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# Policy note

## Fiscal space for social protection in Albania – 2022 updates

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### 1. Introduction

At a time of great uncertainty, the need to create a comprehensive and resilient social protection system has never been greater. Governments must explore all possible measures to expand fiscal space to promote the SDGs and national development agenda through jobs and social protection.

In Albania, the ILO conducted in 2021 an analysis of the fiscal space for the social protection system and a review of the social protection system under the Joint UN Programme “Catalysing Municipal Social Protection.”<sup>1</sup> The fiscal space analysis was based on the data of the period 2015-2019. Its main purpose was to provide general guidance to the government, social partners and other stakeholders at the national and local levels on mobilising resources to finance social protection during normal times.

The twin shocks that hit Albania – the earthquakes in November 2019 and the COVID-19 pandemic during 2020-2022 – had significant implications on the economy, labour market and public finance. Furthermore, the inflationary pressures due to the war in Ukraine overshadow the post-pandemic economic recovery. All these factors affect the national capacities to generate sufficient financing for social protection and move towards a long-term goal of universal social protection.

Against this background, in the framework of the Joint UN Programme “Strategic Policy Options for SDG Financing,” the ILO conducted an update of fiscal space analysis of Albania by taking into account newly available data covering the COVID-19 pandemic period. This policy brief summarises the key findings and recommendations and highlights the main changes that affected the capacity of the country to create fiscal space for social protection.

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1. ILO. 2021. Fiscal space for financing social protection in Albania.

ILO. 2021. Review of social protection system in Albania: coverage, expenditure, adequacy and financing.

## 2. Economic context from 2019 to 2022

The 2019 earthquakes and the COVID-19 pandemic had a profound impact on the Albanian economy. In response to the COVID-19 pandemic, the Albanian government adopted a series of measures, including additional budget for public health, economic support to workers and businesses affected by the pandemic, and cash assistance and emergency humanitarian support for poor and vulnerable families.<sup>2</sup> The cost of three major support packages totalled 3.6% of GDP.

Albania's GDP contracted by 3.5% in 2020 but has recorded 8.5% growth in 2021. In the first and second quarters of 2022, the GDP grew 6.5% and 2.2%, respectively. The GDP per capita fell 2.9% in 2020, but grew 9.6% in 2021. According to the World Bank, the fast recovery is explained by the policy stimulus of the government and the dynamics observed in consumption and industrial sectors including earthquake reconstruction works.

The recovery of the labour market has been lagging behind. The Labour Force Survey data show that labour force participation rates decreased by 0.9%-points in 2020 to 59.5% (66.9% for men, 52.3% for women) and, although some recovery has been observed since 2021, they still have not recovered the pre-pandemic level. Unemployment rates increased 0.2%-points in 2020 to 11.7% (11.5% for men, 11.9% for women). Since then, contrary to previous years, the unemployment rate of women has been persistently higher than that of men.

The dual shocks also had significant implications on public finance. Due to the emergency spendings for crises response, the fiscal deficit as a percentage of GDP widened from 1.9% in 2019 to 6.7% in 2020 and to 4.5% in 2021, which resulted in increasing levels of deficit financing. Since 2015, the public debt level had decreased almost 7%-points to 65.8% of GDP in 2019. However, due to the COVID-19 pandemic the public debt as a percentage of GDP reached a maximum level at 74.5% in 2020, lowering to 73.2% in 2021. Accordingly, debt service (payment of principal and interest) increased sharply from 3.8% of GDP in 2019 to 5.9% in 2020 then decreased to 3.9% in 2021.

Since the beginning of 2022, an increasing inflationary pressure has been observed. While the average inflation rate during 2015-2019 was 1.9% per year, it is 8.1% in September 2022 with sharp increases in food (14.0%) and transportation (17.2%).

The weak labour market recovery and the deterioration of public finance resulted in further constraints on social protection financing through reduced tax base and fiscal pressure to contain rising fiscal deficits and public debts. On the other hand, accelerated inflation affected the living costs and poverty levels, and may require additional adjustment of wages and social protection benefits.<sup>3</sup>

2. ILO. 2021. Assessment of the Social Security Responses to COVID-19: Lessons from the Western Balkans and Eastern Europe during the first stage of the pandemic.

3. In response to the rapid rise in food and energy prices in 2022, the government implemented emergency support for pensioners receiving low pensions, economic assistance beneficiary families, persons with disabilities, as well as subsidies for energy prices, under two Social Resistance Packages.

### 3. Fiscal space analysis updates

By taking into account the economic tendency observed in the recent years, major financing options to create the fiscal space for social protection have been reassessed. Table 1 compares the results of the 2022 updates with those of the 2021 report (see Box).

**Table 1. Financing options and their effects, 2022 updates**

Financing options	Measures	Fiscal effects (% of GDP)	
		2021 report	2022 updates
Expanding social security coverage and contributory revenues	Universal coverage of workers	5.8	4.65
Increasing tax revenue	VAT, additional 1%-point	0.44	0.41
	Profit tax, +1%-point	0.20	0.18
	Excise tax, +1%-point	0.28	0.27
	Personal income tax, +1%-point	0.16	0.14
	National taxes and others, +1%-point	0.28	0.22
	Customs duties, +1%-point	0.06	0.05
	16% reduction in tax evasion	1.1	0.85
	20% reduction in tax expenditures	1.1	1.1
Eliminating illicit financial flows	20% reduction of illicit flows	0.95-1.36*	0.80-1.17
Public expenditure reprioritisation	10% re-prioritisation	0.05	0.04
Use of fiscal and foreign exchange reserves	20% of the reserves in excess under the most restricted scenario	0.40	0.40
Debt restructuring	1%-point decline in the average cost of the Albanian debt	0.56	0.78
	5% reduction in the debt service	0.39	0.24
	10% decline in the interest payments	0.22	0.21
	5% reduction in the public and publicly guaranteed loans with international financial institutions	0.43	0.40
	5% reduction in the multilateral debt	0.36	0.89
Adopting an accommodative macro-economic policy	Set fiscal deficit at 2% of GDP	0.40	Not considered

Source: ILO own estimations.

Notes: The estimates reflect substantial retrospective data adjustments.

Overall, the earthquake and the COVID-19 pandemic have negatively affected the potential to create additional fiscal space for social protection. In total, 13 out of 18 individual measures considered in the analysis exhibit less effects on their fiscal space generation potential compared with the previous report. However, the results also show the robustness in the sense that the order of effectiveness by individual measures remain unaltered.

Several specific issues require detailed explanations.

- The direct revenue-generating options, typically through social security contributions and taxation, still have a significant potential to create fiscal space for contributory social insurance and non-contributory social assistance and social services. However, due to the decrease in employment and the contraction of GDP, their effectiveness has manifestly diminished. Thus the direct revenue-generating options require further efforts to expand social protection financing.
- The options for improved efficiency and expenditure management include the reduction of illicit financing flows, expenditure reprioritisation and debt-restructuring. Again, substantial decrease was observed in these options, while the reduction of illicit financial flows still remains as a possibility of creating substantial fiscal space.
- The recent budget performance and allocation of public resources reduced considerably the possibility of creating fiscal space from spending reallocation. There is still a room for expanding the budget in respect of remunerations, transfers and capital spending, but the functional budget reallocation observed a reduction in its potential of fiscal space creation. In addition, the excess reserves remain equally effective although their use for social protection benefits may face legal constraints.
- The debt service returned to the pre-pandemic level in 2021. Some debt management alternatives, for instance, a 1%-point decline in the average cost of the Albanian debt and a 5% reduction of the multilateral debt, can yield additional space for social protection, although it may be more difficult to reduce the average cost than five years ago as the public debt to GDP ratio is greater. It should be noted that short-term debt fell substantially from 50% of the country's reserves to 14%, hence lower interest payments could contribute to reduce the overall debt.
- Finally, as an option to adopt a more accommodating macroeconomic policy, the 2021 report suggested a measure which allows for certain fiscal deficits, for instance at 2% of GDP, so that the country can increase resources for social protection without jeopardizing macroeconomic stability. However, under the current public debt levels and inflationary pressures, this option is not considered feasible. Only when inflation is stabilised and the debt level is contained can one revisit this option.

The feasibility of all the financing alternatives should be assessed from broad perspectives. First, the economic effects of each measure should be assessed in terms of sustainability, equity promotion and welfare enhancement. Second, it is necessary to assess the capacity of the Albanian institutions, including the human, financial and IT resources as well as well-designed strategies to effectively

implement these measures. Thirdly, it is also necessary to assess how these measures can receive support from different stakeholders who may possibly have conflicting interests. It should also be noted that some of the measures such as the formalisation of the informal economy, tax evasion control, and the fight against illicit financial flows, can yield substantial revenues only after several years of continuous efforts, perhaps more than a decade.

### **Box. Fiscal space for social protection: Concept and options**

Fiscal space is defined as the resources available as a result of the active exploration and utilisation of all possible revenue sources by a government. There is a wide variety of options to expand fiscal space and generate resources for social protection, even in the poorest countries. The eight financing options, all supported by policy statements of the United Nations and the international financial institutions, are as follows:

1. Expanding social security coverage and contributory revenues;
2. Increasing tax revenue;
3. Eliminating illicit financial flows;
4. Re-allocating public expenditures;
5. Using fiscal and central bank foreign exchange reserves;
6. Managing debt: borrowing or restructuring sovereign debt;
7. Increasing aid and transfers;
8. Adopting a more accommodating macroeconomic framework.

Source: Ortiz, I. et. al. 2019. Fiscal Space for Social Protection: A Handbook for Assessing Financing Options. ILO, UNWOMEN.

## 4. Municipal financing and social protection

As a result of Albania's fiscal and administrative decentralisation that started in 2015,<sup>4</sup> a large part of administration and financing of social assistance and social services have been transferred from the central government to local governments (61 municipalities).

Local governments, in particular the social administrators, now play a key role in identifying the families in need of cash economic assistance, verifying the self-declared information and monitoring the living conditions of the beneficiary families, in particular the efforts towards integration of the beneficiaries into labour market. The costs of cash economic assistance are covered by the transfer from the central government. However, 6% of the cash economic assistance budget is allocated to local governments for approving the benefits at their own discretion.

Local governments are responsible for the delivery and financing of social services. Each municipality should develop its Social Care Plan which specifies the costs for services and the resources allocated from the municipality budget. The capacity and resources of the municipalities to deliver social care vary significantly. Many local governments remain heavily dependent on the transfer from the state budget. To ensure an adequate level of funding at local levels for implementing Social Care Plans, the Social Fund was established in 2018. Between 2019 and 2021, the Social Fund disbursed 344.1 million lek to 22 municipalities. The Social Fund plans to allocate additional 200 million lek for 2022.

As shown in Table 2, local government revenues exhibit an increasing tendency even during the pandemic years. The total local government revenue increased from 2.4% of GDP in 2015 to 3.7% in 2021. Transfers from the central government represent the most important source of income for local governments which account for more than 60% of the total revenues. The share of the government grant gradually fell but increased during the pandemic years and attained 2.3% of GDP in 2021. Local taxes became the driving force of the increasing municipal revenues. Over the last five years, these levies increased by more than 60%, reaching at 1.1% of GDP in 2021. The property tax and small business tax have been stable since 2016.

Clearly, fiscal space in local governments is insufficient for substantially increasing social protection funding at the local level. This is true even if taxes are raised. For instance, a 20% increase in local taxes may generate 0.21% of GDP assuming no evasion, while some researchers consider the potential to expand revenue collection from property tax up to 0.8% of GDP.

**Table 2. Revenues of local governments by source, 2016-2021 (% GDP)**

	2016	2017	2018	2019	2020	2021
Grants from central government	1.94	1.81	1.70	1.96	1.80	2.29
Local taxes	0.66	0.86	1.00	1.04	1.00	1.07
Property tax	0.32	0.31	0.32	0.31	0.31	0.32
Small business tax	0.04	0.02	0.02	0.02	0.02	0.02
Total	2.96	3.00	3.03	3.32	3.14	3.70

Source: ILO own calculations based on the Ministry of Finance and Economy reports.

4. Law No. 139/2015 "On Self-Local Governance."

## 5. Conclusions

The COVID-19 pandemic demonstrated the importance of social protection to mitigate the risks associated with public health, poverty and unemployment. However, the crisis has revealed gaps in the existing social security system. In particular, the COVID-19 crisis has highlighted the importance of proactive investment to build comprehensive and resilient social protection systems that can respond quickly and effectively to shocks when they emerge.

In relation to the 2021 report, this updated fiscal space analysis revealed that both pandemic and earthquake have negatively affected the efficacy of the financing alternatives to generate additional fiscal space for social protection. This is typically the case for social security contributions and taxation. The debt restructuring yielded some positive outcomes only under specific conditions such as the average cost decrease and the reduction of multilateral debt. However, increasing the debt stock is not a considered politically feasible given the pressure to control debt build-ups. Other sources, such as the use of excess reserves and the budget reallocation, also leave less margin to create fiscal space. Despite those limitations, the strategic considerations of the policy priorities in the 2021 report remain basically valid. It should be stressed that extending the coverage of the contributory social insurance remains one of the most credible options for creating fiscal space for social protection. Depending upon the macroeconomic conditions for the post-pandemic period, there still exists a reasonable scope for the government to further expand fiscal space for social protection.

In view of the crucial role of the social protection system in protecting people's lives at unprecedented shocks such as the COVID-19 crisis, Albania should make continuous efforts to achieve the long-term goal of universal social protection. For this purpose, the government at both central and local levels should explore all possible fiscal options. The set of alternative policy options should be assessed with due consideration of their associated social impacts, risks and trade-offs, and discussed with all stakeholders to build a consensus based on a national dialogue.

At the ILO, we believe that the fiscal space analysis offers useful quantitative information to motivate and navigate the policy discussion. The ILO, together with partner UN organisations, are committed to be actively involved in the national discussion on creating fiscal space for universal social protection and furthermore the achievement of the Sustainable Development Goals.

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