discourage land speculation and experience has shown that administrative measures, such requirements placed on foreign investors in Albania, are not very effective and can cause other bureaucratic problems. Other countries have seen better results by resorting to more legal (e.g. setting prevention clauses in standard contract) and fiscal (e.g. capital gain tax, and property tax based on the highest use value of the land) measures.

82. **Construction approvals process**. Prior to initiating construction (and likewise prior to receiving land purchase permission), the investor must receive construction approvals. Based on discussions with investors, the approval process is lengthy, discretionary and can be very costly. The system is ridden with overlapping reviews and inspections, involving multiple authorities with inconsistent standards, and incidences of corruption are reportedly high. First, the investor must submit the project design and feasibility study prepared by a licensed engineer to the Territory Planning Department in the Ministry of Public Works. Other approvals (clearances) must be obtained by the Ministry of Health (sanitary requirements), the Committee for Environment (environmental requirements), the Ministry of Labor (examination of labor issues and work permits), and the local water supply, electricity and waste management authorities.

83. The above documentation is then presented to the Municipal Territory Council, which meets once a month and screens requests for approval. The Council approves the construction site, technical construction project, construction permission, permission for destroying old buildings and permission for cutting any trees that might be on the construction site. Those projects that are approved by the Municipal Territory Council but go beyond its competencies (as specified in the "Law on Urban Planning" No. 8403 September 1998), are presented to the National Territory Council, which meets on an *ad hoc* basis once "a number" of cases are awaiting approval. The National Territory Council, headed by the Prime Minister, has complete discretion over its decisions and is not obligated to provide explanations in cases where projects are not approved. Prefectures can also temporarily block implementation of a decision taken at the Municipal level until the National Territory Council screens such acts.

84. Public interest in zoning, environment, building standards and other municipal responsibilities, such as safety, do indeed legitimize the need for government approval and monitoring in these areas. However, the problem in Albania is that the required licensing procedures and standards are generally not clear or transparent to the investor and, depending

on the situation, a variety of different approvals and clearances may need to be obtained from various governments agencies. For instance, the Committee of Tourism is involved in the approval process when the investment takes place in an area defined as 'touristic.' If the investment deals with agricultural land, the Ministry of Agriculture and Foodstuff must approve it. There is an urgent need to streamline the required procedures and increase transparency in criteria for granting approvals.

85. **Land registration and titles.** Regarding real property, Law No. 7843, for Registering Real Estate, provides a comprehensive land registration system. The system still needs to be implemented, and faced a set back during the civil unrest in 1997 when project records and equipment were damaged. In addition, there is still confusion about what constitutes proper title, and proper documentation remains problematic. Many people have had to turn to the unreliable records found in the *Hipoteka* offices (mortgage registries), even though the new registration offices are meant to replace the *Hipoteka* and *Cadeistre* offices where transactions of land or buildings are concerned.[50] It is not unusual for multiple persons to claim ownership of the same portion of land, all with various forms of title, some even dating back to the Ottoman Empire. Thus, Albania must continue to work on creating the property records for a new system to register immovable property and a policy to clarify the priorities and criterion against which competing claims can be judged. The term "immovable property" includes parcels of land as well as those constructions tied permanently to the land.

86. Although much progress has been made in the area of land registration with assistance from USAID, the inability to gain title to land still persists and is a major obstacle to investment. The National Land Registry is near completion for all agricultural land, which involves the registration of 1500 cadastral zones. A cadastral zone is the smallest administrative unit in the immovable property registration system. Work is progressing on the completion of the urban land registration. The work is being carried out through the "Immovable Property Registration System" (IPRS), composed of 33 District Registration Offices.

87. **Property expropriation and weak court system.** Another element feared by investors is 'subjective' interpretation of the law on expropriation of property for public interest, which includes: national roads; highways; gas and oil pipes; cultural heritage; public order and national security; construction of housing blocks; and construction of water and electricity works. Moreover, investors are concerned that former owners who have yet to settle their claims may rely on Albania's Constitution, which states simply that: "property should belong to the legitimate owner." It is not uncommon in Albania for several persons to claim to be the legitimate owner of a disputed section of land. This particularly affects foreign investors. Once an investment is made, the value of the land increases, thus raising the incentive to claim 'legitimate ownership' and increasing the number of individual claims to the land.[51]

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[50] See *Nations In Transit* 1999.

[51] While some individuals may possess 'official' title to the land from different periods of time, others carry false title documentation, which reportedly is obtained by bribing registration officials.

88. In the end, due to the difficult situation regarding land ownership, titles cannot be warranted or insured, nor can they be used as security by financial institutions, which impedes many smaller foreign investors' ability to access finance.

Recommendations:

- Registration. The government must increase its efforts to create a modern, unified and comprehensive land registration system to record, display and protect property rights. The government should make certain that necessary space and equipment are provided for the Immovable Property Registration Offices. The government should continue to improve the public's awareness of the new registration system.

- Land speculation. Prevent land speculation through legal and fiscal rather than administrative mechanisms. Concerns about potential speculation and/or intention to not develop land for productive purposes should be handled through protective clauses and penalties put in the relevant laws and model contracts. Capital gains tax and property tax based on use value rather than acquisition costs can also be used to discourage land speculation.

- Construction approvals. In order to reduce the length of the land and construction approvals process, the government should establish a clear policy and procedural framework in which investment projects can be easily and quickly developed. This can be achieved by:

  - Establishing clear, streamlined rules, procedures and standards;
  - Establishing time limits and stating the criteria for rejecting an application; and
  - Developing professional institutions with qualified staff.

  If requested by the government, FIAS would be glad to advise on streamlining construction and building approvals, as part of the Administrative Barriers to Investment project (refer to Box 6 on page 39).

- Industrial zones. The government should promote privately owned, developed and managed industrial zones. Of all the measures the government can take to improve the land (and infrastructure) situation for investors, emphasizing private development of industrial zones would be likely to generate results in the short to medium term (See Box 3). The government can also extend blanket approvals for developing or establishing businesses in industrial zones. Companies who locate in such zones would face far less difficulties in operationalizing their investments, and will generate higher level of employment in a shorter period of time. See Annex A for more discussion on issues related to developing industrial and free zones.

Box 3: Access to Land and Industrial Zones

Many governments have promoted the development of private industrial estates and zones to improve the land (and infrastructure) situation for investors.

Private development of multi-plot sites allows for the consolidation of utility hook-ups, building permits and other site development procedures under a single roof—that of the developer. In many countries, industrial zone developers receive blanket construction permits for standard factory buildings, which they can then construct on an as need basis without forcing individual investors to go through all the paperwork normally associated with building permits.

Private developers also solicit the installation of, or provide independently, power, telephone, water and other services for groups of tenants in advance. This allows interested investors to simply arrive and negotiate most required site development services and procedures directly with the private developer, simplifying the process and facilitating economies of scale.

3. Taxation

89. Albania is in the process of initiating a major revision of its tax laws. In cooperation with the IMF, Albania has focused on modernizing its tax system by simplifying laws and procedures and reducing the distortions prevalent in the country's tax system. The main reform efforts are aimed at raising tax revenues, limiting border custom corruption, and raising revenues targeted at social spending in order to reduce poverty and rebuild the country's poor infrastructure.

90. Despite these efforts to improve the overall tax system in Albania, companies doing business in Albania still experience significant problems, including ineffective tax reimbursement mechanisms, frequent and harassing inspector visits, corrupt tax and customs authorities, inconsistent application of tax rules and regulations, and burdensome and changing documentation requirements.

91. **Tax administration**. One of the most important tax issues highlighted by foreign investors is the need for tax administration reform. Foreign investors consistently report that the tax authorities do not consistently and fairly apply the tax law. They report that tax authorities have a general low level of knowledge and experience in the key areas of tax law; a general lack of ethics; and a poor and harassing attitude towards taxpayers. A memo by the Italian Investors Association illustrates the types and severity of problems faced by foreign investors (See Annex B). Foreign investors also note that tax procedures in Albania are "confusing and vague", leading to inconsistent interpretations.

92. An example of the misapplication the Tax Law is found under Article 30.1. Under 30.1 (a) the Law provides that the advance profit payment for the first four months of the year is based on the company's profits of the previous two years of operation, as reported in the company's financial statements. Article 30.1(b) of the Law provides that the tax for the remaining eight months of the year is based on the company's reported profits in the previous year alone.

93. Based on discussion with foreign investors and their representatives, up until last year the Albanian tax authorities had required advance payment of the profit tax to be based on an assumed profit of 10% of the turnover of the previous year's operations, regardless of whether the company actually recorded a profit. While this practice is no longer used, it has reportedly been substituted by another rule, that of fixed prepayment amounts between LEK 30,000 to 40,000 per month, independent of whether the taxpayer may have suffered losses. The tax authorities are also reportedly ignoring a provision of the tax law that says if a taxpayer suffers "serve under-performance" during the year (i.e., a 10% decrease in profit) then he can decrease the amount of prepayment.

94. Another misapplication of the tax laws involves start-up companies. Often, start-up companies, particularly foreign investors, anticipate a net loss for the first few years of operation. Article 30.4 of the Tax Law provides for the advance profit tax payment to be based on the company's proposed budget, which would result in a low or even zero profit tax for the first year of operation. Despite this legal mandate, foreign investors indicate that tax authorities frequently ignore it and "calculate" a tax based on an arbitrary estimate of the company's first year's profits.

95. To make obligatory the fulfillment of such prepayment requests, the tax authorities reportedly do not give to the taxpayer the VAT monthly declaration form and consequently the taxpayer is unable to issues the VAT completed and pay the VAT on or before the 14th of the month. The investors are then subject to penalties and interest applied on unpaid VAT.

96. Because of the tax authority's real and perceived power over companies doing business in Albania, many foreign investors simply want as little to do with the tax authority as possible. This "avoidance syndrome" even affects foreign investors who are entitled to a tax overpayment refund. Rather than raise the ire of the tax authority by filing a refund application, which reportedly leads to harassment, many foreign investors prefer to simply "roll over" the refund to future years.

97. Foreign investors also expressed significant concern about abuse of seizure powers by the tax authorities. As part of Albania's efforts to improve taxation collection, enforcement mechanisms in the tax laws were strengthened to enhance the rights of the tax authorities to seize assets of non-compliant taxpayers. For example, investors told FIAS that it is not uncommon for tax authorities to threaten to freeze a company's assets if the company does not abide by the tax agent's arbitrary demand for tax payment (e.g., the estimated annual profit tax).

98. When foreign investors do face an arbitrary decision of the tax authority, there is no effective avenue to appeal the decision. Letters, phone calls and visits to higher officials do not generally bring resolution to the disputed matter and there are no administrative appeals procedures.

99. **Taxation of export–oriented activity.** In order for Albania to be attractive to export-oriented FDI, investors stressed that Albania needs reliable mechanisms to ensure that export producers face world prices for their inputs. In Albania, there is no simple system of duty exemption or VAT refund for imported inputs used for export goods. In theory, some

exemptions exist under Albania's duty drawback and bonded warehouse facilities for exporters. However, investors still pay up-front import duties on the goods, which then require them to seek reimbursement for the paid duties. In doing so, investors face the same ineffective reimbursement mechanism that exist for prepaid corporate tax reimbursement (see discussion above).

100. Although entitled under law to the VAT reimbursements, exporters have faced severe delays in obtaining the refunds. As discussed above, many investors indicated that it is nearly impossible to obtain VAT forms unless they accept the tax authorities' arbitrary determination of the profit tax. Businesses in Albania that qualify for VAT reimbursement (i.e., for export or re-export) must wait six months to reconcile their bills. In addition, authorities must audit the submissions before reimbursements can be processed. Foreign investors report that VAT audits occur infrequently and reimbursements are constantly delayed. The failure by the government to honor the credits to which businesses are entitled further undermines the confidence in the tax authorities. This behavior reinforces the mutual suspicion that exists between the tax authorities and the tax paying business community.

101. Another problem with VAT payments involves the "draconian" way the tax authorities penalize the taxpayer for late payments. Businesses must pay the VAT on the 14^{th} of each month. If the payment is not received on this exact date, a 10% interest penalty is assessed against the business. Under current practices, a taxpayer is assessed the 10% penalty if payment is received by the authorities past that date. A common problem expressed by investors is that the taxpayer has likely ordered his bank to make payment by the 14^{th}, but because of the inefficiencies of the Albanian banking system, payment is not received until after the 14^{th} and the 10% penalty is charged to the taxpayer.

102. With assistance from the IMF, extensive legal redrafting of reimbursements legislation aimed at addressing these difficulties will take place over the next several months. These changes should help strengthen Albania's ability to promote export-oriented investment.

103. **Incentives.** While some form of tax incentives may benefit Albania, they are not the main basis for deciding whether to invest in a country such as Albania. Investors consider the whole investment climate, including the relevant characteristics of the market, when deciding whether or not to invest. Heavy government regulations are often perceived by foreign investors as disincentives to investment. Thus, rather than focus on providing "additional" incentives to attract FDI, Albania should focus on eliminating the general disincentives for FDI in Albania's current business climate.

104. As discussed in early sections, discretionary and arbitrary decisions by the government are one of the most significant disincentives for foreign investors. Under Albania's Law on Concessions, investors may receive some fiscal incentives, including tax exemptions. However, a major problem is that these exemptions are being implemented on a discretionary case-by-case basis without clear eligibility criteria. This effectively places the "favored" investor at an advantage over others and is perceived by foreign investors as an unfair process. As discussed earlier, practices that support discretionary approvals in laws and procedures should be removed and replaced with more clear and transparent rules and procedures. This principal is particularly important when introducing investment incentives in Albania where the incidence of corruption is common.

Box 4: The Pros and Cons of Tax Holidays

Benefits:

- Tax holidays provide large up-front benefits for start up companies that can start earning profits immediately.
- Tax holidays are primarily beneficial to firms that are either relatively mobile or short-term in nature. More specifically, tax holiday provisions tend to attract "footloose industries" that can move from one location to another, (or close and re-open under a new name), taking advantage of the most lucrative short-term incentives a country can offer. Such investments are usually relatively low value-added assembly operations, and are often labor intensive.
- As interest deductions are of no value to firms qualifying for tax holidays, firms are less encouraged to use debt financing and this can act to lower the risk of corporate bankruptcy.

Drawbacks:

- The implementation of tax holidays requires careful monitoring by the government and therefore added administrative cost for compliance by the recipient firm.
- As firms deduct depreciation costs during the tax holiday period, long-term investments are discriminated against in favor of short-lived capital. While tax holidays tend to attract footloose industries, they tend to discourage firms from undertaking substantially long term investments. This tends to bias investment away from high technology and high-value added activities.
- Tax holidays can easily lead to large revenue losses for governments. Revenue losses can occur from profitable firms not paying taxes during the tax holiday term, firms that abuse the system by closing and re-opening under a new name and registration, and also as a result of arbitrage transfer pricing schemes that allow horizontally and vertically integrated firms to minimize total corporate taxes.
- For US and Japanese multinationals qualifying for tax holidays, it is often the case that the value of the firm's tax holiday benefit will be added to their home tax liabilities, requiring an additional tax payment to the US or Japanese tax authorities. In these cases, the taxpayers in the host countries (those offering the tax holidays) would be subsidizing the treasuries of the US and Japan, rather than the investor, and the country therefore fails to attract US and Japanese firms.
- Tax holidays inevitably create distortions between firms that qualify for the incentives and those that do not. Older firms, even those that are making new investments to upgrade or expand operations, are forced to compete with start-ups who will enjoy the benefits of the tax holiday. Firms just below the minimum capital requirement are disadvantaged vis-à-vis firms just over the minimum capital requirement. Such arbitrary criteria create economic distortions that interfere with the normal functioning of the capital market and therefore reduce efficiency and overall competitiveness.
- Screening for eligibility almost inevitably involves a degree of discretion on the part of the authorities. Such discretion opens the possibility of corruption in decision-making, and indeed the track record of tax holidays is that they are often associated with corruption and kickbacks.

105. Further, after phasing out corporate profit tax holidays to investors in last year, Albania recently reintroduced a 10-year profit tax exemption for investments made in free zones (Law 8636, July 2000). Again, such a policy creates an unfair playing field between investors and discriminates against firms who are not able to relocate in free zones or "qualify" for free zone status. Moreover, the procedures of approvals and licensing for free zone eligibility extend discretionary decision–making powers to authorities, which opens the possibility of corruption. Box 4 presents some of the pros and cons of tax holidays.

106. When attempting to entice foreign direct investment, transition countries such as Albania should look for ways to lower the effective tax rates for investors, rather than rely on tax holidays. A broad definition of deductible expenses will lower taxable profit. A number of countries have implemented this form of taxation and, in doing so, have benefited both domestic and foreign investors. Albania might benefit by adopting international standards for accounting principles in general, including increased cost deductibility, loss-carrying forward provisions, faster depreciation, and possibly tax allowance or tax credits.[52] Such targeted incentives reward business initiative and risk-taking to encourage investment.

107. However, among the most effective economic policies used to stimulate investment (foreign and domestic) is lowering the corporate income tax rate.[53] Albania's statutory corporate income tax is 30%. Rates for neighboring countries include: Croatia (35%), Bulgaria (40%), Romania (38%), Slovenia (25%), Macedonia (15%) and Hungary (18%). Lowering the rate has several advantages over tax holidays. First, compliance and administration would be much easier, which may result in higher corporate tax revenues for the government. Second, investors look favorably upon lower tax rates because they signal to foreign investors the government's interest in encouraging businesses without undue government influence in the area of taxation. Finally a lower corporate tax rate is in itself the most significant incentive for foreign investors. Albania recognizes this. In a significant move, the Albanian government has announced that effective January 1, 2001, the corporate tax rate was reduced from 30% to 25%.

Recommendations:

- The government must immediately address and eliminate the misapplication of tax law and procedures. The Ministry of Finance must assume sufficient control of the tax authority and ensure that laws and procedures are being properly and consistently implemented.
- In cooperation with the IMF and other donors, all tax authority workers should undertake an extensive training program on the new law, regulations, procedures and financial accounting.
- The government should create an independent administrative appeals procedure for taxpayers to resolve a disputed decision by the tax authorities.
- The government must objectively enforce strong disciplinary measures against tax officials who arbitrarily misapply the tax laws and regulations.
- Reimbursements of VAT on imported inputs for export-oriented production should be paid promptly. An absolute time limit should be set (e.g., 90 days)

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[52] The provisions of Albania's Law on Profit Tax share many problems common to tax systems in countries of Central and Eastern Europe. In short, there are some limitations on deductions; depreciation rates for intangible assets are low; and loss carry – forward is limited.

[53] Once the tax burden is reasonable, and the administration reasonably honest and hassle-free, no additional lowering of effective tax rates is likely to stimulate FDI. In most of sub-Sahara African countries generous incentives virtually guarantee no taxes ever, yet no non-niche FDI comes anyway. A country such as Albania needs to collect taxes to improve its government, governance, education, infrastructure, etc.

by which repayment must be made, including interest paid for 60 days (90 days minus the 30 day original filling date).

- There should be a time limit on the duration given tax authorities to conduct VAT reimbursement audits. At the expiration of this time limit, late reimbursement should be subject to the same interest rate charged to delinquent taxpayers. The tax authorities should be required to account for rebates and penalty interest payments separately. These changes will provide the tax authorities with the incentive to execute audits in a timely manner and will help restore investor confidence.

4. Customs

108. On September 8, 2000, Albania became the 138th member of WTO. Currently, there are three basic customs rates for imports depending on the type of product: 5%, 10% and 18%. Albania has committed to continue its policy to reduce tariffs on imports. Current excise taxes on imported and domestically produced goods have been harmonized and a new customs code was adopted in 1999.

109. Despite these measures, nearly all firms with trade-related activities complained about the arbitrariness of the application of customs law and procedure. Investors complained that from one customs officer to another and from one point of entry to another, the documentation required and the level of customs duty varies.

110. Furthermore, under the most recent customs law, valuation floors were eliminated in favor of invoice valuation. Presently, customs officials use reference prices to determine the accuracy of invoice pricing. The problem experienced by investors is that the reference prices are applied inconsistently and are not disclosed to the importer who has no basis for easily challenging or appealing the value placed on the imported goods. Despite the work of the EU Customs Assistance Mission, it would help to enforce correct valuation and the application of consistent and correct duty.

111. The government of Albania is well aware of the severity of this problem, and is cooperating with the donor community to reform and improve the current system. Still, it should be made clear that foreign investors, especially those who view Albania as an export-platform to Europe and beyond, have many choices about where to locate. Albania cannot continue to rely on its relative abundance of inexpensive labor to attract investors (existing and new) given that the costs associated with inconsistent application of duties are high and persistent. Albania should prioritize customs reform and can benefit from lessons of experience of reform in other countries, such as Mexico, which have managed to reduce administrative time and costs to investors (see Box 5). Through an Administrative Barriers to Investment study, FIAS could advise the government on streamling customs procedures (see Box 6, page 40).

Box 5: Customs Reform in Mexico

In the late 1980s, Mexico initiated a major program of customs reform to accompany its new policy of trade liberalization. In addition to reducing tariffs, Mexico abolished official reference prices on all imports and almost all exports. From mid 1989, a radical reform was begun to modernize and improve efficiency of the customs process. The excessive costs of clearing customs were effectively another barrier to trade, because customs procedures did not keep pace with the trade reforms. Traders faced long processing delays and substantial undocumented costs in clearing merchandise. The authorities had effectively lost control of the customs process and revenues and the system had become bogged down in a mire of bureaucracy, ad hoc decision-making, and corruption. Customs regulations implied that every merchandise transaction had to be inspected individually, and hundreds of regulations could be applied. Enormous discretion and negotiating power were given to customs officers, with the predictable result that the authorities effectively lost control of the process.

Importers used private customs brokers to find their way around the myriad statutory obligations and provisions. Customs brokers were generally considered to be major accomplices in customs irregularities. Entry to the profession had been tightly controlled by means of licenses and the number of customs brokers remained roughly constant for over a decade.

As of January 1, 1990, Customs was integrated with general tax collection, which was based on voluntary declaration of tax liability. Similarly, customs duties in Mexico are now paid in advance of clearance procedures, and are made through commercial banks rather than directly to customs officials. A basic premise of the new system was that meaningful individual inspection of each transaction is impossible. A computer generated random selection process now determines which trade transactions are inspected. The authorities refined sampling techniques based on lessons learned from the information being gathered - for example, more frequent inspections where higher irregularities are found.

The number of steps in the customs process was reduced by two-third, and the reduction in processing time is a major source of savings for both the authorities and the traders. Entry to the formerly tightly controlled customs brokers' profession was freed-up, and fees are determined by market competition. The random inspection system is complemented by stiff fines and penalties for all parties involved if irregularities are discovered during the inspection. The normal processing time per transaction was cut from around 3 days to 20 minutes, or a maximum of 3 hours if selected for merchandise inspection. The volume of operations increased by 50% after six months at some of the main entry points, while daily collections adjusted for trade increased by over 10%.

5. Business Regulations

112. The four most common forms of Albanian businesses are: sole proprietorships, partnerships, limited liability companies (LLC) and joint stock companies. LLCs are the most common Albanian Corporate form. The Law 7639 on Commercial Companies is the Key Section of legislation governing business operations in Albania. In accordance with the Law for Registering Business, all business entities must register. The actual process of registration, however, is inefficient, burdensome and overly bureaucratic. Transparent and consistent procedures are lacking.

113. Licensing procedures and regulations are similarly burdensome. Based on extensive interviews, one of the most opaque and confusing issues faced by foreign investors in Albania is the seemingly basic question of whether a ministerial license is needed and what

permit is required for a particular activity. In Albania, the requirements for licenses and approvals have been steadily increasing over the past few years. It is unclear if these requirements are linked to a motivation to raise fees or is a leftover from Albania's previous command-economy, with its heavy emphasis on bureaucratic interference. Furthermore, foreign investors complain repeatedly that they cannot be certain if the documents submitted to a certain ministry for approval will satisfy the ministry. The problem is that clear rules are not available. Instead, there is a high degree of individual interpretation regarding documentation requirements by a public official, who is not accountable. In addition to the ambiguities in the licensing process, investors complain of lengthy procedures that are time-consuming and confusing.

114. Albania should streamline the bureaucratic registration and licensing requirements with a view to reducing the amount of time, paperwork and steps and increasing procedural transparency. FIAS has assisted numerous countries worldwide in this area (see Box 6).

Recommendations:

- Introduce a single business registration form.
- Set up a single contact point where a single registration form can de deposited.
- Introduce a system whereby public authorities can recognize enterprises by a single identification number.
- Ensure that different government departments avoid introducing duplicative or superfluous forms and/or contact points.
- Set clear targets in terms of deadlines for the processing of enterprises' requests and the granting of licenses or authorizations. Introduce, where appropriate, a system whereby an application is deemed to have been automatically granted if the administration has not responded before a fixed deadline.
- Use information technology and databases as much as possible for the transmission and authentication of information submitted and/or the exchange of information between public authorities.
- Licensing for many non-strategic industrial/manufacturing sectors should be eliminated. There are existing general laws in place to protect public policy and guide private sector activity related to labor, safety and environmental issues.
- In sectors where licensing and permits can be denied on a discretionary basis (e.g., free zones and construction) there needs to be a more transparent approval process.

Box 6: Administrative Barriers to Investment Study

FIAS has assisted numerous countries worldwide where administrative procedures to obtain necessary permits, licenses, approvals and clearances were suspected to pose a significant barrier to establishing and operating investment projects. Such an Administrative Barriers study investigates in detail all the key processes where investors come in contact with the public sector, including:

- Investment approvals/licenses;
- Other authorizations (incentives, exemptions, etc.);
- Company registration;
- Tax and foreign exchange registration and reporting;
- Registration with other authorities (statistical offices, social security, labor, etc.);
- Visas, work permits, and residence permits;
- Local and municipal business licenses;
- Access to land and land titles or long-term leases;
- Construction and building permits;
- Environmental permits and approvals;
- Utility connections (telephone, water, sewerage, electricity, gas, etc.);
- Selected sectoral approvals or licenses;
- Operational formalities such as import/export, labor, transport, taxes, etc.;
- Procedures to initiate a case in court.

The study reviews each of these processes in terms of the individual procedural steps, information requirements, associated (direct and indirect) costs, and time needed. It assesses how each process should work based on existing rules and regulations as well as how it works in practice based on an evaluation of investor experiences. Each process is then compared to international best practice and experiences made in other countries to place the country's performance in an international comparative context. Based on these findings, the study will make recommendations and suggestions on how to improve the most complicated and bureaucratic procedures.

The analysis, findings, and recommendations are presented and discussed in a workshop for senior government officials. The purpose of this workshop is to identify those procedures which pose the most significant impediments and bottlenecks to investors, and to develop an action plan and framework for initiating the appropriate policy reform measures.

PART TWO

IMPLICATIONS FOR INVESTMENT PROMOTION IN ALBANIA

CHAPTER III

PROMOTING ALBANIA AS A PLACE TO INVEST: STRATEGY AND FUNCTIONS OF PROMOTION

115. Focus should be placed on improving the investment climate (the 'product') before large amounts of resources are dedicated to promoting FDI (marketing the 'product'). There is no point in promoting a poor investment environment. Therefore, at this time FIAS recommends a selective investment promotion strategy to support efforts to improve the investment environment. When Albania makes progress on its investment climate, then some promotional efforts might be justified in order to speed the spread of this good news as appropriate.

116. As part of this project, FIAS was requested by the Minister of Privatization to advise the government on investment promotion strategy and institution strengthening. Further, the Ministry of Economic Cooperation and Trade and the Ministry of Finance have also expressed interest in establishing an investment promotion agency in Albania to replace AEDA. This chapter will make a brief presentation of the concepts and functions of investment promotion; set out recommendations for an investment promotion strategy support of the efforts being made to improve the investment environment in Albania; and will offer options for the institutional set up to implement the investment promotion strategy.

A. Concepts and Functions of Investment Promotion

117. Countries with very large markets (such as Brazil and China) and countries with very rich mineral or hydrocarbon resources (Kazakhstan, Ghana, Azerbaijan) can attract FDI without much effort. Aside from these, most companies only consider a small range of potential investment locations, and many countries are not even on their map. Small countries need to be particularly pro-active to get attention from international investors. If these countries offer world-class business environments, as did Singapore, Malaysia, and Ireland, then promotion can be a useful complement and increase or speed up the inflow of FDI. As Albania improves its business climate, if it truly wants to attract FDI, it will also have to develop a comprehensive, well-organized and pro-active investment promotion strategy in line with its resource base and investment climate.

118. Promoting and attracting FDI is a highly competitive and specialized activity, with an increasing number of countries actively seeking foreign investors and developing systematic promotional campaigns. The new competitive foreign investment environment has led countries to behave like companies in search of increased market share. Countries, like companies, have some degree of control and hence some ability to creatively use three variables in their overall marketing strategies:

- The "product", or the country itself as an investment site. Some aspects of the product—the country's endowments of size, population, location and natural resources—are beyond the ability of the government to change. Other factors, such as macro-economic stability, investment regime, and social and economic infrastructure are more under the influence of government policies.

- The "price", or the cost to the investor of locating and operating within the investment site. For governments, this usually means the cost of land and infrastructure, taxes, subsidies and similar price mechanisms. Governments can also affect investor costs by removing regulations, procedures, and deficiencies that increase business costs, but do not serve useful public functions.

- "Promotion", or activities that disseminate information about or attempt to create an image of the investment site and provide services for the prospective investor. The idea is to capitalize on a country's product and price advantages. By its success or failure, promotion can also be a mirror for government to see whether its price and product are indeed competitive in the market; and what it learns in its contact with investors can be the source of highly practical advice for guiding policy adjustments.

119. The promotion strategy formula needs to address two specific key questions: "What to promote" and "How to promote." "What to promote" depends the investment supply and demand equation—i.e. what the country has to offer in terms of its investment environment (e.g. physical and human resources, competitiveness of sectors, policy framework and governance, etc.)-- the corresponding business opportunities investors are looking for and the national development objectives. Decisions on what to promote are seldom made quickly and are often subject to review and adjustment over time. Initially, agencies usually focus on the sectors, countries and companies which are most familiar to them and which offer the best prospects for success. They refine and develop the approach over time and with experience.

120. Decisions on "how to promote" involve formulating a balance of four basic functions of investment promotion: image building, investment generation, investor servicing and policy advocacy. The balance between these functions varies from one country to another and can change over time. It depends on the needs of a country at the time, the domestic and international economic environment, and resources and priorities of a government. According to international best practice[54], each of the key functions should be present to some degree when conducting investment promotion. National circumstances should guide the relative emphasis given to one or another and how the mix of these functions should evolve over time.

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[54] Considerable experience now exists on the strategies and techniques of promotion of FDI and on what works and what does not. See "Marketing a Country", by Louis T Wells and Alvin A Wint, FIAS Occasional Paper, March 2000.

1. Image-building

121. Image building is the function of creating the perception of a country as an attractive site for international investment, based in reality. Activities commonly associated with image-building include fact sheets, newsletters, reports, speeches, literature including a flagship brochure, general and targeted advertising, public relations events, and the generation of favorable news stories by cultivating journalists, etc. Many of these activities, and especially general advertising, are very expensive and care is needed to avoid useless and wasteful activities. Few countries can afford international advertising campaigns, and where advertising campaigns are deemed necessary, they need to be carefully structured and timed.

122. The essential task of image building is not specifically to call the attention to the many investment opportunities that the country may possess, but to market the country as a whole. Just as consumers are more likely to buy a product if the brand name is known and trusted, so are foreign investors likely to be more receptive to the particular advantages of investing in a country if "brand A" itself, for example, connotes a positive image.[55]

123. Image building is only useful when investors' image of a country as a location for investment is less favorable than reality, and where the fundamental prerequisites for attracting investment are present. Countries that stand to benefit most from image building are those where change has been rapid and positive, but not yet widely known. Also, if a country wishes to promote its name in a market where it is relatively unknown, image building serves the further purpose of establishing a necessary minimum level of positive awareness. The extensive use of image building activities to enhance a country's image abroad can be sensible and beneficial to investment promotion when it is conducted at the right time, but it can be wasteful and counterproductive if conducted too early and when the country in reality offers a "bad product" to investors.

2. Investment Generation

124. Investment generation involves identifying potential investors who are most likely to be interested in the country, developing a strategy to contact them, and working with them with the objective of having them commit to an investment. Specific techniques include: mail and phone campaigns; investment seminars; in-bound and out-bound missions; and direct marketing.

125. The most effective technique involves direct presentations to specific targeted firms. The first step involves identifying opportunities in host country industries and sectors. Firms

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[55] Effective image building is usually preceded by obtaining an "image assessment", or baseline measure of how a country is actually perceived. The baseline check can seek to capture perceptions of a general nature through, for example, reviewing editorials and periodical literature in targeted countries and regions. The baseline check can also measure more specific information, e.g. how freight liners perceive "Country X" as a trans-shipment site against a group of comparative countries. To be effective, image building must be truthful. Investors are expert buyers, and making false claims can do damage to a country's reputation and thus be counter-productive. With an image assessment, a country has an objective basis for identifying areas where its image fails to capture the advantages the country wishes to emphasize. Armed with such information, a country can develop appropriate promotional themes, and can design and launch campaigns to remedy the situation.

that may want to invest in those industries are then identified and specific decision-makers within these firms are targeted for presentations by the promotion agency. The presentation outlines the investment climate in the country and tries to get the decision-maker to visit the country to investigate an opportunity. When the investor visits the country, the promotion agency prepares an itinerary and provides whatever information is requested. The agency then tries to persuade the firm to make an investment commitment.

126. Decisions on what companies, sectors and industries to target take time, research, information, and experience. Investment generation techniques can be very expensive and experience shows that the proper use of these techniques can produce meager results unless done well and at the right time. The techniques require careful planning and follow-up and agencies need to be skilled in knowing when to use and how to use the different techniques.

3. Investor Servicing

127. Investor servicing is the core component of all investment promotion strategies. Investor servicing can be divided into two components: pre-registration and post-registration. Pre-registration servicing, or facilitation, focuses on assisting potential investors into operation as quickly as possible, including helping them access information, organizing site visits, introducing them to organizations in the public and private sectors, helping them obtain required clearances and permits from the government, and assisting them to overcome the numerous problems that arise in setting up investment projects. Investor tracking and follow-up procedures are required and these should be automated to the greatest extent possible, to save time for clients.

128. Engaging in facilitation requires well-qualified people who understand how to work with the Ministries and government agencies involved in the entire investment process, including knowledge of all the potential permits, registrations, and approvals an investor may need to set up operations. In the course of assisting investors, the agency will become a leading authority on the weak points and slow stages of the investment process. This knowledge and client base can make it an informed and effective advocate for investor-oriented policy reform.

129. Post-registration, or “after care”, services are also a valuable extension of the investor service function. Experience shows that satisfied investors and realized projects provide the best promotional tool for encouraging more investments. First, existing investors are usually the most important source of future FDI through expansions of their operations. Second, there is no better advertisement to prospective investors on a site visit to the country, than to hear that the existing investors are satisfied with their investment experience there.

130. Investor servicing can be conducted in a pro-active or reactive manner. A pro-active approach would require the agency to actively seek to assist the investor and follow up on progress, while the reactive approach focuses on responding to requests for assistance. International experience shows that pro-active investor facilitation services can significantly increase the realization of projects. For example, Singapore, which has one of the best investor servicing programs in the world, claims a realization rate of 80 percent, which means that four out of five registered investments there are realized within five years. Other

countries in the Asia region claim realization rates that range from 60 to 20 percent. A pro-active approach is costly, however, and a strategic decision is required on which of the two approaches to follow.

4. Policy Feedback and Advocacy Function

131. Promotional agencies are in charge of selling the product of investing in a country. They are uniquely positioned to receive a flow of feedback information from private investors, “the market”, on how the country compares as an investment destination, including its strengths and weaknesses. Authorities should be able to tap into this information and take it into account to strengthen existing policies or design new ones, which can help to influence the price and quality of the product. Just as executives of large companies cannot afford to ignore the feedback of its sales force on consumer preferences, government officials should take note of the message of the market.

132. Most, if not all, of the top investment promotion agencies around the world carry out this function. In implementing this function the agency will need to develop a capability and structure to undertake it. To do this requires a suitably qualified and experienced manager in this area. The agency needs to be able to convince the government and the investment community that it has the ability to perform the task, and to develop the clout and status to have its views reflected in new policies or policy changes.

B. Strategy of Investment Promotion for Albania

1. Current and Past Investment Promotion Activities

133. Until now, FDI promotion has not been a high priority for the authorities in Albania. As a result of the failure to implement policy reforms, or to develop a sensible investment promotion strategy, FDI flows to the country have remained disappointing[56]. Prior to the civil disturbances of 1997, interest by foreign investors was higher with the prior investment promotion agency’s records showing 520 meetings with foreign companies in 1994; 270 meetings in 1995; and 320 meetings in 1996. Many of these meetings focused on trade rather than investment, and less than 5% of these potential investors actually investing in the country, but the evidence points to some interest by German, Greek, Italian, and Turkish investors in the country. This interest dropped in recent years, but with an improving environment it is likely that it can be reactivated again.

134. The lack of government commitment to FDI was also reflected in weak institutional support for investment promotion. All three investment promotion agencies established since 1991 have failed. The Foreign Investment Agency, formed in October 1991, was in charge of coordinating investment promotion on a national basis. The agency was under the Ministry of Trade and had no formal authority or power regarding its neither functions/duties nor formal linkages with the other ministries, which also handled promotional functions

[56] As mentioned previously, inflows of only $43 million were recorded for 1999 although the position for the year 2000 is more positive with inflows of $100 million predicted by the authorities

abroad. Efforts to work with other ministries resulted in conflict and the agency became ineffective and ultimately failed.

135. Then in 1993, the Albanian Center for Foreign Investment Promotion replaced its predecessor by decree. This time the agency was placed under the Council of Ministers. Yet again, the agency had no real authority and was given no formal linkages within the government and across ministries. Relations with ministries were informal and based on personal contacts. Worse yet, the agency had no one to report to—not even a board of directors—and the Council of Ministers was not actively committed to promoting the agency's mandate.

136. In the wake of the second agency's failure, the Albania Economic Development Agency, AEDA, was created in 1998, as a public sector joint-stock company reporting to the Ministry of Privatization and Public Economy. A board of five directors was formed this time, composed of government representatives from ministries of privatization, economic cooperation and trade, and finance, the countries statistical agency (INSTAT), and a member of the private sector, whose seat remains vacant. Once again, no formal linkages across ministries were made to facilitate investment promotion. In addition, the agency was given no operational budget and did not have a business plan. The agency now finds itself in a situation similar to its predecessors—a marginalized body that has no real authority, credibility or power to execute its mandate.

137. Moreover, AEDA's mandate was expanded to include numerous tasks and duties with the broad objective of promoting economic development in Albania, including:

- Collection and distribution of economic, financial and commercial information from state-owned, private, national and international institutions.
- Organization of conferences, seminars, roundtables and publication of materials to promote commercial exchanges and private investment in Albania.
- Sectoral studies to identify investment opportunities.
- Promotion of the privatization process in Albania.
- Promotion of Albania exports and commercial exchanges.
- Assistance to local and foreign investors for information and consulting services, and contract finalization.
- Coordination of information and cooperation with other similar agencies, chambers of commerce and industry, business associations, NGOs and international organizations active in promoting economic development in Albania, and
- Publication of a government financial newspaper.

138. AEDA's current mandate of activities is far too wide to be an effective investment promotion agency. It includes publishing a financial newspaper, offering consulting services, promotion of exports, etc. Production of the economic newspaper, for example, consumes

nearly half of the monthly expenditures, generates insignificant revenues and adds no value to its mandate. Offering consulting services conflicts with investment promotion activities and the two activities cannot rest side by side in the same agency. In addition to lack of focus, the agency does not have sufficient funding and support needed to execute even the most basic promotional activities in its mandate, let alone carry out all of the tasks drawn up in its mandate. The result is that AEDA relies financially on funding they raise on an *ad hoc* basis, and all staff, regardless of specialization or existing work program/duties, are reassigned to the work on whatever activity comes up with funding.[57] In sum, the broad mandate of AEDA is confusing, conflicting and lacks purpose and focus, and funding is not available to implement most of its activities.

139. The establishment of yet another investment promotion agency will not, of itself, bring about the critical changes needed in the investment climate. This can only be done through fundamental changes in the policy environment facing investors. If the authorities in Albania succeed in making these policy changes then international experience shows that increased FDI inflows can usefully be promoted as the investment climate improves. But without an improvement in the environment, no amount of investment promotion, nor juggling of different institutional arrangements for promotion, is likely to have a significant impact. In contrast, the commitment to deeper policy reforms combined with an appropriate investment promotion strategy, and a properly structured investment promotional agency, which avoids past mistakes, can deliver the type of positive results sought by the government.

2. Elements of a Future Investment Promotion Strategy

140. Against the background of limited inflows of FDI to date, the poor ranking of the country as a location in surveys of international investors, and of three failed attempts to establish an investment promotion institution, there is a need for fundamental policy and procedural changes if FDI is to be attracted to the country in the levels desired. As noted in the main body (or Part One) of this report the country has several potential inherent attractions for FDI, which the available evidence suggests can only be realized if changes are made in the investment climate operating in the country.

141. In addition to deepening reform, experience elsewhere suggests that the authorities in Albania should be realistic and practical in defining an investment promotion strategy for the country. Recent performance, as reflected in actual FDI inflows, means that modest ambitions need to be set for any such strategy in the short term. As performance improves, and as the impact of policy reforms becomes more evident, then more ambitious expectations can be defined for this strategy.

142. In view of the current realities, FIAS recommends developing a two phase investment promotion strategy that supports efforts to improve the investment climate. In the first phase, the key areas of a suitable strategy for Albania include: (i) supporting the privatization program, which offers the most potential for FDI in the near term implying that the bulk of

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[57] Nearly all of AEDA's funds over the past two years came from contract work through the Ministry of Privatization to support the privatization program.

promotional efforts should be focused here; (ii) providing investor services--namely through much needed information to investors, facilitation with a view to increasing the 'conversion' ratio of interested investors into actual investors, streamlining investment procedures, and encouraging existing investors to expand; and (iii) advocating policy reforms to improve the investment climate.

143. In the second phase, once improvements are made in the investment climate, the investment promotion strategy should expand to incorporate suitable image building and more targeted investor generation activities. A more focused approach to investment generation and 'What to Promote' can be developed over time.

144. How and what to promote? As described above, FIAS recommends that promotional activities in Albania be limited and selective in the first phase, with priority given to promoting privatization, investor servicing and policy advocacy. Conditions are not appropriate for investment generation and image building. Use of these promotional techniques should await important improvements in the investment climate of the country. Table 3 places the four investment promotion techniques within a time and priority framework suitable for Albania.

Table 3: Recommended Mix of Investment Promotion Techniques for Albania

	Phase one: Short-term (2001-2004)	**Phase two: Medium and Longer-term (beyond 2004)**
Investor servicing	High Priority	High Priority
Policy advocacy	High Priority – Focus on improving product "Albania"	High Priority—improving the business climate will be a long-term task
Investment generation	Very selective--focusing on the privatization program	Medium to High Priority--depending on pace of improvements and targeted sectors
Image building	Too soon—Focus first on improving product "Albania", and as improvements are made and successful deals made, get the word out to investors	Very Selective—Use of image building will depend on pace and nature of improvements

145. Investor servicing. For small countries like Albania, an effective and efficient investor servicing function is important to successful FDI promotion. In a country where the regulations are still difficult, information hard to find, and many institutions still weak, this function is badly needed. It is a highly cost-effective form of investment promotion and should, it is proposed, focus on actions to ensure that visiting potential investors end up becoming satisfied actual investors. Investment servicing activities in Albania should focus first on improving the registration process, where long delays occur, and on pre-registration servicing, which is non-existent at present.

146. Investor servicing should concentrate on converting potential investors into actual investors. Existing investors then become key to the future investment promotion strategy of the country, and should become an important source of future FDI flows. Moreover, satisfied investors are one of the best advertisements a country can demonstrate to potential new investors.

147. Some servicing is offered to incoming companies now, but room exists for considerable improvement in the following areas:

- informing investors of the investment promotion agency together with contact details;
- providing information on a range of topics, including economic laws, rules, procedures and policies;
- arranging more airport-to-airport "site visits" including key introductions to people in both the private and public sectors;
- introducing an investor tracking system to follow-up on all potential investors; and
- introducing office management systems for these and all other promotion procedures.

148. Other areas requiring improvement are actions to speed up registration, public sector clearance process, and utilities access. In these areas actions are needed to:

- define all steps in the process and the procedures required at each step;
- take a pro-active role in eliminating unnecessary steps and streamlining those remaining; and
- introduce practical one-stop-servicing to overcome the long delays now occurring.

149. Considerable room exists for removing administrative barriers to investment that exist in Albania, and this work should become a central part of efforts to improve the business climate. This can probably best be done by initially undertaking a study of the administrative barriers to investment, and then using its recommendations as a blueprint for reform.

150. A range of post-registration servicing activities are also recommended including:

- action to ensure that promised permits and clearances, including planning permissions are delivered quickly;
- action to help facilitate access to land, buildings and infrastructure; and
- assistance with customs, immigration, labor, taxation and other such issues, in day to day problems covering project matters.

151. **Policy Advocacy**. FIAS also recommends that the future investment promotion strategy give high priority to advocating policy reforms designed to improve the investment climate in the country. To do this, it is proposed that the agency charged with implementing the strategy use its contacts with investors to identify priority policy reforms and proposed

solutions to increase FDI flows, and to bring these to the attention of government. It is not proposed that the agency become a policy research body, rather it is proposed that it listen to potential FDI investors and learn from them what reforms are required, and how these reforms can be implemented. In doing this work the agency can use respected academic or policy research people in the country to help prepare proposals for government consideration.

152. **Investment generation**. During phase one, investment generation activities in the short term should be highly selective and should focus on promoting:

- Albania's privatization program;
- private investment in infrastructure where there is an adequate regulatory framework; and
- investment in tourism infrastructure.

153. Much of this form of investment generation is project specific and requires detailed statements on the projects being promoted, lists of potential international companies, contact with key decision makers in these international companies, and follow-up with those showing an interest in investment. Over time this project specific promotion is likely to give way to country promotion activities aimed at attracting greenfield FDI.

154. A more focused approach to investment generation can be developed in time and with experience. In phase two, when improvements are made to the investment climate, and to the investment process, it will be the time to implement a more focused or targeted approach. Success in the privatization program will help in the launch of a more targeted investor generation campaign later. Much work is required, however, before a targeted approach is feasible or practical. For the time being FIAS is of the view that the priorities are to formulate, and then implement a more modest investment promotion strategy for the country along the lines outlined here.

155. **Image building.** Image building is most appropriate when investors' image of a country as a location for investment is less favorable than reality, and where the fundamental prerequisites for attracting investment are present. Image building can be highly wasteful and counterproductive if conducted too early and when the country in reality offers a relatively insufficient 'product' to investors. FIAS recommends that, in the short term, no image building activities be undertaken in Albania. Only if the policy environment improves substantially and practically, should image building activities be conducted to get the word out to the international investor community.

C. Developing a New Institutional Framework for Promotion

156. The institutional framework for promoting FDI in Albania is on the verge of changing once again. At the time of FIAS' field visit, the government expressed interest in creating a new institution to promote foreign investment, including a one-stop-shop for providing investor facilitation services. At the same time, there was some discussion in government circles and in the donor community regarding the future role and mandate of AEDA. In an

informal note to AEDA in May 2000, FIAS provided preliminary assistance on guidelines and recommendations for the formation of a new investment promotion agency. This section builds on that initial dialogue, and on a subsequent workshop which discussed the institutional options open to the government.

157. FIAS believes that Albania can enhance the marketing of the country and investor servicing by establishing a small, focused and pro-active promotion institution according to international best practice that supports efforts to improve the investment climate. This institution can take the lead in formulating an investment promotion strategy for the country, and in subsequently implementing that strategy. Without strong government commitment to devoting resources and giving institutional support, the effectiveness and success of the agency will be limited. The agency needs to be established under a suitable legal instrument. Moreover, it needs a suitable and specific mandate; appropriate organizational structure and strategy, staffing and skills mix; operating systems and procedures; and private sector involvement.

158. The authorities in Albania need to consider the issues involved in each of these topics and not dash into establishing another ineffective structure. After three efforts to establish an institution already there is little point in rushing into a fourth unsuccessful venture. Careful consideration is called for so that proper decisions are made, and an appropriate institution established. In the following sections FIAS highlights issues that need resolution, and offers what it considers to be the best way forward in the short and medium term.

1. Legal Basis and Mandate

159. A solid legal basis and a clearly defined mandate, are essential ingredients to establishing an effective FDI promotion body. The legal instrument used to establish the body should provide its authority, powers and control measures; should define its functions and responsibilities; its external structure including its links with government and the private sector; the composition and selection process of its Board or governing body; its staffing and reporting arrangements; and how it is to be funded. Each of these items influences effectiveness, and if they are not properly catered for in the legal structure underpinning the organization, then it will suffer in its work.

160. Without a well-defined and robust legal basis, an FDI promotion agency is unlikely to survive the many crises and attacks it will face, or withstand the repeated and often unwarranted intrusions likely to come from government or private sector bodies, or attract the quality of staff and board members necessary. Albania's own experience shows that a weak institution with a weak legal basis can be made ineffective in the face of ministerial conflicts and government changes.

161. Experience elsewhere shows that the most successful investment promotion bodies worldwide are statutory bodies, and the strongest of those are established under an act of parliament. Weaker legal instruments sometimes used are government decisions or decrees, and/or ministerial orders. These are weaker because they can be easily overturned, and can be dropped or modified with a change of government, or by a change in policy of an individual government.

162. FIAS is aware that a draft law to establish an FDI promotion agency exists in Albania, and if a well-structured law can be enacted in parliament then this is the best way to establish the proposed agency. However, FIAS was strongly advised, at the time of its field visit to the country, that it would not be possible to have a meaningful act of this type passed by parliament at this stage. The view in the country at that time was that the necessary political consensus did not exist to approve, and support, such an act.

163. If this is so, and if the political consensus does not exist across the major political parties for the approval of this act, and for maintaining this support subsequently, then the merits of seeking parliamentary approval in the first case are questionable, and may even be counterproductive. To be meaningful the act should be well constructed, and it should attract support across the political divide. If not, the new law may be seen as politically partisan, and may be rescinded by a subsequent government, as has happened in other countries.

164. On the other hand, if the necessary political consensus exists to enact a well-structured act, then this approach can provide the best and strongest legal basis for the new agency, and is to be recommended.

165. The option of establishing the agency as a joint stock company, has also been considered in Albania, but this is not a realistic option in FIAS' view. The reason is because such companies in Albania cannot legally receive exchequer funds, and budgetary funds are essential to the effective operations of FDI promotion agencies. Donor funding can meet short-term needs, but in the longer term the experience of country after country is that FDI promotion needs public sector funding. Otherwise promotional activity it will not happen to any significant degree.

166. As an alternative to establishing the agency under an act of parliament, another option, albeit a weaker one, is to establish it by way of a government decision or decree. This approach can work as a short-term solution although it is not the approach used in the best performing investment promotion agencies worldwide. In the medium to long term, the decree option can and should be strengthened, and the agency should be underpinned by an act of parliament, if not now, then as soon as possible.

167. Albania can opt to establish the agency with a number of mandates, or it can focus it on the single mandate of FDI promotion. A multiple mandate agency can be made responsible for export, tourism, SME and FDI promotion, or alternatively separate agencies can be given responsibility for each of these different activities. Experience elsewhere is that the single mandate approach is preferable to the multiple one, because each of these functions are complex in themselves, all are critical to development plans in most countries, and each needs to be implemented successfully. Moreover little synergy exists among the different activities, and where multiple mandates have been combined in a single agency separate departments have implemented them. As a result governments have progressively moved to establish mostly stand alone FDI promotion bodies, and FIAS considers this approach as likely to be most effective in Albania.

168. FIAS considers that the single mandate of FDI promotion should require and empower the agency to undertake servicing and facilitation activities; policy advocacy on the

investment climate; networking and coordinating investment promotion activities across the public and private sector; investment generation and image building;[58] and the installation of procedures and facilities necessary to the implementation of these different promotional elements. These are the elements of FDI promotion and the ability and responsibility of the agency to implement them for the country should be specified in the legal expression of its mandate.

169. The degree to which these individual promotional powers are used will depend on the promotional strategy of the time, and their relative importance will change over time. Initially servicing and facilitating incoming investors requirements should receive top priority, and it is proposed that the agency operate as a one-stop service center for FDI in reflecting this priority.

2. Government and Private Sector Links

170. The legal instrument to establish the investment promotion function should also define the external structure and governance mechanisms of the agency, and preferably allow it to define its own internal structures. In defining the external structural arrangements the agency's links to government, should be specified, as should its reporting requirements to government, its links to the private sector, and the size and selection procedures for its governing board.

171. In practice all FDI promotion agencies worldwide are linked to and report to governments, as without this strong link they cannot work effectively. Many are actually located within government, a number of highly successful ones are established as para-statal bodies, and a few have been set up as private sector organizations. Those set up by the private sector require on-going donor funding, and most have been short lived. Even private sector agencies need to develop close links with government or they cannot operate.

172. Many countries require the promotional body to report to the Prime Minister's office in the hope that this will lead to more effective facilitation across individual ministries, and reduce inter-ministerial conflicts. Other countries opt for a reporting relationship to a ministry such as industry, or privatization, which is strongly linked to FDI flows. In the end a pragmatic decision as to the best reporting relationship is required for individual countries.

a. Reporting to the Government

173. Strong views exist in Albania as to which part of the government the new investment promotion agency should report to, and good reasons exist for the different options put forward. But FIAS is of the view that the dominant consideration right now is that any new promotional agency established should be given the best possible chance of surviving and of

[58] While the mandate should indeed include these best practice FDI promotion techniques, the strategy adopted by the agency, and approved by the Board, in the first phase should use investor generator and image building techniques in a highly selective manner, as described previously in the report. As the situation in Albania evolves, the mandate should be flexible to adapt to the new circumstances, which may justify a more targeted investor generation approach or launching image building campaigns.

being effective. In view of this, FIAS suggests that two options be carefully considered in phase one of the two-phase approach outlined above. Each option has its pros and cons and the government will ultimately have to weigh the trade-offs in line with their objectives and special circumstances.

OPTION 1. Broaden the institution being established to promote privatization into a foreign investment promotion agency under the Minister of Privatization. In the short term, the most important asset for promoting FDI in Albania is the privatization program, and privatization is therefore expected to be the single largest source of FDI. The success of this program is key and the promotional functions of the program should not be given to a second party. Taking the program's promotional work out of the Ministry of Privatization and other ministries directly working on this program, can create confusion and may be the cause of slip-ups in the program, which Albania simply cannot afford.

FIAS has been informed that the government has established institutional structures to promote FDI in privatization. It is our understanding that under this arrangement, the privatization ministry will coordinate promotional activity with the different relevant ministries and experts responsible for promoting the privatization program. This option proposes expanding the coordinating unit under the Ministry of Privatization to include the functions of a national FDI promotion unit, sitting with one body in the Ministry of Privatization. However, if the authorities have formally split the promotion functions of privatization across several ministries, leaving a very limited promotional role to the Ministry of Privatization, then an agency under this ministry could encounter operational difficulties.

A risk associated with establishing the agency under the Ministry of Privatization is that other promotional activities, such as investor servicing of greenfield FDI and policy advocacy may be marginalized or less effective. In order to strengthen the agency’s incentive to execute these functions, its mandate should explicitly include them, and, accordingly, resources should be dedicated to them. Further, the Board of Directors must be committed to supporting the mandate through close coordination. Experience from countries in Eastern Europe is that at the height of the privatization process, greenfield FDI may be neglected or may be pressured towards privatization options, especially where promotional bodies report to the privatization ministry. This risk should be guarded against as greenfield investment is equally, and in the long term perhaps more important, than privatization investment. Also, on occasions the privatization options available may not be attractive to foreign investors. It is foolish and damaging to attempt to force investors into such unattractive options. The IPA should include allowing and supporting greenfield investors to establish projects that may compete directly with projects that are being privatized.

As the Agency establishes itself and gains promotional experience, and as the relative importance of greenfield investment increases and that of promoting the privatization program wanes, then the agency's reporting relationship to the government should be reevaluated. It should be made clear that in the second phase, especially as the privatization program wraps up, that the agency move out of the Ministry of Privatization, to perhaps under the Prime Minister's Office.

OPTION 2. Establish a smaller Investment Promotion Unit under the Prime Minister. Under this option the unit would undertake limited promotions to attract greenfield FDI, and would implement the investor servicing and policy advocacy tasks. It could also coordinate activity with and undertake contract promotional activity for the privatization program, as requested.

Under the PM's office, the unit could be in a better position to coordinate activity across ministries to remove bureaucratic hurdles and conduct policy advocacy. However, the major risk for this option is that in the absence of short-term 'concrete' results, the unit's clout may suffer, which could undermine the its credibility and ability to carry other functions, such as policy advocacy and effective streamlining investment procedures. It may also erode government and donor commitment to funding. The proposed initial activities of the unit, namely providing information to investors, basic registration services, and streamlining the investor registration process and conducting a policy advocacy role, will have longer-term payoffs. As privatization is expected to be the largest source of FDI, delinking privatization from its core activities will reduce the unit's ability to generate tangible results at the end of each year. In addition, under the current investment climate, the investor servicing function will show only limited direct and 'concrete' results in attracting greenfield FDI, e.g. increase in the number of investors/volume of investment, number of jobs created by those investors, amount of foreign exchange generated, etc.[59]

In order to hedge against this risk, the government should establish a very small and focused unit and manage expectations in the first phase. Accordingly, government and donor funding commitments will need to be based on long-term developmental objectives. A high level of commitment from the Prime Minister and Board of Managers will also allow the unit to maximize the policy advocacy role and task of streamlining investment procedures.

174. Regardless of the option, the unit should give careful consideration during the first phase to strengthening the national promotion function and institutional linkages, which can be explored through legal means, by building formal linkages with the private sector and across government agencies, and through study tours to see what different arrangements work best in other countries. By preparing the initial groundwork, the unit can actively create the necessary conditions for success in phase two, when it would expand functions and staff.

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[59] Albania's past and current experience also indicates that 'new investor servicing' will yield limited results. First, the number of investors who registered with the assistance of the two previous FDI promotion agencies in Albania since 1994 are as follows: 16 in 1994; 8 in 1995; 3 in 1996; 0 in 1997; 3 in 1998; 5 in 1999. Second, a rough indicator for greenfield FDI is the number of foreign companies who register in industry per year. From 1992 to 1999, this figure averaged 40 per year; however, in recent years it has dropped, and in 1999, only 8 registered, out of a total 51 (28 of which were in trade, 7 each in construction and services and 1 in transport).

b. Governance and External Structure

175. Other important elements of the external structure are the private sector links, and the governance of the agency. The most common and most effective mechanism used to combine public and private sector links is to appoint a governing board composed of representation from both sectors. This board can have a majority public sector representation, or a majority private sector representation, or equal representation from both. In many countries, such as in Eastern Europe where the private sector is weak and emerging, governments opt for a majority public sector board, but in countries where the private sector is strong then a majority private sector board is common. Typically these boards consist of 7 or 9 members and need to be kept small to remain effective.

176. In Albania a board of 9 members should be adequate, and initially it is proposed that it consist of four from the public sector and four from the private sector, with and independent chairman. Public sector representatives should be the top ranking officials from selected ministries including the office of the Prime Minister, the Ministry of Privatization and Public Economy, the Ministry of Economic Cooperation and Trade, and another ministry directly affected by FDI either through potential inflows or in providing critical infrastructure.

177. The private sector members should, it is proposed, include established and respected local business people, and perhaps a member of the FDI community. Private sector participation will help ensure that a private sector ethos applies in the agency, that operations and personnel policies are conducted in a way suitable for effective promotions, and that the agency is accepted and respected by the private sector. Private sector members should not directly represent the business associations, to reduce conflict of interest.

178. It is suggested that all board members be appointed by the government for three, or a maximum of five years, with procedures provided for board continuity as well as for membership turnover. Private sector members should be capable of reappointment, yet a ceiling should be placed on the number of consecutive years. Public sector members should be appointed in an “ex offico” capacity.

179. The functions of the Board should, it is proposed be to direct, manage, and control the agency, and to appoint or remove the chief executive. The overall promotional strategy of the agency should be agreed with government, and then day-to-day operations should be carried out by the chief executive and the staff, working under the supervision and control of the board. The Board should not directly interfere in the day-to-day operations. Instead, the Board should require the executive to define the targets to be achieved under the agreed strategy, and it should receive reports on progress towards the delivery of these targets. All internal structural arrangements, personnel policies, budgetary provisions, and targets should be cleared by the board, and the chief executive should then implement agreed actions.

180. Effective networking across the public and private sectors at home, and across the private sector in foreign markets, is another essential structural feature of successful promotional work. Mechanisms, both formal and informal, are required by all FDI promotional bodies to establish and maintain these networks.

3. One-Stop-Shop

181. Providing a one-stop-shop, or a one-stop-service, requires a degree of efficient networking, which most countries aspire to, but which few achieve. Albania wishes to establish a one-stop-shop as part of the institutional structure to facilitate FDI in the country. Some of the one-stop-shop proposals circulating in the country, however, unwisely suggest establishing separate institutions for one-stop-facilitation, and for other investment promotion and generation activities. This separation is not something that is used elsewhere in the world and is something that FIAS would not recommend. These individual functions are integral parts of the promotional task. Both need to be combined within the responsibility of a single FDI promotional agency.

Box 7: International Models of One-Stop-Shops

Different models of one-stop-shop have been developed worldwide as countries seek ways of making this concept work in practice. Some countries have opted to establish agencies with strong legal powers that over-ride all other ministries and agencies. But in practice this approach does not work. Strong ministries fight back, they highlight inconsistencies, and governments are invariably forced to backtrack from this approach.

Other governments have sought to have all key ministries represented on the board of the agency, and require ministries to provide necessary approvals at board meetings. In practice this leads to delayed board meetings as key ministries are absent, and while the approach can improve investor servicing, in many cases it does not.

Another approach is to have all key ministries and agencies represented in a single room, each with a single window, and the investor can go from window to window to receive necessary approvals. Again this approach can lead to some improvement in investor servicing, but also what happens is that windows are often left unmanned as the officials involved return to their office for other work. In practice it becomes impractical to have top officials sitting behind windows where the flow of investors is not regular, and may not occur for days, and where issues often need referral to files in the parent ministry. Often the individual windows become post-boxes where applications are collected and returned to the parent ministry for processing.

Still another approach, which does not attempt to create a one-stop-shop, is to seek to provide one-stop-servicing. This approach involves appointing project service officers in the FDI promotional agency, establishing networks across the public and private sectors, and through these networks providing the necessary clearances, permits, or other requirements of investors. For this approach to work the project officers need good and effective networks, and equally important, the demonstrated support of their board and of the government to ensure that bottlenecks are removed quickly.

182. For Albania, FIAS recommends the incorporation of a one-stop-servicing function within the investment promotion agency. This requires the agency to appoint project officers with responsibility for servicing a defined portfolio of investors. Moreover, and to assist the provision of one-stop-servicing along these lines, Box 7, formal public sector networks can be established with officials in all key ministries nominated, and charged with delivering timely clearances and permits for their respective ministry. These officials should, it is recommended, be formally named as part of the investor servicing network, and be charged with working with the promotional agency's project officers to deliver timely services to investors. Failures to do this within agreed time periods, should be reported to the board of the agency, and/or to the government as appropriate, and suitable action should be taken. This would then become the one-stop approach adopted by the government.

183. This approach is somewhat similar to the one window approach described in Box 6, except that in this case the officials work from their own offices rather than from a common office. Moreover, under this approach the investment promotion agency is centrally involved in the facilitation process through its project officers. They provide a line of responsibility for the facilitation process, together with a mechanism to manage and control the facilitation process.

184. Government support for this investor servicing is essential, and can be demonstrated by it taking a strong line to ensure that complaints of poor servicing received from the board of the promotional agency, or from investors, are dealt with effectively and in a way that is clear to the audiences involved. This strong line needs to be backed up with policy actions that remove, or reduce, the causes of the bottlenecks giving problems. Project officers, or government officials cannot be blamed where it is the lack of government policy decisions that is causing the problem, or where required infrastructure simply does not exist to support investments.

185. It should be emphasized, however, that neither one-stop-servicing, nor any other one-stop approach can work, where the investment process is complex, bureaucratic, and diffuse. This is the case in Albania at present. A basic prerequisite for any one-stop system to work is that the investment process itself be simple, straightforward, and transparent. When this is not the case, steps are required to review and reform existing procedures, and actions need to be taken to remove unnecessary hurdles and to simplify others. When these actions are taken, then one-stop-servicing can usefully help investors overcome the remaining hurdles and obtain outstanding clearances.

186. So as a first step in Albania, FIAS recommends that the existing investment process be reviewed, and be streamlined to the maximum extent possible. An identification of the administrative barriers to investment should be completed immediately. After which, FIAS recommends that the FDI promotion agency be charged with providing one-stop-servicing to incoming investors.

4. Internal Structure

187. The internal structure of the agency can only be defined after its mandate is known. The promotional strategy followed will also influence internal structures. It is proposed that the legal instrument establishing the agency should not define a specific internal structure, rather that this should be left up to the board and the chief executive to modify in line with promotional requirements.

188. If the agency's mandate focuses exclusively on FDI promotion, and if one-stop-servicing, investment generation, image building, and policy advocacy are part of that mandate, then the internal structure should cater for each of these requirements. In that case the agency could, for example, be subdivided into three operating departments. One could perform the investor servicing tasks including the one-stop-servicing activities. Another could undertake the investment generation and image-building tasks, and the third could be responsible for organizational planning, policy advocacy, and all administrative functions. If the government opts for a promotional unit under the Prime Minister's office as its first

phase, then the scale of the investment generation and image building department should be reduced accordingly.

189. The design of the internal structure is an important task which needs to be addressed in detail once decisions are made on the type of agency to establish, its mandate, and its main external structural features. Prior to making these decisions, detailed recommendations on internal structures are premature.

5. Staffing

190. Investment promotion is fundamentally a 'people-business'; and success depends on capable staff, who are properly directed, motivated and rewarded, and whose performance is monitored and reported on regularly. Public sector staffing procedures and policies seldom lead to effective promotional work for a range of reasons. Promotional staff, for example, need to behave in an entrepreneurial manner, while good public sector work calls for precision and the careful application of rules. Opportunities for advancement in the public service are normally across departments, whereas promotional bodies wish to retain good and effective staff for itself. Moreover, pay levels and conditions of employment in the public service are often so poor that they do not attract good promotional staff.

191. In Albania pay and employment conditions in the public staff are seen by many locals, and by outside consultants, as being inadequate to attract capable promotional staff. This point was made forcibly to FIAS during its field visit. For that, and other reasons, FIAS recommends the establishment of the FDI promotional agency outside the public sector, but attached to the government, as recommended earlier. In this way flexibility can be introduced in such areas as pay, employment conditions, and personnel policies, and these are essential features to ensuring good promotional work in the country.

192. Pay levels do not need to equate to those in the private sector to attract good staff, but they need to be at a level that will entice and retain such staff. Sometimes the top levels available in the public sector are sufficient, but in some countries higher pay levels are necessary.

193. Flexibility in pay levels can be introduced through contract employment, or performance related pay. Equally flexibility can be achieved in allowing for speeded-up annual increments, or through good travel and subsistence rates that can be attractive to promotional staff as they are normally required to travel extensively in their work.

194. Detailed staffing decisions can only be made after the mandate, structure and strategy of the agency is defined. If the agency is to be set up under the Ministry of Privatization and undertake promoting privatization as a core function in addition to investors servicing and policy advocacy, then a relatively limited core team of staff will be required initially, probably in the order of 15-20 officers. If the government chooses to set up a smaller unit under the Prime Minister's office, than the core team of staff should be less, in the order of 8 officers. Training will be a key part of future human resource management in the agency, initially to familiarize staff with their tasks and to provide them with proper operating procedures, and later to up-date and refine these capabilities. The range of skills required

from staff will include selling and influencing, presentation and negotiation, public and media relations, research and information gathering, strategy formulation and implementation, market research and planning, networking and organizing, communication skills, and foreign languages.

6. Funding

195. FDI promotional agencies need public sector funding. No country has found an alternative method of funding these agencies. FDI promotion is fundamentally a 'public good' and if it is not funded by the public sector it simply will not happen to a sufficient degree. Private sector contributions can be obtained in a variety of ways to augment exchequer funds, and donor funding can be arranged at start-up. But these cannot and will not remove the need for allocations from the public budget.

196. Donor funding can be expected to be provided to help establish an agency in Albania, and to meet its operational needs for the first 3-5 years. Even in this initial period donors are likely to want to see a government commitment in some form towards meeting the funding costs of the agency. This is particularly so given the recent experience with AEDA which, once established, was starved of funding. The provision of suitable office space is one way in which the government can contribute towards the agency's initial costs, but here also recent experience in the country is poor. There is little point going to the time and cost of establishing an FDI promotional body and then locating it in totally unsuitable offices. Investors visiting these offices make judgments based on appearances as to the priority given to FDI by the government, and they act accordingly. So locating the agency in suitable offices, and in a convenient location for visitors, reflects positively on the country and will impact on the promotional effort. The opposite is the case where the agency is located in distant, and/or in shabby accommodation.

197. The scale of funding required for an agency in Albania, focusing exclusively on FDI promotion would need careful assessment taking into account the promotional targets being set for the agency. But for general planning purposes a figure of $1 to 1.5 million over three years would seem to be appropriate ($330,000 to 500,000 per year). If the government opts for the smaller unit under the Prime Minister's office then a figure of $0.75 million over three years should be adequate ($250,000 per year). By international standards this is a modest figure and it reflects the early phase at which FDI promotion is at in the country. Countries of a similar size to Albania, who are at a more advanced phase of FDI promotion, spend between $25 to 30 million annually on such promotion.

198. If the government wish FIAS can assist in establishing a small but active investment promotion agency, in organizing training for its staff, and in encouraging a package of donor funding for its initial years.

ANNEX A

INDUSTRIAL AND FREE ZONES

1. This section first briefly outlines some international best practice guidelines for developing industrial and free zones. Then, the section outlines some broad areas where the unofficial translation of the Albanian Free Zone Law Proposal could be strengthened. It should be noted that within the scope of the Diagnostic study of the overall environment for FDI, this review of the Free Zone initiative is not meant to be comprehensive.

2. A free zone is an enclosed area that is effectively outside the customs territory and is not subject to the international trade taxes or controls of the country in which it is located. These zones generally provide industrial land, warehouses, and factory buildings to private investors. They also offer free trade, storage, or manufacturing based on simple control mechanisms of material inflows to and from the enclosed area. Free zone programs work best where they reduce bureaucracy, provide efficient and enforceable legal rules, streamline regulations, and limit corruption. In many cases, countries employ free zones specifically to resolve the problem of legal and regulatory system weaknesses.

3. The success of a free zone program is dependent on the institutional structure and administrative arrangements provided by the free zone regulation. Most countries have typically devised specialized institutional and administrative structures for their free zone programs, designed to enhance the efficiency and effectiveness of free zone operations. The choice of an institutional framework is a complex process that must take into consideration existing constitutional and institutional arrangements within each country. No "ideal" model exists as a blueprint for institutional reform. However, the development of an appropriate institutional framework requires the consideration of several key issues: (i) a strong degree of institutional autonomy and authority can depoliticize the free zone regime, ensuring that policies are geared toward economic success; (ii) cooperation between private and public sectors improves efficiency and encourages market-oriented solutions; (iii) free zone policies must also reconcile the costs to existing administrative arrangements that may be affected by a new constitutional framework.

4. The best free zone oversight bodies are characterized by business-like management structures and systems, including private-sector representation. While some institutional frameworks - such as government corporations or autonomous bodies - have more flexibility in establishing such organizational structures, other government institutions can adapt their systems to approximate these management features. The best free zones have oversight organizations that operate as virtual one-stop shops for investors, providing a single point of contact. The core responsibilities of a free zone oversight organization could include: prompt processing of investor applications; investor aftercare; and special free zone customs unit operations.

5. The basic concept of a free zone is defined by its extraterritorial status, the standards for which are set out in the Kyoto Convention. This concept of extraterritoriality is embraced

by most free zones around the world. By definition, free zones are not subject to usual customs controls. Instead, free zone customs procedures are streamlined with minimal controls, limited to those deemed essential to ensure compliance with regulations. Globally, most free zones have chosen to eliminate the need for regular physical controls and rely on documentation.

6. A well-conceived legal and regulatory framework is crucial to the creation of a proper enabling environment for zone development. A freezone law should clearly articulate national zone policy, provide basic rules on investor participation, taxation arrangements and administrative procedures, and establish and circumscribe the regulatory authority charged with implementation. The law should also provide for a WTO compatible incentive framework.

7. Free zone laws may detail various investor rights (e.g., national treatment of foreign investors, free repatriation of capital and profits, compensation in case of expropriation and recourse to international arbitration mechanisms in the case of a dispute) and often establish specific institutions for handling free zone application procedures, along with policy-level administration. Private property rights may also be specified (in the case where they are not adequately covered by commercial and other legislation), along with guidelines concerning applications for incentives, physical access to the zone, transactions with the customs territory and suspension or revocation of incentives.

8. In the case of Albania, free trade zones can help buffer investors from some of the negative aspects of the current investment climate by providing an environment of stability and protection, quality infrastructure services, easy access to land, streamlined investment procedures, and reduced bureaucracy and corruption. Albania's legal and regulatory framework, along with relevant institutions, can greatly affect the performance of free zones. Bureaucratic regulations and procedures governing foreign investment and other areas related to free zones may deter foreign investors and cause program failure. Arbitrary decision making by public agencies and officials can also undermine investor confidence and inhibit investment. Free zone firms are expected to be export-oriented and face international competition. Within this perspective, legal and regulatory constraints will make them less competitive and restrain investment.

9. While a step in a positive direction, the new free zone law contains certain problematic aspects and should be reviewed and adjusted, in accordance with international best practice experiences and within the context of Albania's realities. Some issues the authority may wish to consider include:

- Article 5 does not clearly specify a negative list for forbidden activities or details on the laws and regulations governing this area. Eligible Activities should include every activity, except those *specifically prohibited by national legislation*. This would be best achieved by direct reference to the respective national legislation or through a negative list of activities. In addition, this method would reduce possibility of arbitrary licensing decisions by the authority.

- In Article 7, the Managing Council would benefit from having more than one representative from the private sector.

- Protection of property and other rights should be clearly established by the law. The section on expropriation and guarantee against expropriation (Art 14) should be expanded to emphasize that the rights and privileges granted to free zone enterprises or operators under this law will not be reduced in any fashion by any law or regulation or by the institution of additional obligations, without prompt and adequate compensation. The law should be specific when citing other legislation. Further in the case of zones developed on private land (art 16), the the sequencing of the process should be carefully reviewed, given the country's problems regarding access to land and construction permits.

- Profit tax exemption for zone investors should be removed from Article 18. As described in the tax section of this report, discriminary tax holidays are unfair, distortionary and may create other problems.

- The role of the Customs Organization and its responsibilities are not clearly defined in the law. It should be noted that effectiveness of customs procedures is an integral component of a successful free zone regime. In view of the fact that investors interested in the free zones would be in part seeking to buffer their investments from the current unpredictability in implementation of laws and regulations in Albania, it would be best to define the roles, activities, and boundaries of the customs administration in the free zones. For this purpose, the law should identify in detail the role of the customs administration and its procedures. This would be comprised of the assignment of customs officers to the free zones, their responsibilities, and the allocation of costs of customs administration at the borders of the free zones between the zone operators and the government. The respective section should also identify the clearance procedures for imports, exports, temporary entry, transit goods, prohibited goods, and penalties for violations of customs policies.

- Under licensing articles 24, 25, and 26, the law should define the application process including the necessary forms and documents required, such as feasibility studies and land and financing requirements. In addition, the law should clearly define the application review process with a time limit that the entity should complete the review. The definition of the review process would also list the criteria that would be used to analyze the application and provide the basic framework/conditions of a license such as duration of the license. It is also essential to clearly outline the appeal process if an application is rejected. While it would be preferable in the law, this information should be clearly described in the regulations, as to minimize the discretionary decision making and reduce potential opportunities for corruption. Clarity in licensing procedures will also facilitate extending blanket approvals to private developers for developing or establishing businesses in industrial zones. Companies who locate in such zones

- Further, article 27, introduces specific discretionary authority with regard to attaching conditions to the developer and user liscenses ‘when it thinks it is necessary’. Instead, the law should clearly define what is permissible and what is not. In addition, article 28, lacks clarity on criteria for termination or change of license and would benefit from an appeals process.

- Article 30 suggests that all the accounting documentation shall be available to the customs and tax authorities ‘whenever they think it is necessary to audit it’. This is an extension of the existing unpredictable agency behavior in Albania. Investors interested in locating to free zone would be seeking to access a more liberal and conducive business environment. References such as "whenever necessary" will not be perceived as stable and clear. These types of clauses should refer to the respective laws and regulations and should clearly state when and how such actions can be taken.

ANNEX B

MEMO FROM ITALIAN INVESTORS' ASSOCIATION

Thanks for the opportunity you are giving to us to share with you our experiences on application of tax matters. After one year from the introduction of the new law on tax on income into the Albanian system we are pleased to give you some "insight" over the application of this law from our "privileged" observatory of tax payers.

In general we are experiencing the following problems.

- Non-application/non-recognition of certain critical parts of the law from tax authorities.
- Too many obscure, contradictory and problematic aspects of the law not clarified by the instructions to the law.
- Unacceptable low level of knowledge and inexperience, lack of ethic values and harassing attitude of tax authorities.

1. Non application of the law from tax authorities

The following parts of the law do not find application from tax authorities:

1.1 Advance payments (art. 30)

1.1.1 Art. 30 point 1 a) and b)

Art. 30 point 1a) states that the prepayment due for the first four months of the year is determined based on the financial statements of two years before. In point 1b) it states that for the remaining eight months the prepayment is based on the financial statement of the prior year. The article is easy to understand, logical and clear.

At the beginning of 1999, a total arbitrary rule for the determination of the tax advance, in contradiction with the above article was determined by tax authorities: profit equal to 10% of turnover of the year before. There was no way to oppose this abuse as who was not paying did not obtain the renewal of the "tax license" necessary to operate in the country (this tax license, thanks to the new law 8560 is no longer necessary).

In October 1999, the Ministry of Finance warned the tax offices about the circumstance that this practice was wrong and in violation of the law. Unfortunately in January 2000 most taxpayers had another surprise: it was impossible to obtain VAT forms unless the taxpayer accepted an arbitrary determination of the profit from tax authorities (the mechanism of calculation was not disclosed): tax authorities were just imposing what they "determined" was correct. The rule established by art. 30 point 1 a), a law of the Republic of Albania, <u>was again completely overruled ignored and violated</u>. Who complains and wants to pay the advance in agreement with the law is blackmailed and harassed.

1.1.2 Art 30 point 5

Art 30 point 5 states that in case the taxpayer suffers an severe under-performance during the year (it is sufficient that the decrease in the profit is of 10%) and could document and demonstrate this under-performance, tax authorities are held to accept a decrease of the monthly installments of prepayment. This article is not accepted by tax authorities even in extreme cases. This represents a violation of the law.

1.1.3 Art 30 point 4

Art. 30 point 4 states that in case of start-up, for the first year of operation the advance payment is calculated based on the budget of the taxpayer. Normally the first year and in many cases more than one year of operation suffer a loss. There are many cases where the first year of operation there are even no revenue. Tax authorities do not accept that and impose their arbitrary calculation in these cases. There are many cases where this arbitrary calculation from tax authorities is totally groundless. This represents a violation of the law.

1.2 Withholding tax from nonresidents (art. 33 point 4)

Art.33 point 4 states that a nonresident taxpayer who earns the incomes subject to withholding taxes may be taxed as if these income were generated in the course of a business undertaken from the nonresident through a permanent unit in the Republic of Albania.

This article was included in the law as the withholding tax of 15% is extremely high (basically it is 30%tax rate calculated on 50% of margin!). Through art.33 point 4 a nonresident has the option of paying 15% or paying 30% of revenue minus costs for the work done by the nonresident in Albania.

Tax authorities do not permit to apply this article and consequently who needs services from abroad suffers a gross up in prices equal to 17,65%. This is particularly unfair when the Albanian taxpayer is importing services from suppliers, which has a margin significantly lower than 50%.

If tax authorities continue to not applying/violating this article, a significant reduction of withholding tax to nonresident is needed.

1.3 Tax return and tax credit (art 29 point 3)

Most companies which last year enjoyed the treatment of the assessment of their advance payment through the famous rule of 10% (see § 1.1.1 above), will ask for the reimbursement of the accumulated tax credit, in accordance to art. 29 point 3, after the presentation of their financial statements at 31 December 1999 (this should happen within the 31 March 2000).

From what we understand from informal discussion with officers of the tax administration, we are really afraid of the reaction of tax authorities. We expect that whoever will file for a reimbursement will be harassed and blackmailed and in any case will not obtain its money back. Many component of our Association, including numerous companies owned by Albanians or other foreigners have repeatedly expressed their concern in respect to this.

Recommendation for improvement

- A new set of instruction to the law is needed. Especially with regard to the above abuses extremely detailed set of rules are necessary.

  In case a new set of instruction is elaborated, we suggest submitting it also to the analysis of the taxpayers. We could give an exceptional contribution not only with technical aspects but also in terms of the following elements: reality of the Albanian business, common sense, sense of responsibility, applicability of the rule in this context, fairness.

- Strong disciplinary penalties should be applied to tax officers who violate the law.

2. Needs of detailed clarifications

Following there is a list of issues (surely not complete) to be clarified and resolved. For instance a new set of instruction on the law could be issued.

2.1 Withholding tax (art. 33)

2.1.1 Occasional works

Tax due in case of occasional works rendered by individuals, according to art. 9 point 2 of the Law is 10%. According to art. 33 on withholding tax, however, the withholding rate is 15%. In such case a permanent tax credit of 5% will be created.

During the recent seminar held by IMF to tax officers, it was clearly stated that the rate to be withheld in the circumstance is 10%.

Unfortunately the law creates confusion. The instruction to the law should clarify that in the above case the rate is 10%.

2.1.2 Services subject to art. 33

Art. 33 details the services on which the withholding tax applies. Certain services need however further clarification. In particular the concepts of management fee and technical assistance seem vague. We believe however that certain services are outside the application of art. 33:

- Transportation
- Surveillance
- Heavy works (removal, moving materials)

The instruction to the law should better define the services subject to withholding tax.

2.1.3 Services from professionals

In Albania virtually all people who practice a profession are subject to the enrollment as small business (see art.3 of Law n. 8313 dated March 1998). Consequently the taxpayer who receives a bill for professional services from individuals(this biil is normallywithout VAT as small businesses are VAT exempt), should assume that the supplier is enrolled as small business and consequently no withholding tax is necessary.

We believe that it is important to include in the instruction that the taxpayer is held to ask to the supplier who claim to be small business to indicate its small business number in the invoice.

2.2 Undeductible expenses (art. 21)

2.2.1 Representation expenses (art. 21 point 1 letter h)

The notion of representation expenses is totally unknown in Albania. Expenses for a meal with a client or a supplier, for instance, are normal business expenses and should not be considered as representative expenses. This does not seem clear to tax authorities. The notion of representative expenses should be clearly defined in the instruction.

2.3 Depreciation of fixed assets (art. 22)

2.3.1 Double binary

Many companies are continuing to calculate depreciation of fixed assets under the straight line method for all fixed assets, whereas for tax purposes certain group of assets, under the new law, are subject to depreciation under the declining method. Many companies, which have sophisticated methodologies to calculate their depreciation will continue to calculate depreciation as in the past and will perform "extra-accounting" a calculation of the depreciation resulting from the new tax law (which by the way is very simple). The resulting difference will be included in the portion of the Albanian financial statements package (the so called "blue form") dedicated to the reconciliation of the taxable income with the income resulting from the profit and loss. Unfortunately it is not yet clear whether the above reasonable practice, normal in many other tax systems, will be accepted by tax authorities.

The instructions to taxpayers should contemplate this possibility.

2.3.2 Obligation of keeping a detailed inventory of fixed assets

Art. 22 point (5) for the categories under a) and b) provide for a simplified method of depreciation, which does not require detailed inventory, fixed assets by year of purchase, register of fixed assets, etc. For companies which will use this new method directly in the financial statements, it is not clear whether the obligation of the Albanian law in terms of detailed inventory of fixed assets remains. This should be clarified by the instructions.

2.4 Determination of salary of personnel (art.8 point1 letter a)

2.4.1 Bonuses

According to art.9 taxes on salaries and wages are withheld based on table 1 attached to the law. This table provides for monthly rates with no equalization at the end of the year. The purpose is to simplify the procedure of calculating tax on personnel, which will be complicated by a yearly equalization.

However this system produces an unfair increase of rate in case of bonus, which is normally granted once a while. In the month of the bonus the marginal rate of the employee dramatically increases. Under the old law this inconvenience was faced through the establishment of a flat rate for bonuses (10%).

We believe that the idea of the flat rate could be re-introduced. In order to eliminate abuses, the flat rate on bonus could be limited to a maximum of one or two bonuses per year.

2.4.2 Daily allowance

Daily allowance, in principle, should not be considered as part of the salary. We understand that in order to limit abuses, some limit should be established. We believe that the best solution is to maintain the principle that daily allowances do not represent compensation but a simplified way to reimburse expenses and that some limit should be established. The portion of the daily allowance, which exceeds the limit established by the Ministry of Finance, would represent compensation.

2.4.3 Documented expenses

The reimbursement to an employee of documented expenses should not represent "daily allowance", provided that the principle of deductibility expressed by art. 20 is respected: an expense is deductible in case is sustained for the production of profit, for insurance or protection of the activity purposes. We understand that tax authorities tend to confuse these two things. There are many circumstances where the daily allowance could not be used, otherwise the employee will be exposes to unacceptable personal losses. There are many cases where it is impossible to remain within certain minimum limit of expenses (trip abroad in an expensive country, obligation of meeting third parties like suppliers and customers or participation to fairs in expensive places, etc).

The problematic of the reimbursement of documented expenses to employees should be completely separated from the one connected to the daily allowance.

3. Tax authorities

This is probably the main obstacle to the application of the law. After one year of application of the new law tax authorities have repeatedly demonstrated the following:

- unacceptable low level of knowledge, competence and experience in too many components of the tax offices;
- general lack of ethic values;
- harassing attitude.

Unfortunately very often at the high hierarchical level of tax authorities there is not enough competence to discuss issues professionally.

Despite the extremely positive attitude shown by the Ministry of Finance toward the requests of taxpayers in term of availability to collaborate, discuss and sort out problems, the tax administration represents a "wall of rubber", the only objective of which seems the achievement of its budget objectives.

The absurd and non-sense consequence is that who totally evades taxes and is in total violation of the law is considered a difficult target and therefore is left harmless, whereas who normally pays taxes is harassed and blackmailed.

Recommendation for improvement

- The Ministry of Finance, assisted by consultants, should assess with independent examination the real level of knowledge of the various officers;
- A minimum standard level of knowledge of tax matters should be set for each position. The higher the position the higher the necessary knowledge;
- In case an insufficient level of competence is assessed, the officer should be assigned to a training and self-study program. At the end of the training and self-study program a re-assessment of the level of competence of the officer should take place. The process should be repeated in case the officer fails again.
- The tax administration should keep officers with insufficient level of knowledge far from taxpayers.

We hope that the above comments will help you in the understanding of the problems of investors in Albania. We are available to discuss with you the content of this letter at any time.

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