

Pension Reform and the Development of Pension Systems: An Evaluation of World Bank Assistance

Background Paper **Albania Country Study**

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Abbreviations

CeRP	Center for Research on Pensions and Welfare Policies
ECA	Europe and Central Asia
GDP	Gross Domestic Product
IBRD	International Bank for Reconstruction and Development
ICR	Implementation Completion Report
IEG	Independent Evaluation Group (formerly Operations Evaluation Department)
ILO	International Labor Organization
IMF	International Monetary Fund
INSTAT	National Statistical Office
MOP	Memorandum and Recommendation of the President
OED	Operations Evaluation Department (changed its name to IEG in December 2005)
PAD	Project Appraisal Document
PID	Project Implementation Document
PR	Progress Report
RRP	President's Report
SAR	Staff Appraisal Report
SII	Social Insurance Institute
SR	Sector Report
WP	Working Paper

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Preface

This paper belongs to series of 19 country and regional case studies commissioned as background research for the World Bank's Independent Evaluation Group (IEG) report "Pension Reform and the Development of Pension Systems." The findings are based on consultant missions to the country or region, interviews with government, Bank, donor, and private sector representatives involved in the pension reform, and analysis of relevant Bank and external documents.

This case study was authored by Elsa Fornero and Pier Marco Ferraresi in 2004.

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1. Objectives and Methodology

1.1 This report seeks to provide an external, independent evaluation of the role of the World Bank in promoting and supporting the pension reform process in Albania after the collapse of the Communist regime in 1991.

1.2 Our analysis is based on both objective and subjective criteria. In terms of objective criteria, we considered:

- The overall design of the pension system in its steady state;
- The timing, costs, and features of the planned transition to the new regime;
- The degree of needed reform and its prioritization with respect to other reforms; and
- The efforts made by the Bank to adapt its theoretical approach (as described in the Bank publication, *Averting the Old Age Crisis* (1994)) to the specific characteristics and circumstances of Albania.

1.3 In terms of subjective criteria, we considered:

- The degree of transparency of the reform process;
- The degree of “ownership” of the reforms by the Albanian government;
- The support from the Bank to develop all direct and indirect means to sustain the reform and evaluate its performance (for example, the development of an administrative and information system, and the organization of the various institutions involved in the process).

1.4 Our main sources of information were Bank documents (selected references are found in Appendix D); interviews with representatives of various institutions and organizations (Appendix C); and numerous articles and papers.

1.5 The structure of this report follows, with some variation, a template suggested by the Bank. The report starts with a brief presentation of the Albanian pension system in the 1990s, before Bank involvement and major reform attempts. Next is a description of the evolution of Bank assistance and an assessment of its impact, followed by a presentation of the study’s findings.

1.6 The final section discusses lessons to be learned from the Albanian pension reform and concludes with an agenda for future action. The appendixes contain a summary table of Bank operations relevant to pension reform, a statistical table, a list of officials interviewed in connection with this study, and a table of cross-referenced sources and authors’ notes.

2. Background

2.1 The collapse of the Communist regime in 1991 left Albania with a more burdensome legacy than in other transition economies, a legacy that can be traced back to the country's long history of isolation.

2.2 During the initial years after the Second World War, Albania had to resist Marshal Tito's attempts to absorb the country into Yugoslavia. Later, when its relationship with the Soviet Union worsened because of the loosening of the Stalinist system by President Nikita Khrushchev, Albania was forced to form closer ties with Communist China. After the death of Mao Zedong in 1976, the relationship with China deteriorated, and Albania was plunged into deep isolation for many years by the Communist leader Enver Hoxha, with his rigid ideological views, ultimately causing Albania to become the least developed economy in Europe.

2.3 After Hoxha's death, in 1985, his successor, Ramiz Alia, made some concessions toward a less authoritative regime, for example, allowing for multi-candidate (but not multiparty) elections, public religious observances, and foreign travel. After the fall of Communism in many Eastern European countries at the beginning of the 1990s, Albania's regime found itself under increasing pressure. In 1990–91, social unrest led the Right to allow the formation of independent political parties, and this began a transition period marked by progress toward democracy but also by high political instability, growing corruption, and disappointing economic performance (in the period 1990–92 GDP fell by almost 50 percent; see Appendix B).

2.4 In 1992, the Democratic Party won the national elections and its leader, Sali Berisha, a prominent post-Communist reformer, came to power. The new government showed a much greater disposition toward accepting support and advice from foreign organizations, especially the IMF and World Bank. The main initial changes were somewhat encouraging—state enterprises gave way to small private businesses, particularly in the agricultural sector. Given the very low initial GDP and the very large role farming had in determining the level, rapid expansion of agriculture contributed to a high rate of growth for the economy (average growth was about 9 percent in the period 1993–96), which certainly helped boost Mr. Berisha's reputation.

2.5 Unsupported by deep reforms, however, the economic boom and new democratic regime proved to be an unstable combination. The financial sector was still very much underdeveloped, and the new prosperity was really due to remittances from emigrant workers, as well as different kinds of illegal smuggling (for example, arms and fuel into Yugoslavia and drugs and people to Europe) and money laundering, tolerated (and possibly even encouraged) by corruption within the

administration. The corruption, together with authoritarian aspects of President Berisha's leadership, started to erode his political support.¹

2.6 The untenable mix of new prosperity, driven by illegal activities and a corrupt administration, tragically culminated in early 1997 when Albania's extensive system of savings-deposit pyramid schemes collapsed.² The schemes were chain devices that promised high interest returns to first investors, paid out of the contributions collected from later investors, in the best tradition of the infamous "Ponzi schemes." Numerous people invested all of their savings in the schemes;³ many even sold their homes to raise money. The massive public uprising following the financial collapse is hardly surprising then.

2.7 In the general chaos and disorder that followed, widespread desertion by soldiers and police officers caused the partial dissolution of the military forces, with many posts simply left unattended. To prevent the collapse of the political system and the ensuing instability, an Italian-led international force was brought in to restore domestic order. The general elections that followed this turbulent period brought to power the *reformed* Communist party, headed by Fatos Nano. In 1998 a new constitution was approved, replacing the interim law of 1991, which had been an immediate attempt at reconstructing a legal framework after the Communist constitution was withdrawn. Since then, even though the institutional structure and the government's authority remains somewhat weak,⁴ Albania seems to have embarked on a more stable path of transition toward democracy and a market economy.

2.8 In 2002 nearly 2.3 million ethnic Albanians lived in adjacent countries, as compared with a resident population of 3.2 million (see Appendix B). This situation frequently caused tensions between Albania and its neighbors but possibly also contributed to improved relationships with the West on the occasion of North Atlantic

¹ The Bank's ECA Region comments that "Although corruption during Berisha's rule was obvious, it was not on such a large scale as perceived nowadays in Albania. All surveys (though some of them are not very plausible) indicate that the rule of law, effectiveness of the government, and overall governance was better in 1996 than in 2002".

² The Bank's ECA Region comments that while "The report indicates that the "new prosperity" and high GDP growth were basically fuelled by inflows from drugs and corrupt administrative is not an accurate description of the sources of growth during the early 1990s."

³ The success of the pyramid schemes in collecting people's money was possibly due to the lack of awareness of even basic principles of a prudential investment strategy in a modern market economy. This lack of financial education is certainly explainable for the vast majority of the population swept up in the rapid and painful transition from Communism. The lack of surveillance by the administration is less acceptable, although one has to acknowledge the lack of expertise needed for adequate supervision. Even less acceptable, however, is the little help Albania received from the international community to set up the foundations of a well-functioning financial market. By contrast, the ECA Region comments that "the Bank and the IMF provided a lot of policy guidance and supported a number of reforms in addition to financial resources. Both the Bank and the IMF warned against the "pyramid schemes" as well."

⁴ Mr. Nano was forced to resign in 1998 after a takeover of government buildings in Tirana. In 2001, new elections brought his party back to power, and, since 2002, Mr. Nano is once again the prime minister, with Alfred Moisiu as the new President of Albania.

Treaty Organization (NATO) air strikes against Yugoslavia in March 1999. All Albanian political parties supported the NATO action as well as the subsequent entry into Kosovo by United Nations administrators and the Kosovo Force. The country, however, paid a price for these military operations through having to accommodate about 445,000 refugees; suffer further damage to its already very poor infrastructure (under restoration as of early 2004); lose much needed foreign investment; and have the process of nation building possibly impeded.

2.9 After the turmoil of 1997, both the Bank and the IMF granted post-conflict help to Albania, conditional on the pursuit of tight economic policies. These policies have produced desirable effects, particularly in promoting a more transparent and secure environment for a normal economic life. Much effort is still required, however, to maintain order across the country and to curtail corruption. As a consequence, the support of multilateral agencies for prospective growth is still needed, particularly in enhancing capability, accountability, and transparency at the different levels of government.

Macroeconomics

2.10 Regarding the *macroeconomic environment*, although some stabilization has been achieved (for example, price stabilization), much remains to be done: the country is still dominated by a sharp division between urban and rural life; the private sector is still very weak; the shift of small businesses from trade to production, which could help in reducing unemployment⁵ is progressing at too slow a pace; the banking system needs further consolidation and, above all, investment in infrastructure and equipment is badly needed—apart from the physical strain, all of the industrial equipment is terribly obsolete.

2.11 Demographic prospects are also a source of worry. Albania has a small population of about 3.2 million, which will age rapidly. The fertility rate declined from 3.03 percent in 1990 to 2.23 percent in 2002 and is projected to decrease further. Life expectancy, contrary to trends in the majority of Eastern European countries, has increased for both men and women (a fact that speaks to the contributing role of climate in determining hardship at any given level of poverty). Moreover, emigration has substantially reduced the working age population, while the elderly population (over age 65) has increased (see Appendix B).

2.12 The *informal economy* plays an important role too, as much as 30–40 percent of GDP, according to estimates provided by the National Statistical Office (INSTAT). Illegal activity alleviates poverty among households, allowing for consumption that is not accounted for by official production and trade, but it also makes assessing the country's macroeconomic performance a more difficult exercise.

⁵ INSTAT (see World Bank, 2003, p. 62–63) calculated a total unemployment rate of 9.8 percent in 2002, as defined by the International Labor Organization. Taking into account those who are not seeking work, are seasonally unemployed, or who have been laid off brings the 2002 figure up to 16.4 percent. Including unemployed agricultural workers, who work less than 15 hours per week, would raise the number even more, up to 19.1 percent.

2.13 An encouraging sign is the strong growth and low inflation Albania achieved after the 1997 crisis. The growth rate of GDP exceeded 7 percent a year in 1998–2000, while inflation was kept as low as 2–4 percent. Present prospects for growth are good (as confirmed by our interviews): a sustained rate of around 6 percent per year is expected for the next seven years, with subsequent possible convergence to around 3 percent by 2015.⁶ Indeed, Albania’s rich natural resources, from mining to potential tourist attractions, increase the chances for stable growth. The huge emigration of Albanians during the initial years of transition—affected by the influence of high Italian living standards—is slowing and property rights in rural areas are being secured.

2.14 The country’s geography facilitates sea transportation and reopening economic ties with Yugoslavia may not only increase regional trade with this important partner, but also improve transportation to Central Europe, thus strengthening an export trend to the European Union after the collapse of the Eastern European markets.

2.15 The largely unexploited coastline, as well as the mountains and many ancient mosques and churches, constitute a sure tourist attraction, though their appeal is limited by the continuing security problems and the poor facilities for tourists.

2.16 In terms of mining, Albania is rich in chromium, copper, and nickel, and also holds some potential for oil extraction. These sectors, however, need substantial intervention, both in terms of capacity building and in updating obsolete equipment. Support is only available from foreign investors and international agencies; for example, the Bank has been particularly active in oil extraction and electricity production. The same degree of technological obsolescence exists in industry. In earlier years, leather goods and textiles received a boost through subcontracts from abroad, but the disorders of 1997 hampered the positive growth.⁷

2.17 Albania’s natural resources, its favorable geographical position, and its cultural homogeneity—without the ethnic and religious tensions that characterize many other countries in the region—could be the basis for a sensible and steady economic development. In order to launch an effective transition to a modern market economy, however, a modern *financial sector* is still needed. Indeed, financial inadequacy has played a crucial role in holding back economic development—most financial transactions are done with cash, and banks are characterized by inefficiency and an excessive dependence on nonperforming loans. Although these deficiencies are on their way to being fixed, foreign participation in the financial system is still

⁶ The ECA Region comments, “The projected growth rates for Albania over the next 10 years... differ from the Bank GDP projections.”

⁷ The ECA Region comments, “The Bank has not been active in oil extraction and electricity production. The Bank has only been active in reforms of the energy sector and is planning to finance investments in energy production only in 2005”.

low. The major prospects for development, therefore, still depend on foreign investments.⁸

2.18 For its part, Albania has very important work to do, which is to steadily embrace a course of *transparency, compliance, and stability* as a necessary precondition for domestic-led growth. Among the transition countries, the desire for change was probably greatest in Albania but, because of the very rigid form of Communism the country long endured, the country could not easily get on a development track. Somewhat paradoxically, the severe and widespread poverty of the population presented (and still partly presents) the main obstacle to pursuing the fundamentals of a market economy because poverty was such a binding constraint in setting the policy agenda. More specifically, the right kind of goals (a legal framework to protect private ownership, proper earnings and incentive structures, and a reward system for efforts and merits) were hindered by the same factors—corruption, black market activities, and illegal trafficking. These factors contributed to the aggravation of problems in the initial years of the transition, mainly by weakening the idea that a law-abiding institutional setting is essential for development and that compliance with the legal framework as a nonnegotiable component.

2.19 It appears, then, that both the government and the public should agree that reinforcing the legal framework, with a clear identification of the individual degrees of freedom and of personal responsibility, is the most important reform, and on which nation building efforts should concentrate.

Social Protection Strategy

2.20 With respect to other countries in Central and Eastern Europe, Albania began its transition from a weaker base and a less developed social safety net. In the initial years of political change, Albania suffered high levels of tension, violence, and disarticulation of its social and economic institutions as well as larger immigration flows than any other area in the region.

2.21 Because of very low income levels, crises created by the changes (such as increased unemployment) and collapse of the egalitarian policies, a large portion of the population found itself vulnerable to dramatic reductions in per capita income in 1991–93.

2.22 Poverty during the previous regime was such a widespread condition that it had neither been assessed nor measured. Consequently, as in many ex-Communist countries, Albania could not know the level or extent of poverty, either in quantitative

⁸ The ECA Region comments, “This statement is outdated. The financial sector is 97 percent in private hands following the privatization of the saving banks. The government has minority shares in only two banks out of 17 Banks operating in Albania and is working on selling its shares in these banks. The majority of the Banks are foreign-owned.”

or qualitative terms. Establishing a conceptual framework and building local capacity with special reference to poverty monitoring was thus one of the priorities of the donor community. Although research has been carried out and specific education supported, this objective was still cited by the Bank as one of the key priorities for the 2001 Social Services Delivery Project.

2.23 The most recent information is from the 1998 Living Conditions Survey (see World Bank, 2002a, p. 7), which only takes account of income, and the 2001 and 2003 Poverty Assessments (see World Bank, 2003), which are more detailed and include the poor themselves in the investigation of the causes, nature, and extent of poverty as well as the way poverty affects their lives. Data show that poverty is widespread and severe, with poverty rates in rural areas (where subsistence agriculture is the norm) and mountain regions significantly higher than in urban areas. One quarter of the population lives below the poverty line,⁹ with about 5 percent living in extreme poverty—that is, they are unable to attain even the most basic food requirements. A large number of individuals are clustered *around* the poverty line; raising the line by 10 percent would increase the percentage of poor individuals by 25 to 50 percent, depending on which poverty line is used (see World Bank, 2003, p. xii). The situation is made worse by the severe lack of access to basic infrastructure, education, health care, and clean water and sanitation.

2.24 Although the ultimate solution for reducing poverty is *economic growth*, the need to substantially improve and increase social protections can easily be seen from two perspectives. First, such extreme and widespread poverty could jeopardize the growth process, negatively affecting demand, by perpetuating a low level of domestic consumption, and supply, through the scarce accumulation of human capital. Second, poverty is fertile ground for illegal activities as well as corruption and political instability; in short, it is an environment inconsistent with investment needed to sustain growth.

2.25 The social safety net inherited from the Communist regime was a mix of ill-targeted, cost-incompatible benefits (that is, benefits determined almost independent of revenue, though always at very low levels) which supported a “wrong” (from a market economy perspective) incentive structure. Its main components were: guaranteed employment, administered wages, subsidized prices on basic consumer goods, and comprehensive social insurance provision. All of these measures were at very low levels but sufficient enough to act as a barrier against the extreme form of poverty that the most destitute segments of a population suffer from in a market economy.

2.26 Such a “paternalistic” structure—congenital for the rigid Communist regime and meant to satisfy the very basic needs of the population—was not acceptable in the new economy that the government was trying to build. At the start of the transition,

⁹ The level used in the 2003 poverty assessment was 4,891 Albanian leks per capita per month (that is, US\$47, as of June 14, 2004). It was based on the consumption of a sample reference population, drawn from the Albania Living Standard Measurement Survey 2002, which was then converted to a monetary measure using the cost-of-basic-needs methodology.

the plan's inadequacy and its contribution to fiscal imbalances became apparent, and the scheme was abandoned, causing a lack of protection for the most vulnerable groups, who suffered the most from the collapse of the economy and the surge of inflation. Moreover, both education and health care services deteriorated drastically during the initial phase. Already limited resources were used to bribe personnel for access to services (which made the services even more inaccessible for the poor).

2.27 Pressed by international donors, the government tried to pursue structural reforms in the income support, unemployment benefits, and pensions, but was forced by events and by short-run emergencies to make less comprehensive changes.

2.28 As for the *income support program*,¹⁰ the only provision was (and still is) an economic aid program called *Ndihma Ekonomike*. Between 1993 and 1998, the numbers of households receiving this kind of support more than doubled because of the growing numbers of long-term unemployed workers and the heavy fallout of the 1997 crisis. The *Ndihma Ekonomike* is administered by local governments, which are given a specific grant by the Ministry of Labor and Social Assistance based on an assessment of their needs. In urban areas, *Ndihma Ekonomik* complements the household's income up to a pre-specified level; in the rural areas the amount is determined on the basis (among other criteria) of the size and the quality of people's landholdings.¹¹

2.29 *Unemployment benefits* were originally established to protect workers who were unemployed as a result of economic reforms. The provision of these benefits, financed on a pay-as-you-go basis by employer contributions, reflects an "insurance" philosophy. The Social Insurance Act, which came into force on October 1, 1993, brought the benefits under the social insurance legislation, and established a flat rate guaranteed for one year, so as not to hinder incentives to job seeking, and also to avoid the administrative burden related to variable levels and durations. The scope of the benefits was subsequently broadened to cover more workers than just those directly affected by economic restructuring.

2.30 The most important cash-transfer program in the social safety net is certainly the *pension system*, covering the largest number of beneficiaries as well as the poorest segment of the population. The Communist pension legacy was a system made up of two plans: the State Social Insurance plan and the Cooperative Farmers Social Insurance plan, both were financed on a pay-as-you-go basis and provided old age and survivor benefits.¹² These schemes shared many of the typical deficiencies of poorly designed pension systems:¹³ division between urban and rural workers, poor

¹⁰ The Social Assistance Act was approved in 1993 and amended in 1994 and 1995.

¹¹ The ECA Region comments that the statement that *Ndihma Ekonomike* was (and still is) the only *income support program* is not accurate."

¹² The State Social Insurance plan also provides maternity and death grants; both provide disability pensions, which have increased in number over time. According to Bank documentation, eligibility rules in this sector are set generously, and there are possible abuses by the medical-expert committees.

¹³ The full-service replacement rate (that is, for 35 years of seniority) was 70 percent, based on the average of the best three salaries of the last decade of service.

correlation between contributions and benefits, early retirement, preferential treatment for more influential groups, very low tax compliance, and poor management. Officially, the retirement age was set at 60 for men and at 55 for women, but because of early retirement and special eligibility based on merit and for particular groups in hazardous occupations, the average actual retirement age was 58 for men and 52 for women.

2.31 These inefficient provisions started causing deficits in 1957, requiring increased contributions from the budget. The figure reached about 35 percent of expenditures during the 1980s¹⁴ because of a large increase in the number of pensioners (which almost tripled in 1980–92) and a reduction in the number of contributors, which started immediately after the fall of the Communist regime (see Appendix B).

2.32 The situation was made worse by a lack of administrative capacity. Even though the social insurance administration had “worked” under Communism, it clearly could not handle the sharp increase in the demand for benefits, enforce an effective contribution collection, or organize an efficient record-keeping system (which is still largely managed manually).

2.33 Even in the absence of sophisticated actuarial analyses, such a situation was clearly unsustainable; a comprehensive reorganization of the whole sector was required, to change the basic design of the system and to improve the efficiency and effectiveness of the administration.

Pension Reform

2.34 The reform process in Albania is characterized by two major interventions: a structural one in 1993 and a parametric one in 2002.¹⁵

2.35 The 1993 reform¹⁶ is described as a “structural intervention” because it produced a comprehensive reorganization of the social insurance system within the conceptual framework of a modern market economy. The Social Insurance Institute (SII) was created as an autonomous body to administer all aspects of the public system. The SII is responsible for collecting contributions,¹⁷ keeping records, and calculating pensions. Its purpose is to take care of the interests of all involved “stakeholders,” with representatives of the government, employers, and unions on its board of directors. In this respect, and according to our interviews, the SII plays

¹⁴ It is worth noting, however, that the conceptual framework leading to a clear separation between insurance and assistance was not yet developed, nor was there any actuarial capacity, and the concept of an equilibrium payroll tax rate, possibly, did not constitute a key issue, because contributions were considered as part of the overall fiscal revenues and pensions part of the overall state expenditure.

¹⁵ Parametric reforms change key elements of the system such as contribution rates, retirement ages, or average benefit levels.

¹⁶ Act No. 7703, ratified November 5, 1993.

¹⁷ The amendments introduced in 2002 by the second pension reform transferred the contribution collection for the urban scheme to the Tax Department of the Ministry of Finance.

more than a mere administrative role. With its technical expertise and its ability to conduct economically sound policy analyses in the field of pensions, it is actually involved in the decision-making process.

2.36 The reform law established the structure of the current pay-as-you-go system in Albania: old-age, survivors and disability pensions are paid out of earmarked contributions;¹⁸ retirement pensions are calculated as a flat-rate benefit,¹⁹ with a supplement determined on a defined-benefit basis, at an accrual rate of 1 percent per year of service. According to the new pension formula, the pension base for calculating the supplement is computed by taking into account the average of *all wages since 1994*,²⁰ implying that in the long run, one's entire working career will be considered (which is a good feature of the system in terms of both redistribution and sustainability).²¹

2.37 Future adequacy, however, is still uncertain, given the limits of the pension formula, which does not clearly distinguish between insurance and assistance. On the one hand, under the new rules, the full-service replacement rate (that is, the replacement rate achieved after 35 years of service) cannot exceed 75 percent, a provision meant to strike a short-run balance between adequacy and sustainability.²² In the long run, however, this will hardly constitute a binding constraint, given that the total public pension level cannot be higher than twice the minimum pension. This ceiling, along with the low accrual rate granted on the variable part of the pension, still implies a substantial degree of redistribution within the system, and future replacement rates will be highly dependent on the adjustments to the flat-rate component.²³

¹⁸ For the urban scheme, the contribution rate was set in 1993 at 42.5 percent, 9.5 percent of which was paid by the employee, with the ceiling for mandatory payments of contributions set at three times the minimum wage, and corresponding (as of 2001) to 23,319 leks per month (equivalent to US\$225 as of June, 14 2004). For the rural scheme, however, contributions are much lower, ranging from 9 percent for mountainous regions to 15 percent for other rural areas; moreover, these rates are applied to a hypothetical annual income fixed in 1993 at 10,800 leks (about US\$102, at current exchange rates). The scheme is chronically in deficit, and one wonders whether it should not be considered an assistance scheme rather than an insurance scheme.

¹⁹ The 2001 level of the flat component was 5,142 leks (about US\$49, at current exchange rates) for the urban scheme and 1,328 leks for the rural one.

²⁰ The wages entered in the pension calculation are indexed to the growth rate of the contribution bill.

²¹ Rural pensions, however, follow a somewhat different rule because the supplement is calculated on the basis of the monthly minimum wage for every year of contribution to the SII since 1994. If the SII contribution period falls short of the required 35 years, a farmer is entitled to the basic rural pension, prorated by the number of contribution years. If these are fewer than 20 years, the retiree is entitled only to social assistance in *Ndihma Ekonomike*.

²² The current average replacement ratio is 42 percent, given the large number of low pensions awarded before 1993, which have been left untouched by the reform.

²³ We found agreement among the interviewed officials on what is considered a minimum monthly income for a decent standard of living: about US\$130. This measure, however, was not explicitly taken into account in any social intervention, nor has it been officially recognized.

2.38 Indexation of benefits is accounted for, although the precise way it will be applied is still unclear.²⁴

2.39 In any pension reform the transitional rules are particularly important because they define the time horizon needed to reach a new steady state, the specific features of the phasing in of the reform, and the distribution of costs, which are higher when the initial conditions imply a very large debt. These costs have to be distributed among current and future generations. Current cohorts are certainly affected, mainly by the way their “accrued rights” are evaluated. In the literature (see AE), transitional fairness can be defined according to two different principles—either in terms of the benefits accrued in the old system or the contributions an individual has paid into the system.

2.40 Reforming the public pension system in Albania stopped possible discrimination by applying the new rules to everyone in the plan. In practice, however, benefits acquired prior to reform are not granted, so the elderly either do not receive benefits, or receive a very low supplement, forcing them to rely almost entirely on the flat pension. However bad the situation is, it seems hardly avoidable given the scarce resources of the country. In the future, pensions will depend much more on a person’s work history and earnings, and it is crucial that people understand this clearly.

2.41 The second reform of the pension system occurred in 2002 and it was a parametric one.²⁵ It was strongly supported by the World Bank (but strongly opposed by the labor unions) as a way to enhance sustainability, reduce the burden of payroll taxes on the labor market; and make the system more appealing to the public.

2.42 Irrespective of its parametric nature the role of the 2002 reform must not be underrated, given the deficiencies of the previous design. As discussed earlier, a reasonable plan had been put at risk by a bad calibration (see Treichel, 2001), as shown by the high payroll tax rate on a very poor contribution base, the still weak incentive structure; and the regressive effects caused by the ceiling on the contribution wage.

2.43 The major changes introduced consisted of: a reduction by four percentage points in the urban contribution rate paid by the employer;²⁶ a gradual increase (6 months per year) in the retirement age, from 55 to 60 for women and from 60 to 65

²⁴ According to our interviews, the introduction of a defined mechanism was expected in 2004. It is not certain, however, how the price index is going to be calculated. The SII has a preference for a “pensioner-specific” index, while INSTAT is not ready to accept the burden in defining and updating a specified basket. The likely solution will be a correction of the general consumption price index according to predetermined coefficients.

²⁵ Refer to Law No. 8889, ratified April 25, 2002, which amended Law No. 7703, ratified November 5, 1993: “On Social Insurance in the Republic of Albania.” Minor changes were also introduced through government decisions and regulations.

²⁶ The total contribution rate was thus reduced from 42.5 percent to 38.5 percent.

for men;²⁷ an increase from 3 to 5 percent in the ratio of the maximum contribution base to the minimum wage. Furthermore, an important change was introduced regarding early retirement provisions: eligibility for early retirement was maintained (at age 57 for women and 62 for men, provided 35 years of service had been completed), but the pension level was subject to actuarial correction.

2.44 On the administrative side, the collection of contributions for the urban plan was transferred from the SII to the Tax Department of the Ministry of Finance. There are, of course, costs and benefits to this measure: it may favor the perception of contributions as taxes instead of savings, but it can also reduce contribution evasion and avoid the duplication of functions within the administration.²⁸

2.45 As is perhaps unavoidable in a reform process, the latest step is not to be construed as the final one. Shortcomings in pension design still exist.

- Clearer distinction should be made between redistribution and insurance. At present, the indexation mechanism is still unclear, casting serious doubts on the future adequacy of pensions.²⁹ Moreover, the definition of the contribution ceiling makes the sustainability of the pension system conditional on the *administered* minimum wage, which will be problematic with the presence of sustained growth in real wages.
- The rural plan, in particular, is still somewhat indistinguishable between an assistance and insurance scheme. If this is unavoidable in the short to medium run, it should not continue in the future steady state. There is no reason for maintaining the separation in the long run particularly since agriculture growth is sure to decrease its contribution to production and employment;
- Administration is still behind in terms of automating procedures with computer technology, as well as in achieving adequate capacity in the fields of actuarial and economic modeling³⁰ and policy design;

²⁷ The starting year for this gradual increase was postponed until 2014 for special categories, including several hardship jobs such as those in mines, foundries, the military, etc. A second group of protected jobs was also established, including those in the textile industry, printing shops, construction, education, public health, the army, etc., for which the gradual increase began in 2004. Although such exemptions may, in many cases, be regarded as overdue because of the very demanding job conditions in these sectors, in other cases, some categories have been particularly effective in protecting their privileges. In the long run, however, the retirement ages are bound to converge for all categories.

²⁸ As for the rural scheme, although no specific action has been taken, and some efforts have been devoted to the increase of efficiency of SII inspectors, from our interviews we expect the contribution collection function could be assigned to the Tax Department. This solution, however, must first prove effective in the urban case, given the transitional costs and the difficulty of matching the contributors' registration numbers with the SII and the Tax Department's records.

²⁹ The ECA region comments, "Bank efforts to include an indexation provision under PRSC-2 stalled when IMF colleagues raised fiscal concerns within the framework of the Fund's 2005 program with Albania.

³⁰ Some evaluations of the reform (which also served as training) were done with the help of the Bank and the Italian *Istituto di Ricerca Sociale*. In 2004, SII staff members were scheduled to be trained in computer simulations at the International Labor Organization in Italy.

- Diversification of pension wealth, through the introduction of a funded component, is still constrained by underdeveloped and under-regulated banking, financial, and insurance markets. The memory of the 1997 crisis is also still fresh in the public's mind.

2.46 On the whole, the country seems to be on a good course toward modernizing and developing a market economy. Although resources are very limited, progress is being made with a very prudential attitude. In the field of social protection and pension reform, in particular, the role of Bank must be acknowledged as particularly relevant in shaping consistent strategies (as discussed in the next section).

2.47 For too long, the Albanian people have been content with the little that was given to them; they lacked any basis of comparison by which to shape different preferences and ambitions. Even with regard to pensions, the acquisition of a framework of personal entitlements and obligations is a crucial aspect of reform. Cultural progress is, in this area, possibly as important as the establishment of a decent legal framework.³¹

³¹ In addition see, World Bank, 1997, pp. v, ix–xii, 12, 13, 16, 19, 20, 34, 39, 55, 59, 60; World Bank, 1998, pp. vi, xii, xiii, xx, 37, 38, 69–80); World Bank, 2001, pp. 1, 3; World Bank, 2001a, pp. 6, 7, 27, 28; and World Bank, 2002a, pp. 6, 8, 9, 14, 16, 20–22, 24, 27, 28, 32, 40.

3. Evolution of Bank Assistance in the 1990s

Genesis

3.1 Building a new, market-oriented democracy after 50 years of almost complete isolation, atop the ruins left by the collapsed Communist regime, is nothing short of a “reinvention” of the country. One must recognize that government action in the difficult years of the transition was effective, particularly with respect to macroeconomic stabilization, and from the beginning, World Bank and IMF assistance contributed substantially to an outcome that cannot be judged as unsatisfactory.

3.2 Tight monetary policies were put into action; a drastic reduction of public expenditure was achieved; and privatization in agriculture, housing, and small enterprises was realized. These measures were sufficient to stop, in a comparatively short time, a steep inflationary spiral and direct the country toward sustained growth. A price was paid in terms of a sharp increase in unemployment and a worsening in the distribution of income, with a substantial fall in real wages (about 30 percent in 1992–93).

3.3 The costs associated with macroeconomic stabilization are perhaps the main reason why reform of the social protection system has received high priority in Bank policies toward transition economies. On social grounds, this priority was determined by the immediate need to protect the weakest segments of the population from the consequences of the breakdown of the previous regime, and by the long-term need for a well-functioning social security system for all. On economic grounds, the need to make room for investments justified reductions in welfare expenditure in the overall state budget and in GDP. Changes also needed to be made in the distortions and implicit taxes associated with badly designed schemes.

3.4 From the initial stages of the Albania’s transition, the Bank had a clear view, derived from analysis and experience in other countries, of the importance of a well-designed, sustainable, and adequate social safety net. Not only was it necessary to have a social consensus for the plan’s implementation, but consensus was the only way to prevent disintegration of the “social fabric” and the further deterioration of the nation’s human resources.

3.5 The Bank was a natural ally of the government in developing a coherent strategy and (based on our documents and interviews) the Bank’s support formed the cornerstone of the process that led to the 1993 reform as well as the main reference point for building local capacity in the pension area.

3.6 The rationale for allowing the Bank to play a leading role in reforming social insurance can be traced back to the special attention it had paid to the elements of good pension design, as formalized in *Averting the Old Age Crisis* (see World Bank, 1994).

3.7 The Bank's diagnosis of the problems faced by the welfare systems of European transition countries, in particular, strongly influenced both the debate and the course of action taken. Conceptually, the Bank's prescription is based on the idea that the social security system is to be conceived of, not as a separate institution, but as a fundamental component of the macroeconomic framework—implying a potential harmonization with the goal of economic growth, which is the ultimate driving force toward welfare improvements.

3.8 To implement this idea in practice, the Bank suggested a system be put into place that accomplished the following: provides both the right incentives for the individual to transfer resources from economically active to the inactive years, with the proper vehicles to do so; guarantees a safety net for the elderly who have only a meager permanent income; and supplies adequate insurance against the risks specific to the elderly. Furthermore, the prescription stresses the importance of transparency (so as to reduce the risk of undue political manipulation) and of good administration and regulation (so as to reduce unnecessary costs).

3.9 As a result, the action plan recommended by the Bank was based on the idea that savings, insurance, and redistribution ought to support the overall welfare design, with further government interventions provided, based on the nation's initial conditions, preferences, and cultural factors.

3.10 In Albania, the Bank clearly recognized that the country's initial conditions were particularly difficult, because of lack of resources and any conceptual basis for reform. In our view, the Bank correctly saw that, under these conditions, it would have been useless, and possibly even harmful, to pursue the elements of good pension design all at once, in a country that could barely keep its "head above water." More specifically, the Bank was deeply involved in the redesign of the pay-as-you-go system but readily recognized that times were not yet ripe to propose the three-pillar system.³² Particularly after the 1997 crisis, the typical optimism shown by the Bank on this front was largely restrained, and wisely so, considering that the crisis had eroded many of the achievements of the previous years and revealed profound weaknesses in governance and regulation

3.11 As a consequence of the Bank's prudent attitude, the government was perhaps more easily convinced of the importance and priority of the pension reform. The result was cooperation toward a well-tailored and not overly ambitious approach. The 1997 crisis, however, was a sudden warning that further improvement in government capacity was needed, and it made very clear that much ground still had to be covered before Albania's economy could accommodate a pension system fully consistent with a three-pillar view.

³² The first pillar is public, the second is mandatory and funded, the third is voluntary and funded.

Description

3.12 The documents made available by the Bank mark the various stages of its involvement in the Albanian transition toward a market economy and, specifically, in the reform process of the social safety net.³³

3.13 Reviewing the record of Bank interventions in the social protection area, one sees that both lending and non-lending instruments were used, and the overall impression, confirmed by our interviews, is of a clear, consistent use of the two. The Bank did not act as just an outside player; on the contrary, its lending strategies appear to have been constantly supported by its contributions in identifying and analyzing the problems, both through very specific economic sector studies and wider economic research.

3.14 The involvement of the Bank in Albania's reform, however, cannot be seen as completely smooth; the 1997 crisis, in particular, required a substantial revision of the country's assistance strategy.

3.15 Before the 1997 crisis, the country assistance strategy was purposely flexible, adapting priorities to the structural changes taking place in the economy, different implementation speeds, and different absorptive capacities. The country strategy was complemented by the macroeconomic stabilization and structural reform program supported by the IMF, and was composed of small projects, specifically focused on physical rehabilitation of rundown infrastructure, provision of public services, modernization of the tax system, and establishment of a new social safety net.

3.16 A specific credit, equivalent to US\$5.5 million, was granted for this last purpose in 1993, supporting the Technical Assistance Project for a Social Safety Net Development. The project was successful in improving the targeting of the social assistance cash-benefits scheme, and in building a new social insurance scheme. The first urgent reforms of the pension system were done under this project, focused on reducing future expenditures, abolishing some privileges, raising the payroll tax rate, and making benefits conditional on payment of contributions.

3.17 Moreover, the project involved the improvement of institutional capacity through a reorganization and modernization of services: the contribution collection system and the recording system for peoples' work histories were rebuilt from scratch; actuarial methods were introduced; the system for delivery of benefits was completely overhauled; computers and software were brought into the administration; capacity building was extended to regional offices, along with reinforcement, at the national level, of the Ministry of Labor and Social Affairs' expertise and the implementation of a poverty-monitoring system.

³³ For a synopsis of Bank projects related to pension issues, see Appendix A.

3.18 These early achievements were fully consistent with results in other sectors, thus contributing to the depiction of Albania as almost a “success story” among transition economies.

3.19 The 1997 crisis, however, suddenly revealed the weakness of the recovery process and, consequently, of the assistance approach. The surreptitious rise of the pyramid schemes, and the damage to the social fabric that followed the collapse, was an abrupt “reality check” for the Bank, and emphasized the limited progress in institution building and governance. Prudential and supervision capacities in the financial sector proved to be weak and inadequate, and the lack of a comprehensive and consistent strategy in this area was a likely secondary cause.

3.20 The crisis prompted the Bank’s approval of a rehabilitation credit, equivalent to US\$25 million, with the objectives being to facilitate termination of the pyramid schemes, increase the budgetary outlays to the social assistance program, and implement an employment promotion program. The project, because of its urgency, neither delivered any structural reform, nor substantially improved long-run perspectives for social security; it was, however, a necessary step and possibly prevented further deterioration, protecting the most vulnerable groups and constituting a starting point for sound revision of the country assistance strategy.

3.21 The 1999–2001 country assistance strategy explicitly recognized the need for a new assistance approach, with a central emphasis on governance and institution building, and greater focus on those areas where agreement with the government had been reached for a satisfactory reform agenda. The strategy was particularly selective, because automatic withdrawal was expected from operations showing inadequate policy or institutional progress.

3.22 Pension reform was identified as a key priority in the approval of two Bank credits:³⁴ the later 1999 Structural Adjustment Credit (US\$45 million), which terminated at the end of 2000, and the 2001 credit for a Social Services Delivery Project (US\$10 million), which is still active.

3.23 The 1999 Structural Adjustment Credit had framed the sustainability of the public pension system as one of the priorities within a broader support strategy, aimed at improving the standards of living and at sustaining stable growth.³⁵ Consistent with

³⁴ It is worth noting that the new assistance approach should not be considered as being at odds with the one-year extension (until June 30, 1999) of the closing date of the 1993 “Technical Assistance Project for Social Safety Net Development.” Indeed, we agree with the Implementation Completion Report (ICR) in judging the extension to be fully justified, considering both the very difficult conditions of the country after 1997 and the difficulty of achieving results and continuous government commitment.

³⁵ In addition to improving the sustainability of the public pension system, the priorities included: maintaining a sustainable macroeconomic framework; privatization programs, in particular, advances in the privatization of small and medium enterprises, banks, and telecommunications; strengthening public administration and the judicial system; facilitating titling of agricultural land distributed to private farmers; and strengthening the regulatory framework of the financial sector by enacting into law the draft legislation on secured transactions.

the comprehensive approach, no specific pension reform was mentioned among the aims of the credit; on the contrary, the need for extensive analysis was stressed, and preliminary work for the preparation of “concept papers” was expressly required. Under the credit, analytical capacity within the government was strengthened, and technical analysis of the pension system was undertaken, providing a “knowledge base” for comprehensive reform. Moreover, substantial institutional progress was represented by changes in accounting that made the accumulation of implicit liabilities more difficult. For example, a more transparent method was used for budgetary transfers to the SII—financing for rural pension deficits was listed as specific state subsidies and was no longer indistinguishable from overall public expenditure.

3.24 The Social Services Delivery Project is financed in cooperation with the central and local governments of Albania (US\$ 2.5 million) and the British Department for International Development (US\$ 2.5 million), though the Bank remains the main lender (US\$10 million). The project confirms the Bank’s commitment to capacity building, and provides support both at the national and at the local levels of government. As for the issues that are most directly related to the pension system, technical assistance is provided to solve the problems with historical data on jobs,³⁶ and to undertake a systematic review of work processes within the SII. Poverty evaluation and monitoring continue to be issues and providing resources to address these issues is still a top priority. To this end, an extensive capacity-building operation within INSTAT—and within the government, to take full advantage of statistical information—has been initiated, making INSTAT an important voice in the pension debate, particularly in defining a minimum standard of living and consumption basket. As a result, significant capacity was provided to conduct an independent analysis of pension parameters and indexation.³⁷

3.25 In 2002 a new Bank strategy was approved. Its objectives are highly consistent with the approach enacted by the Social Service Delivery Project, thus providing a rationale for continuing support and extending it, without major changes, to different country assistance strategies.

3.26 In particular, the strategy was designed to be a major contribution to the government’s poverty reduction strategy, helping the country to move from short-term crisis management to a long-term vision of sustainable development. Great emphasis was given to improving governance and strengthening institutions, promoting sustainable private sector growth, and fostering human development. The lending program included a series of Poverty Reduction and Support Credits, and ought to be constantly backed by non-lending analysis and advisory activity, thus strengthening government actions and supporting the Bank’s operations.

³⁶ Problems concern the reconstruction of work histories before 1994, as well as for jobs in enterprises that did not report salaries or pay contributions, or that were liquidated after 1993.

³⁷ The project, however, has much wider objectives, and the largest part of funding (US\$10.6 million) is devoted to community-based social services, for their institution and implementation, and for capacity building at the levels of the local government and the service providers.

3.27 In order to create an affordable and equitable system and to reduce reliance on budget subsidies, support for pension reform was expressly stated as a priority and consistently appeared as one of the objectives of the 2002 Poverty Reduction and Support Credits (US\$20 million). Reforming the pension system was seen as a key aspect of fiscal consolidation, and the Bank's objectives were fully reflected in the 2002 reform (see section on pension reform).

3.28 In conclusion, we can confidently state that the pension reform process was backed by the Bank through a number of different lending and non-lending instruments, all of them structured within a broader approach to economic growth and the development of an adequate social safety net. The Bank consistently adapted the strategies to the rapidly evolving priorities of the country and was ready to recognize deficiencies in the approach adopted before the 1997 crisis. This flexible attitude helped Albania's recovery process and now supports the country on a path to more stable growth.³⁸

³⁸ References for this paragraph, in addition to the citations in the text, are: World Bank, 1994a, p. 39; World Bank, 1998, pp. 14, 16, 77–79, 97; World Bank, 1999) p. 2; World Bank, 2001), pp. 3–7; World Bank, 2001a, pp. 9–13, 15–18, 23, 28, 31, 32, 38–40, 45–48, 52, 53, 65, 82); and World Bank, 2002, pp. 2, 3).

4. Impact Assessment of Bank Assistance

Outcomes

4.1 The focus of the following assessment is of both the relevance and efficacy of Bank assistance to the Albanian pension reform. *Relevance* refers to the extent to which the objectives of the overall assistance and individual projects were consistent with the country's initial conditions, needs, and development priorities. *Efficacy* refers to the extent to which the objectives were achieved.

Relevance

4.2 The central question is whether pension reform was really a priority in the early years of Albania's transition to a market economy. Before answering, we need to look a bit more closely at the concept of relevance: (i) Is the reform supportive of economic development?, (ii) Does it provide adequate social protection, by also reducing the distribution gaps between households and between men and women?, and (iii) Does the reform strike a good balance between efficiency and redistribution?, between financial equilibrium and equity?

4.3 Looking at the reform's support of economic growth, one must recognize that development paths are not independent of initial conditions. In Albania, these conditions included not only a general state of poverty and isolation, but people were unfamiliar with such fundamental concepts of a modern society as personal property, personal responsibility, or personal choice. Albania's institutions, moreover, were utterly unprepared to handle the deteriorating life conditions that normally accompany the transition from a (rigidly) planned system to a market economy. Under these circumstances, it is not surprising that the struggle to survive could foster violence, corruption, and political instability. Furthermore, confidence in private enterprise and in the market, which had been laboriously introduced, suffered hard setbacks with the 1997 crisis and the war in Kosovo. The former destroyed the people's desire for change and their already weak trust in the newly created authorities; the latter damaged the nation's infrastructures, and caused the influx of very large numbers of refugees.

4.4 Given such a situation, restructuring the social security system is a priority only insofar as the most basic social and political conditions could be met. On theoretical grounds, the idea that the social protection systems are to be considered important factors in the determination of the overall economic performance, and ultimately as a precondition for social peace, is hardly arguable. In the Albanian case, however, it was more urgent to establish other conditions, such as the fundamental elements of a free and democratic society and a self-sufficient economy. It is not the aim of this report to evaluate the progress achieved by the country in these respects, but we certainly do *not* regard the fact that the international donors or the Bank in particular, did not pursue optimal reform from the start as a failure.

4.5 As for whether the reform provided social protection for the poor, no one would argue that a democratic society should not protect its less fortunate members. In Albania, poverty was widespread and occurred in a society without a cultural background to help people make judgments about personal responsibility, insurance schemes, and public assistance. Trying to provide everyone, in different situations, with the right conceptual framework is almost as important as providing material help, especially in a country where everyone is poor. The Bank correctly identified and gave priority to conceptual issues, as is clearly evidenced by the research work and technical assistance provided to INSTAT and other institutions. The belief that this type of poverty would have jeopardized both economic growth and political stability was shown in the significant role played by the Bank in the social assistance area as well as in its prudence in reshaping the social insurance system. Indeed, the Bank effectively tried to introduce an incentive structure into the system, without hindering the system's fundamental role as a poverty alleviation device.

4.6 Efforts to effectively separate social insurance from social assistance will require that reform measures strike a satisfactory balance in the tradeoff between efficiency and distribution. The economy can gain by financing social assistance through progressive income taxation, instead of earmarking payroll taxes. In principle, if the programs are efficiently designed and managed, there is no reason why this would bring fewer resources to the schemes. On the contrary, because the separation of social insurance and social assistance represents another important element in the effort to strengthen economic development, it could mean increasing gains for everyone.

4.7 In the Albanian case, however, a clear-cut separation between efficiency and redistribution could, at most, represent a theoretical benchmark, given that pensions are the main income-maintenance program for the elderly (the poorest of the poor). Privileges were certainly not unknown under the previous system, and their abolition as a result of establishing stricter correlation between benefits and contributions, was certainly welcome. Making the system more "incentive-compatible" was needed and clearly acknowledged, but bad redistribution was not the main problem. Besides, complete and rapid change in the distribution system would have been a bad choice, as well as nearly impossible—for example, who would pay for the pensions of the elderly rural population?

4.8 Within this framework, it is possible to maintain that the first priority in Albania was to take a comprehensive nation-building approach and that the pension and social assistance reforms could be seen as very important complementary tools. Because we do not have full information, the evaluation we provide assumes that the other elements in the approach were met. Our evaluation (Table 1) determines that the Bank gave pension reform the right degree of priority, that is, it recognized the deficiencies of the first "emergency approach" adopted before the 1997 crisis and consistently adapted its strategies to the evolving needs of the country.

Table 1: Evaluation of Relevance

<i>Features</i>	<i>Relevance</i>
Supporting economic development	Substantial
Protecting the poor and reducing distribution gaps	High
Striking a good balance between efficiency and redistribution	Substantial
<i>Overall Evaluation of Relevance</i>	<i>Substantial</i>

Efficacy

4.9 Efficacy is assessed on the same basis as the issues we considered in determining relevancy, that is, adopting as guiding criteria: (i) support for economic development; (ii) protection of the poor; and (iii) tradeoff between redistribution and efficiency (Table 2).

4.10 Support for economic development requires pension expenditures not to absorb too large a fraction of the public budget, and that there be financial equilibrium of the scheme and a good incentive structure for saving and labor choices. The Albanian pension reforms have certainly achieved substantial results in improving the pension design.

4.11 However, when allowing for adequate pension levels, the sustainability of the system is in doubt, particularly because of the burden represented by rural pensions, and of the regressive effect of the contributions ceiling. Moreover, the high contribution rate (38 percent, reduced from 42 percent), flat benefits, and low accrual granted on the supplementary pension all add to the perception of contributions as a form of taxation and of pensions as a form of subsidy. If this is not fixed in the early transition, it will pose increasing problems later on, as the economy gathers speed. The Bank was quite ready to put these issues among its strategic priorities, and quite effective in helping the government to enact some corrections with the 2002 reform. Much work, however, still needs to be done, and the Bank's commitment to support Albania's growth and poverty reduction strategy can be regarded as promising.

4.12 As for protecting the poor, the matter is addressed only with regard to the pension system, leaving aside the Bank's activity in the fields of social assistance and social service delivery. The critical issue is whether the system, as it is now designed, will be able to deliver adequate pension benefits. The real growth rates of current pensions, the flat rate component of the newly awarded pensions, and the minimum wage all play fundamental roles. From our documents and interviews, however, we were not able to devise a transparent indexation mechanism. In the prospective of sustained real growth, the adequacy of pension benefits appears to be still in doubt, and the scope for discretionary interventions is too large. The system is not poorly designed and it is certainly suitable to accommodate more transparent limits, possibly avoiding the risk that the adequacy of pensions and of the contribution base may be hindered by the growth process itself.

4.13 The point about the tradeoff between redistribution and efficiency strongly relies on the distinction between assistance and insurance. The government never abandoned the objective of building an efficient system, notwithstanding the political and social turmoil that undermined the stability of the country in the late 1990s. The Bank consistently urged the government to take action toward reform in reducing the contribution rate, increasing the retirement age, introducing a near contribution-based pension formula (with reference to the whole working career), indexing past wages to the growth rate of the wage bill, and (almost) correcting actuary benefits for early retirement.

4.14 This, of course, is far from an optimal system because it allows for too much political discretion and too much redistribution. But, given the initial conditions, it is not a bad (indeed, almost a good) result. In short, the Bank was effective in promoting a consistent design but had to account for the severity of the cultural and institutional conditions.

Table 2: Evaluation of Efficacy

<i>Features</i>	<i>Efficacy</i>
Support for economic development	Substantial
Protecting the poor and reducing distribution gaps	Modest
Striking a good balance between efficiency and redistribution	Modest
<i>Overall Evaluation of Efficacy</i>	<i>Modest</i>

Overall Outcome Evaluation

4.15 The overall evaluation (Table 3) takes into account both relevance and efficacy, and can be seen as the extent to which the major relevant objectives of the project were achieved or are expected to be achieved.

Table 3: Overall Evaluation of Outcome

<i>Item</i>	<i>Rating</i>
Relevance	Substantial
Efficacy	Modest
<i>Overall Evaluation Outcome</i>	<i>Moderately Satisfactory</i>

Institutional Development Impact

4.16 The institutional development impact is assessed here according to its relevance and efficacy (Table 4), while the requirements that will make the reform sustainable in the long run—when international help will presumably be gone—will be discussed later.

4.17 As for the *relevance* of the Bank’s action for institutional development, the difficult initial conditions must be noted. The political instability, the administrative weaknesses, the need to substitute old ideologies with new “philosophies,” the lack of information and specific expertise, all pointed to a need for deep intervention to bring about not only much-needed technical skills but also an appropriate cultural framework.

4.18 Our analysis of relevant documents as well as our interviews led us to the conclusion that the Bank’s support strategy for the pension system could be described as a comprehensive capacity-building operation. In addition to the research work, all the loans were for the purpose of providing technical assistance and promoting institutional development, both at the national and local levels. Evidence from our interviews suggests that the Bank’s role in shaping both structural and parametric reform was fundamental. Focusing on a cooperative approach that provided “on-the-job training,” in order to improve capacities within the relevant institutions, was particularly significant.

4.19 One specific and duly admitted inadequacy was in the pre-1997 policy: by concentrating on “operative problems” in the specific area of social insurance and assistance, the Bank failed to grasp the potentially explosive effects of institutional and governance weakness, especially within the financial sector.

4.20 Since the 1999 country assistance strategy, however, the Bank has fully recognized the importance of the creation of a sound legal and institutional framework, and of strengthening the rule of law and governance capacities as a prerequisite for any sound reform process. Consistent actions thus have been undertaken since the Structural Adjustment Credit of 1999.

4.21 As for *efficacy*, it is worth noting that capacity had to be rebuilt from scratch. Furthermore, the 1997 turmoil produced substantial damages to government buildings, newly installed information systems, and individual records. The very low starting point and political instability generally prevented the country from implementing modern administrative procedures, with the pension system being no exception. According to our interviews, however, adequate preparation of government officials is generally considered an integral part of administration improvement, a goal to which commitment appears to be deep and strong.

Table 4: Overall Evaluation of Institutional Development Impact

<i>Item</i>	<i>Rating</i>
Relevance	Substantial
Efficacy	Modest
<i>Overall Evaluation of Institutional Development Impact</i>	<i>Substantial</i>

Sustainability

4.22 Generally speaking, *sustainability* can be defined as the ability of the system to deliver adequate pensions, while substantially maintaining financial equilibrium (if not year after year, at least over the long run), in the face of predictable negative shocks. “Adequate” pensions can be achieved by a sufficiently high contribution rate, a “good” composition of the pension wealth, and relatively high returns to contributions. A system that meets these criteria is sustainable. How does the Albanian pension system rate in these respects?

4.23 In this section, sustainability will be assessed in two different respects: economic and political. *Economic sustainability* will be considered, not only in terms of internal consistency but also with regard to the reform’s ability to withstand negative changes in both demographic and macroeconomic variables. *Political sustainability* will be assessed in terms of popular support for and political willingness to proceed with the reforms as well as in terms of continued capacity building.

4.24 As for *economic sustainability*, the system will probably require further changes, because satisfactory solutions have not yet been found for a number of system parameters: the ceiling on contributions is at risk of becoming a binding constraint, compressing the contributory base in the event of sustained economic growth; the high level of contributions makes it practically impossible to consider further raises and should instead be lowered in order to avoid evasion and labor market distortions; and finally, the farmers’ plan is strongly unbalanced and should conform to the urban workers’ rules.

4.25 It should be added that the fiscal burden stemming from imbalances in the pension system should not be reduced merely by changing the system parameters but also through pension redesign and administration efficiency improvements. Unfortunately, on the administrative side, Albania still lags behind in certain desirable goals: satisfactory pension records management, coordination between the local and national levels, and implementation of effective contribution collection and income monitoring, especially in the rural sector.

4.26 *Political sustainability* is linked to both pension adequacy and compliance with the pension rules. As for adequacy, not only are current pensions exceedingly meager, but doubts are also appropriate with regard to the sustainability of future pension levels, given the very low accrual rate for the wage-based pension component, and the fundamental role of the flat component. Moreover, the private pension pillar is still nonexistent, and the early stages of the financial and insurance markets and the banking system, as well as the still weak governance capacity do not support the introduction of any funded component.³⁹

³⁹ We cannot but agree with Peter Diamond’s assessment: *I think we have to recognize that individual accounts are much harder to set up and run for a country with an inadequate capital market than a lot of people suggest. In some former Communist countries, with no capital markets and no regulatory*

4.27 As for compliance, documents and interviews confirm that this is a serious problem because of the size of the informal sector and the difficulty in contributions collections. The people's weak sense of civic responsibility and the burdensome legacy of Communism are certainly not limited to pensions. As mentioned above, the transition to a market economy cannot be separated, particularly in the Albanian case, from a more general nation-building policy, aimed at strengthening the rule of law and confidence in institutions, two cornerstones of any free society.

4.28 A further threat to political sustainability may come from the fiercely critical attitude of the Workers Unions with respect to reform and, in particular, the Bank's actions.⁴⁰ We are not in a position to evaluate to what extent the unions actually represent workers' positions. Our interviews, however, gave us the impression that their resistance lies, at least to some extent, on a poor understanding of the basics of a market economy.⁴¹

4.29 Table 5 presents a summary evaluation of sustainability.⁴² It is worth mentioning that our judgment is based on a sort of extrapolation of the status quo, and that the system may well undergo further changes without disruption. Assessing whether these changes will have the necessary support or whether they will be the right kind, however, is a much more difficult task.

Table 5: Evaluation of Sustainability

<i>Item</i>	<i>Sustainability</i>
Economic sustainability	Modest
Political sustainability	Modest
<i>Overall Evaluation of Sustainability</i>	<i>Unlikely</i>

ability, setting up individual accounts seems to me to be pointless: they will hold government debt. Talk about political risk: some of these countries have enormous troubles collecting taxes, and what is the one thing you can surely collect taxes on? Pension accounts that the government is holding. So they may be more vulnerable to heavy taxation than any other asset. And there may be less political protection from inflation than with defined benefits.

⁴⁰ The Worker's Union, which still strongly opposes the increase of the retirement age, tried to bring the 2002 reform to a halt through a referendum but it was ruled illegal by the Constitutional Court. Moreover, the union is critical of the implementation of the privatization process (claiming that it favors foreign ownership), and opposes trade liberalization (which it considers premature).

⁴¹ References for this paragraph, in addition to the citations in the text, are, in particular; World Bank, 1998, p. 4); World Bank, 1999, p. 3; World Bank, 2001, pp. 3, 11, 12; World Bank, 2001a, pp. 6, 7, 23, 25–28, 31, 32, 52, 53; World Bank, 2002, p. 3; and World Bank, 2002a, pp. 4, 8, 9, 18, 19).

⁴² The ECA region comments, "The claims of unsustainability are based on an explicit assumption that there will be no further changes in the structure of the pension system, even if these are fairly obvious changes that could easily be accommodated. No one connected with the development of and support for, Albania's pension system sees the current structure as the final one. Nor have they seen assured short-term and long-term financial balance from the early 2000s as a reasonable statement of the reform process's objective."

5. Findings

5.1 Following evaluations of the various aspects of the Bank’s involvement in the Albanian pension reform, we consider the following overall evaluation (Table 6) to be appropriate:

Table 6: Evaluation of Bank Performance

<i>Item</i>	<i>Sustainability</i>
Quality at Entry	Satisfactory
Supervision	Satisfactory
<i>Overall Evaluation of Bank Performance</i>	<i>Satisfactory</i>

5.2 According to our interviews and analysis of documents, the Bank had a central role in shaping the pension reform. It resisted the easy temptation of adopting a “top-down” approach and was able to establish a very fruitful cooperation with involved officials, and to build capacity through on-the-job training. On strictly operational terms, in our interviews with officials the Bank was recognized as particularly effective in administering and supervising the approved loans, which resulted in a very satisfactory disbursement rate. The adopted strategies were always backed by in-depth research and preparation, resulting in a relevant number of economic studies, also useful to the donor community at large.

5.3 In this respect, the Bank played a leading role in donor coordination, cooperating closely with the IMF, European Union, European Bank for Reconstruction and Development, and bilateral donors, including, in particular, the United States and Italy. Although problems emerged during the Kosovo crisis, due to the interruption of the sector donor meetings, collaboration has now been resumed, in particular, building on the government’s Growth and Poverty Reduction Strategy. In the pension area, however, the Bank played an almost exclusive role, while other donors greatly helped in closely related fields. The International Labor Organization, whose pension reform philosophy appears to be at odds with the Bank’s in a number of other countries, worked closely with the Bank in capacity building and on labor market issues, and is also expected to train some SII staff on pension simulations.

5.4 Although donor coordination still needs improvement, in the aftermath of the Kosovo crisis, we are not aware of any fundamental disagreement among the various institutions, and cooperation appears to be based on the recognition of the complementarities of roles.

5.5 As for the country’s performance (Table 7), we recognized a notable commitment within the government toward implementing the advice received. Notwithstanding the political instability and the turmoil that followed the 1997 crisis, the government never disowned the principles of a sound pension reform. The capacity of developing autonomous policies, however, still has to be improved. Much effort should be devoted toward promoting a full understanding of the workings of a

market economy, stressing the need for right incentive structures and transparent governance; further help is needed to improve the administration on an operative basis.

Table 7: Evaluation of Borrower Performance

<i>Item</i>	<i>Performance</i>
Preparation	Satisfactory
Implementation	Satisfactory
Compliance	Satisfactory
<i>Overall Evaluation of Borrower Performance</i>	<i>Satisfactory</i>

5.6 Finally, we attempt to sketch a “what-if” scenario, which means speculating about what likely would have happened had the Bank not been involved in the Albanian pension reform. This exercise is particularly difficult in the Albanian case, because of the very important role played by the Bank, not only in pension reform but also in donor coordination, and because of the very difficult initial conditions of the country.

5.7 Widespread poverty and social disruption following the fall of Communism demanded both emergency and structural interventions to adequately reform the social safety net. Had the Bank not intervened, the pension reform would have probably been taken up by the donor community. Our interviews, however, clearly stressed the unique aspects of the Bank’s approach, which were characterized by a cooperative attitude and a very effective and efficient management. Had the Bank not acted on this issue, the result would have probably been a stronger top-down approach, lower government commitment and, possibly, substantial implementation delays, particularly as a result of the 1997 crisis.

5.8 As for the specific content of the reform, a prudential attitude led to a satisfactory intervention. It is likely that Albania could have taken a different path in the absence of the Bank. Depending on which institution took the lead in pension reform, a more dangerous outcome with less effective parametric reforms or, alternatively, premature funding could have occurred instead.

6. Lessons and Future Action

6.1 In spite of many similarities, the transition paths of Eastern European countries differ considerably, reflecting special characteristics and circumstances. In the Albanian case, work had to “start from scratch”—building a foundation, rather than simply transition, was the issue. Basic civic values as well as basic institutions had to be created. While pension reform can never be considered merely a technical problem, the links between economic change and more general constitutional development should be kept clearly in mind. More attention should be paid to the way the former may positively or negatively influence the latter.

6.2 If this broader strategy had been followed, the Bank would have been able to anticipate the dangers of unfettered and immature financial market developments and the dire repercussions for Albanian society of the pyramid schemes and their inevitable collapse. Development of a wider perspective by the Bank would be a positive element of its work well beyond the Albanian case.⁴³

6.3 Turning to the more specific issues of institution and market governance in particular, it should be noted that market building, by itself, is not enough. A market built based on theoretical constructs alone—without knowledge of how governments, citizens, and potential buyers and sellers behave—may not only be ineffective but also potentially dangerous. Crises are likely to start and spread more generally to society and endanger the whole transition process. More thought needs to be given to these general consequences. With hindsight, it is fortunate that Albania’s economy and society—with the help of massive foreign aid—did not degenerate into irreversible chaos. Time is needed, however, for damages to be repaired and for the long and difficult journey toward sustainable development to be completed.

⁴³ The ECA Region comments, “The view that the Bank could and should have prevented the pyramids crisis is “heroic” and probably unreasonable, but cannot be construed as implying a failure on the part of technical sectoral assistance with pensions.

Appendix A: Bank Assistance Instruments for Albanian Pension Reform

LENDING INSTRUMENTS		NON-LENDING INSTRUMENTS	
Before 1999			
Instrument	Aim	Instrument	Aim
Technical Assistance Project for Social Safety Net Development in the amount of SDR 3.9 million (P008265)	<ol style="list-style-type: none"> To support social insurance reform (establishing a Social Insurance Fund, developing new systems to collect contributions, developing an automated Social Insurance Register, strengthening the Social Insurance Institute) To develop social assistance (promoting policies, strengthening institutional capacity, developing a statistical database) 	Economic report Albania: Building a New Economy (1994)	<ol style="list-style-type: none"> To focus on the Albanian economic situation.
Rehabilitation Credit in the amount of SDR 18.3 Million (P053357)	<ol style="list-style-type: none"> To strengthen the social safety net. 	Economic report Albania: Growing out of Poverty (1997)	<ol style="list-style-type: none"> To analyze Albania's economic recovery process.
		Economic report Albania beyond the Crisis. A Strategy for Recovery and Growth. (1998)	<ol style="list-style-type: none"> To focus projects under way and to plan reforms.
1999-2001			
Instrument	Aim	Instrument	Aim
Structural Adjustment Credit in the amount of SDR 33.2 Million (AL-PE-55160)	<ol style="list-style-type: none"> To complete the privatization of enterprises and banks. To reduce public sector intervention. To ensure sustainability of public pensions (by providing actuarial analyses and by preparing a pension reform paper). 	Poverty assessment A Qualitative Assessment of Poverty in 10 Areas of Albania (2001)	<ol style="list-style-type: none"> To analyze the main determinants of poverty in Albania. To understand who are the poor in Albania.
Social Services Delivery Project in the amount equivalent to US\$10 million (P055383)	<ol style="list-style-type: none"> To develop policies and build capacity (poverty monitoring, social service policy development, pension policy modeling). To build social service administration capacity. To create community based social services. To ensure an efficient implementation of project management, building information systems and monitoring. 		
2002-2005			
Instrument	Aim	Instrument	Aim
Poverty Reduction Support Credit in the amount of SDR 16 million (P 069935)	<ol style="list-style-type: none"> To develop and implement fiscally sustainable policies. 	Albania Poverty Assessment (2003)	Quantification and analysis of poverty, and support to the government poverty reduction strategy

Appendix B: Statistical Summary

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Macroeconomic data													
GDP current prices (LCU)	16,812,999,680	16,403,999,744	53,232,001,024	125,340,000,256	187,891,007,488	224,744,996,864	280,997,986,304	341,720,989,696	460,651,015,424	506,204,913,664	539,210,153,984	590,237,007,872	658,061,983,744
GDP current prices (US\$)	2,101,624,960	1,139,166,720	709,760,000	1,228,101,120	1,985,742,976	2,424,483,664	2,688,975,872	2,294,507,520	3,058,029,568	3,676,410,112	3,752,070,912	4,113,723,392	4,695,412,224
GDP real rate of growth	-9.6	-27.5	-7.2	9.6	9.4	8.9	9.1	-7.0	7.9	7.3	7.8	6.5	4.7
GDP per capita (constant 1995 US\$)	842	607	563	621	687	761	841	788	853	914	979	1,032	1,071
Nominal Monthly Wage (current LCU)		2,094	3,418	4,773	5,957	7,663	7,996	9,063	10,894	12,118	13,355	14,820	
Nominal Monthly Wage (current US\$)		366	51	43	57	75	79	61	73	89	94	104	
Real monthly wage (1991 = 100)		100.0	46.7	65.0	91.1	117.1	91.1	86.7	96.2	108.6	111.5	107.9	
Number of employed (thousands)	1,434,000	1,404,000	1,095,000	1,046,000	1,162,000	1,153,000	1,116,000	1,108,000	1,085,104	1,065,104	1,068,190	920,569	920,144
Average annual exchange rate lek/US\$	5.7151	5.7249	67.1100	110.3085	104.1573	101.9067	101.8442	149.5500	150.1400	136.0170	142.7929	142.7534	139.3859
Rate of inflation (GDP deflator)	-0.47	34.54	249.68	114.84	37.03	9.84	14.60	30.76	24.96	2.47	-1.19	2.80	6.49
Demographic statistics													
Total population	3,277,000	3,297,000	3,297,640	3,278,910	3,241,140	3,185,000	3,144,730	3,119,740	3,109,690	3,114,420	3,134,000	3,164,400	3,195,100
Population 0 - 14	1,074,077	1,059,961	1,046,031	1,032,284	1,018,718	1,005,330	987,434	969,859	952,599	935,648	919,000	906,247	893,674
Population 15 - 64	2,028,363	2,024,305	2,020,256	2,016,214	2,012,181	2,008,156	2,007,724	2,007,292	2,006,861	2,006,430	2,006,000	2,040,400	2,075,389
Population 65 and above	174,560	173,944	173,332	172,722	172,117	171,515	178,583	185,933	193,636	201,647	210,000	217,083	224,415
Life expectancy at birth M	75.4	75.4	74.3	74.3	75.6	74.3	74.7	74.7	76.4	76.4	76.4	76.4	76.4
Life expectancy at birth F	69.3	69.3	68.5	68.5	69.5	68.5	68.8	68.8	71.7	71.7	71.7	71.7	71.7
Life expectancy at birth	72.3	72.3	71.3	71.3	72.5	71.3	71.7	71.7	74.0	74.0	74.0	74.0	74.0
Fertility rate	3.03		2.85		2.70	2.64	2.58	2.52	2.20	2.10	2.14	2.19	2.23
Pension statistics													
Contributors (thousands)	1,429	1,345	1,160	731	502	506	432	348	362	423	500	505	524
Old - age pensioners (thousands)				364	378	384	393	398	406	417	427	437	446
Disability pensioners (thousands)						17	19	18	26	31	38	40	31
Survivor pensioners (thousands)													73
Total number of pensioners (thousands)	321	372	426	470	473	482	497	506	515	527	538	545	555
System dependency ratio	0.22	0.28	0.37	0.64	0.94	0.95	1.15	1.45	1.42	1.25	1.08	1.08	1.06
Average real monthly pension - urban (LCU)				2,299	2,414	2,840	2,999	2,229	2,326	2,574	2,787	5,921	6,446
Average real monthly pension - rural (LCU)				711	754	700	776	545	543	539	614	1,276	1,575
Average real monthly pension - urban (US\$)				20.8	23.2	27.9	29.4	14.9	15.5	18.9	19.5	41	46
Average real monthly pension - rural (US\$)				6.4	7.2	6.9	7.6	3.6	3.6	4.0	4.3	9	11
Pensions payments (current prices - million LCU)	1,440	1,985	3,513	8,022	11,649	15,058							
Pensions payments (current prices - million US\$)	252	347	52	73	112	148							
Average replacement ratio - urban				36.7	32.3	32.5	32.2	31.9	31.8	30.1	30.1	30.1	30.1
Average replacement ratio - rural				11.4	10.1	8.0	8.3	7.8	7.4	6.3	6.6	6.6	6.6

Source: the World Bank, the IMF, INSTAT and Ufficio Italiano Cambi

The average replacement rate is calculated on the basis of salaries in the public sector

For FY 2001 and 2002 the pension figures are in nominal and not in real terms. For the other years the base year is 1995

Appendix C: Interviewed Officials

Mr. Ilir Beqa	General Director Social Insurance Institute
Mr. Ahmet Ceni	Deputy Minister Albania Ministry of Labor and Social Affairs
Ms. Milva Ekonomi	General Director INSTAT
Ms. Evis Gjebrea	World Bank Projects Coordinator Albania Ministry of Finance
Ms. Lorena Kostallari	Operations Officer for Human Development Projects World Bank
Mr. Erjon Luçi	Head of the Research Department Bank of Albania
Mr. Minella Mano	Chairman Trade Union of Health and Social Services
Ms. Greta Minxhozi	Senior Operation Officer for Private and Financial Sector Development
Mr. Nadir Mohammed	Country Manager World Bank
Mr. Kastriot Muço	Chairman Confederation of Trade Unions of Albania
Mr. Sokol Qeraxhiu	Director, Information Technology Department Bank of Albania
Mr. Dritan Shano	Deputy Minister Albania Ministry of Finance

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