

Mario Holzner

Albania: becoming a flat tax country

The Albanian government has approved a flat tax regime of 10%. Conservative Prime Minister Sali Berisha declared this move to be a fiscal revolution for Albania which now allegedly features one of the lowest tax rates in the world. This is believed to be a strong weapon in the fight against the informal sector, a carrot for increased FDI penetration and above all a magic bullet for economic prosperity, to generate double-digit economic growth rates. However, current GDP growth prospects are only at about 5%. The lack in energy supply is the main obstacle to higher growth rates.

The government's decision in favour of the flat tax was made by the end of May 2007. The 10% flat tax is supposed to replace the current personal income tax, which is a progressive tax, rising from 1% to 20%, as well as the current profit tax of 20% (i.e. corporate tax). The income tax is not a pure flat tax as it exempts the first 10,000 lek for incomes below 30,000 lek. The new income tax will become effective from July 2007, while the new profit tax will be in place from January 2008.

Given the traditionally low willingness of Albanians to pay taxes it is debateable whether the tax reform will have any effect at all. However, if it does have any impact, it will most probably increase economic inequality in the country. It is also quite likely that tax revenues will fall to a certain extent. Cutting the nominal corporate tax into half might have considerable consequences for the government budget. This is especially what the IMF fears. Thus the head of the IMF mission to Albania had discouraged the government from introducing the flat tax; instead the IMF expressed its strong interest in prioritizing the country's energy problem.

In order to overcome the chronic energy crisis, investments in the order of EUR 1 billion are needed as estimated by the new management of the Albanian energy corporation (KESH). This is to overhaul the existing system as well as to invest in thermal power plants, which should help to reduce Albania's dependency on hydropower generation and electricity imports. The management also expects further power cuts of about four hours daily or more following the summer. The lack of rain, enormous losses in the distribution network, together with consumers' unwillingness to pay their energy bill are the main obstacles to a proper electricity supply in Albania. Moreover, regional energy prices are rising and import capacities are allegedly limited.

Interestingly enough, the huge amount of energy imports in the past several months has had an impact on the euro exchange rate of the Albanian lek (ALL). After years of nominal appreciation against the euro, the strong increase in foreign currency spending to afford the import of energy has exerted a depreciating pressure. However, in nominal effective

annual terms, the lek depreciated only by an average of 0.1% over the first quarter of 2007. This is because the lek is still appreciating against the US dollar. In any case, a more relaxed exchange rate regime might support the Albanian industry and its exports.

Currently it is mainly domestic demand that drives economic growth. The construction sector in particular is booming. Nevertheless, according to the Ministry of Economy half of the Albanian businesses are in a state of bankruptcy because they have created a scheme of debt dependency among each other. Especially in the construction sector barter transactions are not uncommon. As important steps transactions are to be formalized through the banking system and legal procedures for bankruptcy recognition are to be introduced. As part of the fiscal package, the government also approved a law that bans cash transactions of more than EUR 2228 for businesses. Approved cash transactions will be limited to 10% of a company's total transactions during the taxable period; or 10% of the total turnover of the business. Moreover all salary transactions have to go via the banking system, or they will not be recognized as expenditures in the balance sheets.

This is good news for Albania's financial sector, which has recently attracted substantial FDI inflows. After the takeover of the country's banking market leader, the Albanian Savings Bank, by Austrian Raiffeisen in 2004, French Société Générale has acquired a majority share in Banka Popullor only recently, in April 2007. Also the insurance market is increasingly a target of FDI, in particular from Austria. The Vienna Insurance Group (Wiener Städtische) plans to acquire 60% of the Sigma insurance company, one of the top three insurance companies in Albania and also active in Kosovo and Macedonia. An insurance company of similar size and market coverage, SIGAL, became part of the Austrian UNIQA insurance group in March 2007. UNIQA has an option of acquiring a majority ownership in SIGAL in the medium term (as of January 2010). Now the Albanian government plans to sell its 51% stake in the state-owned INSIG insurance company. Thus more FDI is expected to trickle into the financial sector of Albania in the time to come. In this respect Albania is following the experience of the other Southeast European countries, where FDI in the financial sector acted as a door opener for FDI in other sectors as well.

The overall growth prospects of the Albanian economy appear to be rather favourable given the expected improvements in physical and institutional infrastructure. Strong domestic demand growth fuelled by remittances from Albanians working abroad is at the core of the country's economic performance. However, an improved business climate should also attract more FDI to the export sector, making this sector an engine of economic growth too. It remains to be seen whether the introduction of a flat tax regime can be supportive in this respect.

Table AL

Albania: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007	2007 forecast	2008 forecast
Population, th pers., end of period	3102.8	3119.5	3135.0	3150.0	3150	.	.	.	.
Gross domestic product, ALL mn, nom.	628527	694018	752367	822035	900000	.	.	970000	1050000
annual change in % (real)	4.3	5.8	6.2	5.6	4.9	.	.	5	5.5
GDP/capita (EUR at exchange rate)	1535	1622	1884	2106	2321	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	3740	3940	4100	4420	4670	.	.	.	.
Gross industrial production									
annual change in % (real) ²⁾	-5.1	29.0	14.1	1.3	1.5	.	.	2	3
Gross agricultural production									
annual change in % (real) ²⁾	2.1	3.2	6.2	0.9	3.5	.	.	3.5	3
Construction output total									
annual change in % (real) ²⁾	21.5	23.6	7.7	15.1	10	.	.	11	12
Consumption of households, ALL mn, nom.	455952	508108	.	.	.	.	.	.	.
in % of GDP	72.5	73.2	.	.	.	.	.	.	.
Gross fixed capital form., ALL mn, nom.	143914	160210	.	.	.	.	.	.	.
in % of GDP	22.9	23.1	.	.	.	.	.	.	.
Reg. employment total, th pers., end of per.	920.1	926.2	931.2	932.0	932.0	931.0	.	.	.
annual change in %	0.1	0.7	0.5	0.1	0.0	0.0	.	.	.
Reg. unemployed, th pers., end of period	172.4	163.0	157.0	155.0	150.0	151.8	.	.	.
Reg. unemployment rate in %, end of period	15.8	15.0	14.4	14.2	13.9	14.0	.	14	13.5
Average gross monthly wages, ALL ³⁾	19659	21325	24393	26808	27900	27333	.	.	.
annual change in % (real, gross) ³⁾	8.1	6.0	11.2	7.3	2.6 ^{HX}	3.3	.	.	.
Consumer prices, % p.a.	5.2	2.2	3.0	2.4	2.4	1.4	2.8	2.5	3
Producer prices in manufacturing ind., % p.a.	5.1	1.8	12.2	4.9	0.7	0.7	.	2	2.5
General governm.budget, nat.def., % GDP									
Revenues	24.6	24.1	24.5	24.8	25.1	.	.	.	.
Expenditures	30.6	29.0	29.6	28.3	28.3	.	.	.	.
Deficit (-) / surplus (+), % GDP	-6.0	-4.9	-5.1	-3.4	-3.2	.	.	-3	-4
Public debt in % of GDP ⁴⁾	60.1	54.7	55.6	56.9	55.6	.	.	.	.
Refinancing base rate, % p.a., end of period	8.5	6.5	5.3	5.0	5.5	5.0	5.5	.	.
Current account, EUR mn ⁵⁾	-445.6	-360.4	-287.8	-492.0	-553.6	-128.8	-183.2	-660	-550
Current account in % of GDP	-9.4	-7.9	-4.9	-7.4	-7.6	.	.	-8.5	-6.6
Gross reserves of BoA incl. gold, EUR mn ⁶⁾	813.0	812.7	1005.2	1201.6	1362.6	1221.5	1372.2	.	.
Gross external debt, EUR mn	1184.4	1105.0	1218.0	1373.5	1467.3	.	.	.	.
Gross external debt in % of GDP	24.9	21.9	20.7	20.7	20.1	.	.	.	.
FDI inflow, EUR mn ⁵⁾	142.9	157.8	278.4	224.2	258.6	56.8	88.2	.	.
FDI outflow, EUR mn	.	.	-9.0	-1.7	-8.2	.	-2.0	.	.
Exports of goods, BOP, EUR mn ⁵⁾	350.5	397.9	485.6	530.2	630.6	144.4	182.0	700	800
annual growth rate in %	3.0	13.5	22.0	9.2	18.9	18.9	26.0	11	14
Imports of goods, BOP, EUR mn ⁵⁾	1574.5	1578.3	1762.3	2006.9	2316.0	515.2	629.5	2500	2500
annual growth rate in %	5.9	0.2	11.7	13.9	15.4	29.4	22.2	8	0
Exports of services, BOP, EUR mn ⁵⁾	619.6	637.8	807.5	967.3	1193.6	276.8	274.2	1300	1500
annual growth rate in %	4.0	2.9	26.6	19.8	23.4	35.8	-0.9	9	15
Imports of services, BOP, EUR mn ⁵⁾	624.9	711.8	848.0	1107.7	1257.8	312.7	303.9	1300	1500
annual growth rate in %	25.9	13.9	19.1	30.6	13.6	37.2	-2.8	3	15
Average exchange rate ALL/USD	140.2	121.9	102.8	99.9	98.1	102.2	95.7	.	.
Average exchange rate ALL/EUR (ECU)	132.4	137.5	127.7	124.2	123.1	123.0	125.3	125	125
Purchasing power parity ALL/USD, wiiw ⁷⁾	46.9	47.9	49.5	49.7	50.4	.	.	.	.
Purchasing power parity ALL/EUR, wiiw ⁷⁾	54.3	56.6	58.7	59.3	61.2	.	.	.	.

1) Preliminary. - 2) According to gross value added. - 3) Public sector only. - 4) Based on IMF data. - 5) Until 2003 calculated from USD with the average exchange rate. - 6) Refer to total foreign assets of Bank of Albania. - 7) wiiw estimates incorporating data of World Development Indicators 2006.

Source: wiiw Database incorporating national statistics; wiiw forecasts.