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## *Prospects for Albania's Light Industry Sector*

Prepared by Deloitte & Touche and  
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**Re: Contract No. EUR-0014-I-00-1056-06, Delivery Order No.  
23, Albania Trade, Investment, and Privatization,  
Report on Task #4.b. - Analysis of the Light Industry Sector**

Dear Mark and Gary:

In accordance with Article IV of the above-referenced Delivery Order, enclosed please find the report on Task #4.b. of the Albania Trade, Investment, and Privatization project. This report summarizes the findings of a 12 firm evaluation of Albania's light industry sector in order to identify possible comparative advantage.

This deliverable was prepared by the Deloitte & Touche/DAI team working in Albania. If you have any questions concerning these deliverables, please call Anne Nisenon at (202) 879-5661.

Sincerely,

Lizann Prosser  
Senior Manager  
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## EXECUTIVE SUMMARY

This report summarizes findings from a USAID-financed rapid survey of 12 firms in Albania's light industry sector. Survey data are reinforced by information gathered through interviews with ministry and donor personnel. The goal of the survey was to identify products that appear to have a comparative advantage within Albania's light industry sector.

In the 1980s, output in Albania's light industry sector grew by about 4 percent per year, but exports declined considerably. When domestic demand collapsed beginning in 1989, the sector was hit hard. Today, after a tough process of employee layoffs and enterprise shutdowns, the sector appears poised for renewed growth. The new light industry sector has a different structure and a far greater emphasis on production for exports than did the old.

Over the past two years, the most promising development by far in the light industry sector has been the rapid blossoming of export-oriented production — in particular, inward processing. Manufacturers of shoes and clothing have switched from production for the local market toward partial processing of inputs for goods that are finished and sold overseas. Processing work has rapidly become a leading source of export revenue. In 1993, foreign exchange earnings of processing work outstripped those for all other manufactured export revenue combined.

This study develops some rough estimates of comparative advantage for a sample of 10 products. It finds that products that are relatively labor-intensive have a comparative advantage in the sector. Of the 10 products examined, processing production and artisanal kilim rug production appear to show the most promise for Albania. But, under some pricing hypotheses, a few other products — wool products, leather shoes, and kiosks — appear competitive.

This study concludes that, because Albania has a comparative advantage in processing production, the Government of Albania should develop a strategy to promote its processing production for countries besides Italy and Greece. Germany and the Benelux countries — Belgium, the Netherlands, and Luxembourg — which have a long experience with processing trade and are highly dependent on it, should be targeted. In addition, some greater promotion of processing production within Albania is needed to reduce the perception that it is a second-rate form of production.

New tax treatment of the inputs for processing production threatens the sustainability of this promising new form of production. Imported inputs for processing and subsequent re-export should not be subject to customs duties. The Customs Office needs to develop a different form of control for the inputs for processing.

## INTRODUCTION

This study was produced under USAID's Albania Investment and Privatization Program. Its analysis of the comparative advantage of products in Albania's light industry sector is designed to feed into the identification of strategies to develop the export potential of competitive Albanian products.

The Investment and Privatization Program is USAID's mechanism for assisting Albania's Ministry of Industry and Trade in its conversion to a ministry that effectively supports and promotes the new free market economy in Albania.

This report analyzes the condition, resources, potential, and regulatory environment for light industry in Albania. Its analysis is based on extended interviews with representatives from 12 firms and on more cursory discussions with representatives from key ministries and donors.<sup>1</sup> To identify areas of comparative advantage in the light industry sector, the study estimates the domestic resource cost (DRC) for production of 10 representative goods.<sup>2</sup>

## CONDITION OF THE LIGHT INDUSTRY SECTOR

### General Characteristics

Since 1989, Albania's light industry sector has undergone a dramatic transformation. Through the 1980s, output in the light industry sector grew by about 4 percent a year, but exports declined considerably. When domestic demand collapsed beginning in 1989, the sector was hit hard.

After a tough process of employee layoffs and enterprise shutdowns, the sector appears poised for renewed growth. The new light industry sector has a different structure and a far greater emphasis on production for foreign markets than did the old. The return to growth has been uneven; some of the light industry subsectors with good long-term growth potential remain mired in a deep recession. But there are other, positive signs of growth and investment that indicate the sector will continue to be an important source of employment and growth in the economy.

### Size

Albania invested heavily in the expansion and diversification of its industrial base from 1950 to 1975, a period during which total industrial output grew by more than 10 percent per year.<sup>3</sup> During the

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<sup>1</sup> The annex lists the persons contacted for this study.

<sup>2</sup> The DRC ratio indicates the relationship between the opportunity cost of domestic resources consumed and foreign exchange earned or saved in the production of one unit of a specified product. A DRC less than 1.0 indicates that the economic costs of production are less than the costs of importing and that the country under study has a comparative advantage in that product.

<sup>3</sup> Mario I. Blejer et al., "Albania: From Isolation toward Reform," International Monetary Fund, September 1992.

1980s, light industry accounted for about 20 percent of industrial output, or roughly 10 percent of net material product. Within the sector, textiles, clothing, and shoes constitute about 70 percent of output. The sector is a major employer of women.

Over the past four years, in preparation for the privatization of the state-owned enterprises (SOEs), once-massive firms have been split along production lines or into workshops. Today, the sector has become overwhelmingly one of medium-sized enterprises.<sup>4</sup>

### **Composition**

Administratively and conceptually, Albania differentiates light industry from heavy industry. Light industry is the relatively less capital-intensive part of industrial output. It includes textiles, clothing, shoes, artisanal work, and light electro-mechanical assembly. For this study, woodwork is also included. Agro-industrial production is not part of the light industry sector.

### **Sample Firm Characteristics**

Most factories visited for this study were sprawling facilities built on large parcels of land. The physical plants were almost always dilapidated, with missing windows, and little or no heat. Most of the factories and the grounds were filthy. Small workshops, each with its own equipment, are set up within the walls of the plant. Barriers have been constructed to isolate the workshops from one another. Sometimes all of the workshops continued to operate; in other plants, some of the workshops appeared permanently out of commission.

Typically, equipment was antiquated, anywhere from 20 to 80 years old. Much of the equipment seen in the sample firms was of Russian and Chinese technology from the 1950s and 1960s. Although the equipment was often well maintained and still operational, its output was generally not exportable.

Because there has been so little new investment since the Chinese left in 1978, firms often carried little or no debt. A more common problem was large stocks of inputs and finished goods.

## **The Reaction to Reform since 1990**

### **The Initial Decline in Output**

From 1990 to 1992, Albania suffered through a collapse in output more severe than any other experienced in Eastern Europe. Overall, gross domestic product (GDP) shrank by 38 percent. The resulting inflation and fiscal crisis were also without precedent in Eastern Europe: in the first half of 1992, as public expenditures rose to 66 percent of GDP to cover increased subsidy demands, the deficit exploded to 42 percent of GDP.

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<sup>4</sup> A medium-sized enterprise employs between 50 and 300 workers.

The severe economic contraction from 1990 to 1992 was most strongly felt in the industrial sector, where output fell by 20 percent in 1990, 37 percent in 1991, and 60 percent in 1992.<sup>5</sup> 1993 production was just 20 percent of that in 1990. The fall in output reflected the collapse in Albanian demand, both public and private. The drop in output accelerated as links in the integrated production chains found in most sectors began to break down. Firms that once relied on locally produced inputs were forced to turn to overseas sources or donors for their inputs (prices for imported inputs are generally higher than those for the local alternatives).

Data are scarce for this period, but Table 1 shows the trend in output volume in the textile, clothing, and shoes industries.<sup>6</sup>

TABLE 1  
TOTAL OUTPUT IN TEXTILES, CLOTHING, AND SHOES

	1989	1990	1991	1992
Textiles ('000 ml)	50,002	41,582	11,379	8,338
Garments ('000 ml)	24,029	21,443	8,440	3,971
Shoes ('000 pairs)	5,882	5,749	1,861	1,214

Source: Albanian Center for Foreign Investment Promotion, "Industry of Cloth-Wearing," November 1993

As output fell, firms were compelled to lay off a substantial portion of their work force. For the nine sample firms with employment data, jobs fell by 35 percent — 66 percent if the two firms that have hired new employees over the past three years are taken out of the average.<sup>7</sup>

### Stabilization and an Uneven Return to Growth

Since mid-1993, the economy appears to have stabilized, and there is some sense that the worst part of the adjustment may be over. The least competitive firms are no longer operating, and most others have trimmed their labor forces substantially to adjust to lower demand. Export-oriented firms are starting to hire new staff as they master international production standards and as demand from overseas rises.

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<sup>5</sup> Blejer, *op. cit.*

<sup>6</sup> There are two things to keep in mind, particularly in the textile, clothing, and shoe industries: clothing work and shoe assembly work are not classified as production and so are not included in these statistics, and private production also is excluded from the statistics.

<sup>7</sup> The two firms that have hired new workers are producing blouses and shoe uppers under processing contracts with European firms.

## **A Small but Growing Private Sector Contribution**

Private sector activity is growing rapidly in Albania, but, for now, private activity is concentrated in commerce (import/export, wholesale, and retail) and services. At the end of 1992, Albania had more than 44,000 private enterprises, of which 645 were industrial.<sup>8</sup> Anecdotal evidence indicates that these firms are concentrated in light industry — furniture making, shoes, and clothing assembly are often cited. Some are recently privatized state-owned enterprises; others, particularly furniture production, are new family-owned operations. Some SOEs are leasing factory floorspace to private business people looking for an established site.

### **Progress toward Privatization**

In all sectors in Albania, including the light industry sector, privatization has been a slow process. For light industry, those privatizations that have occurred have most often been employee purchases of a small assembly line or workshop.

Potential foreign buyers face substantial hurdles when purchasing firms. To date, few firms have been privatized to foreign ownership; instead, foreign investors, even those that have expressed a desire to fully purchase an enterprise, are usually held to a joint venture arrangement. This study did not systematically study privatization efforts in the sector. But discussions with subsector specialists in the Ministry of Industry and Trade identified 10 joint ventures in the sector, all with foreign partners. Of eight privatizations cited, only one was to foreign ownership. One foreign investor that had tried to purchase a plant and had settled for a joint venture explained that the major problem encountered was an unrealistic valuation of the state-owned assets.

Rather than battle to purchase an enterprise full of outdated equipment, some foreign investors have preferred to lease space from an enterprise and set up shop within the leased shell. An Italian shoe manufacturer is operating out of an old cable manufacturing firm in Tirana. The company is fully private and has signed a five-year lease with the defunct cable-manufacturer. Another option is to sign a contract for inward processing with a local firm.

### **Development of Inward Processing Production**

Over the past two years, the most promising development by far in the light industry sector has been the rapid blossoming of inward processing production.<sup>9</sup>

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<sup>8</sup> Alan Osman, "The Albanian SME Sector, from Non-Existence to First Steps," November 1993.

<sup>9</sup> There is no consensus on the terminology for this practice. In Albania, it was frequently translated by using the French terminology, "façon" production. The European Union (EU) refers to it as "overseas processing." In the United States, the practice is better known as "maquiladora" production. "Inward processing" is the term used by the World Bank. Because that term is harmonious with the EU terminology, it is adopted in this text.

## **Definition**

Inward processing is not production — it is a service performed by a low-wage country. The low-wage country adds value to a good produced in a high-wage country. For example, suppose a European manufacturer wants to produce a blouse. The manufacturer designs and cuts out the cloth for the blouse. The pre-cut cloth is shipped to a nearby low-wage country — typically in Eastern Europe or in Northern Africa — where it is sewn up and finished. The blouse is sent back to the country of origin for sale. The input — the pre-cut cloth — remains the property of the firm of origin. Thus, when the input is shipped for processing, it is not registered as an import by the recipient country, nor is the final product registered as an export. The product retains its initial country of origin. The processing country earns foreign exchange for the service it provides, not for the final product.

## **Role in the European Union/Eastern European Market**

Inward processing was pioneered by West Germany, as a way to maintain its position in the highly competitive international clothing market. West Germany's high productivity did not entirely compensate for its high wages. To remain competitive, it began to farm out the most labor intensive stages of clothing manufacture. Over the past 10 years, this strategy has been adopted by other high-wage European countries, and its application has been broadened to include other labor-intensive manufactures, such as shoes, furniture, and mechanical assembly.

Germany remains the leading practitioner of this production strategy, accounting for more than 60 percent of European Union (EU) processing trade in clothing in 1992. It has generally looked nearby, to countries in Eastern Europe, for its processing partners. In 1992, the leading sites for inward processing were, by order of importance, Poland, the former Yugoslavia, Hungary, and Romania. Romania showed a substantial increase in output between 1991 and 1992.<sup>10</sup>

Inward processing is new in Albania. In 1992, Albania was not among the top 20 processing sites internationally. But the market for processing services is fairly deconcentrated and adapts rapidly to changing market conditions. Key factors in success in this market are low-cost labor, quality control, reliability, and rapid turnaround.<sup>11</sup>

Processing trade has become a significant enough factor in the EU clothing and textile market that EU countries are subject to quotas limiting the amount of their processing production. Southern European countries — in particular, Spain, Portugal, and Greece — have not participated much in this market. But as wages in these countries increase, the countries are growing interested in the strategy. In Albania, there are Greek investors carrying out inward processing.

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<sup>10</sup> "European Report," No. 1876, July 17, 1993, p. 5.

<sup>11</sup> Foreign partners of Albanian firms had mixed reports on quality control and productivity in Albania. Because so many of the processing contracts were less than one year old, the European firms were still classifying their Albanian ventures as start-up activities. All intended to put more time into developing their workers' skills.

TABLE 2  
MAJOR EUROPEAN PARTICIPANTS IN OVERSEAS PROCESSING TRADE  
(clothing in tons)

Country	1991		1992	
	Tons	Percentage of Clothing Imports	Tons	Percentage of Clothing Imports
Germany	77,725	9.8%	82,527	10.7%
France	15,083	4.8%	16,742	5.2%
Italy	1,783	1.7%	4,840	3.7%
Benelux	15,167	4.8%	17,215	5.3%
TOTAL - EU	118,074	9.2%	133,826	9.9%

Source: "European Report," No. 1876, July 17, 1993, p. 4

### The Development of Inward Processing in Albania

**Interest for Foreigners.** Inward processing is developing rapidly in Albania. The principal impetuses behind this trend are Albania's low wages and its proximity to Western Europe. Italy and Greece are the leaders in establishing inward processing relationships with Albanian producers. This is an unusual development, since neither Italy nor Greece is particularly important in the international processing market, dominated by Germany. Greece's wages are among the lowest in the European Union, but the differential between its wage rates and those of Albania is such that outward processing is of interest to Greek producers. Producers from Germany and Austria also have established processing contracts with Albanian producers.

An outward processing contract with an Albanian company offers a Western European firm a far less risky entrée to Albania than a direct investment. Typically, the source firm installs its equipment on site and provides one or two staff members to oversee production. Some processing contracts include provisions allowing the local firm to purchase equipment from the partner company. Contracts are generally from one to three months, and are then rolled over. Low investment costs and short contract duration allow the source firm to terminate the relationship relatively quickly and painlessly.

**Interest for Albania.** Albania already earns more foreign exchange through processing work than it ever earned through the export of finished light industry goods. Earnings from processing trade have risen rapidly over the past year, from about \$8 million (0.8 billion lek) in 1992 to roughly \$32 million (3.2 billion lek) in 1993.<sup>12</sup> In comparison, earnings for exports of finished light industry goods were far less. 1993 EU trade data (EUROSTAT) show that Albania's exports of finished light industry products to Europe totaled about \$15.5 million. Even in 1989, when Albania's dollar earnings for

<sup>12</sup> All processing trade data are classified. The 1992 figure is partial. No breakdown on the content of either figure is available. The exchange rate of lek to dollars in both 1992 and 1993 was roughly 100 to 1.

exports of all manufactured goods — including light industry — peaked, they did not exceed \$24 million.<sup>13</sup>

Dollar for dollar, foreign exchange earned in processing trade has more impact than that earned in trade in final goods. Why? Because processing exports are pure value added. For exports of finished goods, some part of foreign exchange earnings is netted out by the value of imported inputs. For that reason, direct comparisons of processing earnings and finished good earnings are misleading.

### **Export-Oriented Sales versus Local Sales — A Widening Gap in Performance**

There is a clear split in the performance of the enterprises visited for this study. The only firms producing anything were those producing for export with new foreign-provided equipment. Factories producing for the local market were turning out little or nothing. Their personnel were reduced to a core staff, and their directors sat waiting for the much-rumored but still-elusive foreign investor.

The survival of firms producing only for the local market is threatened by three factors:

- Weak local demand;
- Cheap imports from Asia and from elsewhere in Eastern Europe; and
- Rising production costs as parts of the domestic production chain close down. For example, kilim producers must now buy imported wool yarn at nearly twice the price of the local product.

### **Responses of Sample Firms to Changing Market Conditions**

#### **Market Evolution for Sample Firms**

Since 1989, all but two of the firms interviewed have decreased employment and reduced output. Those in the shoe and clothing subsectors, in particular, have subsequently rebounded by bringing in joint venture partners and establishing processing contracts. According to the sectoral staff at the Ministry of Industry and Trade, of 33 SOEs in the shoe and clothing industries, 4 have been privatized, 4 are in joint ventures, and 21 hold processing contracts. Firms that are fully or partially owned by foreign investors export all of their output.

No other industry has reoriented its production so successfully. But within some industries, individual firms have adapted well to market changes. For instance, a factory that until recently made wagons for transporting metal ore has shifted into kiosk and decorative metal production. The director hopes that demand for wagons in the mining sector will recover before demand for kiosks tails off.

More than a few of the enterprise directors interviewed had done little to adapt to the new market and are allowing the physical plants to decay.

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<sup>13</sup> Blejer, *op. cit.*

Some of the fundamentals of product marketing and promotion have not yet caught on in Albania. For instance, bulk purchasers still pay the same unit price as individual purchasers. And none of the firms visited had considered offering delivery of output; customers still come to the supplier.

### **Market Position of Sample Firms**

The firms producing for the local market target only the large low end of that market. Since 1989, these firms have experienced an increase in competition from imports. Those worst affected by the competition are the textile manufacturers. Other firms producing for the local market — makers of shoes, underwear, and electrodes — report that their output has a lower price than almost any import and so remains popular.

With the elevated price sensitivity of Albanian consumers, the cheapest and the most durable items constitute the best choices. Durability appears to be the most salient indicator of quality on the local market. The producers of shoes and of underwear both identified their market as rural households. They reported that no import can match the durability of their products at their low prices. The state-owned furniture manufacturer is neither the cheapest nor the most durable, and both imports and local private furniture makers are taking away the market.

Firms producing only for the export market follow a different strategy. Rather than emphasizing extreme low cost and durability, they are building their reputations for low costs, quality, and timeliness.

## **ASSESSMENT OF COMPARATIVE ADVANTAGE**

### **Methodology**

The analytic portion of this report draws from a rapid survey of 12 firms in Tirana, Durres, and Korce. The survey was designed to yield the following information:

- A qualitative assessment of the evolution of the market since 1990, and the firm's response to market changes; and
- A rough estimate of production costs of one or more products made in the enterprise.

To adjust local production costs to world prices, data on tariff rates, taxes, and import and export prices were collected from the Ministry of Trade and Industry, the Ministry of Finance, and the Customs Office.

### **Introduction to Firms**

Twelve firms were interviewed for this report, of which 1 is private, 1 is in a joint venture (JV), 10 are SOEs, and 6 are under contract for processing work. Of those 12, 10 were able to provide rough estimates of their costs of production. The sample is most certainly not a rigorous statistical representation of the sector. But it does touch upon the major activities in light industry, and it offers a variety of market orientations and ownership structures. General characteristics of the firms are shown in Table 3.

TABLE 3  
KEY CHARACTERISTICS OF THE SAMPLE FIRMS

Industry	Product	Ownership	Export Share	Market
Textiles	Acrylic blend thread and cloth	100% state	0	Local
	Wool yarn, cloth, and blankets	100% state	0	Local
	Cotton and cotton/polyester thread and cloth	100% state	0	Local
Clothing	Blouses	100% state	100%, processing	Germany, Austria, Italy
	Underwear	5 workshops, 4 100% state, 1 JV	4 workshops, 100% (processing); 1 workshop, no exports	Local, Greece
Shoes	Shoes and uppers	100% state	1 workshop, 100% export (processing); 1 workshop local	Local, Italy
	Leather uppers	50-50 JV with Italian firm	100%, processing	Italy
		100% private	100%, processing	Italy
Artisanal Work	Kilims	100% state	60% export	Local, various EU
Wood Work	Household furniture	100% state	0	Local
Mechanical Assembly	Kiosks, Wrought-iron work	100% state	Kiosks: 0 Wrought iron: 100% (processing)	Local, Italy
Electro-Mechanical	Electrodes	100% state (JV under negotiation)	0	Local

## Production Costs

### Caveats on Reliability of Quantitative Analysis

The SOEs had little idea of their true production costs. Their annual statements still are generally based on rigid, outmoded, and incomplete input-output ratios. In 1994, accounts should be prepared according to a new European standard accounting framework. But analysis for this study was handicapped by poor accounting:

- There was confusion between subsidies and non-wage benefits for workers;
- Overhead expenses were only crudely estimated. The total was often a function of wage costs. The pool of money designated for overhead covered an ill-defined mix of administrative salaries and expenses, overhead, transport, and amortization expenses;
- Firms did not explicitly amortize their capital stock; and
- Profits sometimes included overhead expenses or interest payments.

### Performance of Sample Firms in 1992-1993

**Value Added.** For this study, "value added" is defined in its broadest sense — that is, the residual of the value of output less that of inputs consumed. This definition is used because firms have relatively little trouble estimating the value of raw materials and electricity consumed in production of a fixed quantity of output, and they know what their sales price is. These estimates are likely to be more accurate than estimates of wages, overhead expenses, amortization, and profit, which are needed for a more precise estimate of value added. The formula used is:

$$VA = OUTPUT - INPUTS,$$

where VA is value added, OUTPUT is the value of the final good, and INPUTS is the value of local and imported raw materials, energy products, intermediate goods, and packaging.

OUTPUT and INPUTS are revalued to reflect their border prices.<sup>14</sup> Figure 1 shows the wide spread in the resulting value added rates. The two processing outputs show value added above 80 percent at world prices. The high rate is normal for production that is essentially only value added. For the

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<sup>14</sup> Border prices are the same as import parity prices. A border price is the price of a competitively priced good delivered to the border of Albania. The border is not necessarily the physical border; it is where the import or export passes through customs. The border price is free of domestic taxes and customs duties, but includes transport and insurance to the border.

For local products, the local price is assumed to be the border price increased by the customs duty and the turnover tax. To estimate the border price for locally produced goods, divide by the sum of the duty and the turnover tax:  $P^* = P/[1 + \text{duty} + \text{turnover tax}]$ . In Albania, electricity is priced at roughly 18 percent of world prices, so electricity rates are adjusted up by 400 percent.

other goods, value added rates are somewhat higher than is typical.<sup>15</sup> High value added reflects high factor costs (that is, high wages or interest costs), high profits, or low productivity. According to the firms interviewed, low productivity is the more likely culprit.

**Salaries.** Salaries are higher in enterprises producing for exports. Public enterprises producing for local consumption typically pay a salary that ranges from 2,200 lek per month to 3,200 lek per month. A salary increment, to cover recent increases in bread prices, was estimated by firms at 60 lek per day. This would bring earnings for employees up to 3,500 to 4,500 lek per month.

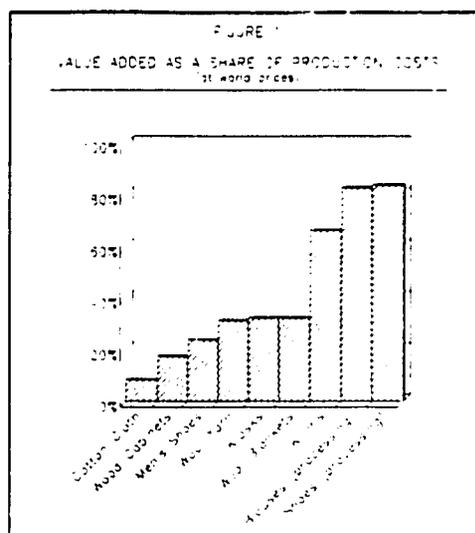
The export-oriented enterprises tend to set wages by the piece. This policy makes it difficult to estimate an average wage. But enterprise managers stated average wages that varied from 4,500 to 7,000 lek per month, including the bread payment.

**Input Costs and Sources.** Firms more and more face a pinch stemming from rising input costs and stagnant domestic demand. Unable to pass their increased costs through, some firms have stopped production. Price increases have been a result of devaluation, local inflation, and greater dependence upon imports.

Until recently, Albania was the most nearly autarkic of all countries. Since 1990, it has made tremendous progress toward opening its markets to foreign goods. At the same time, some local enterprises have ceased production. The result is that an increasing share of the inputs for those firms still producing comes from overseas. Privileged sources for imported inputs include Bulgaria, Romania, and Russia for metals, hardware, processed wood products, and mechanical parts. Firms are getting a taste for Western European and American inputs through aid programs. The European Union is providing necessary inputs for some firms as part of its large PHARE project. The United States is supplying cotton that is used by the cotton mill for its cloth. All donated materials are sold at roughly their market value. Much to the delight of the local cotton mill, the U.S. cotton is less expensive than alternatives used before. But the EU materials are frequently as expensive as or more expensive than the Albanian materials they replace.

As input costs rise, enterprise margins are squeezed. For instance, a kilim rug producer had depended upon the local wool mill for its yarn. When that mill stopped producing, the kilim producer was obliged to turn to better quality and more costly imported wool yarn.

**Effective Protection Rate.** The effective protection rate measures the impact of trade barriers on the protection of the value added of a product. The measure is used as a proxy for the economic incentives to produce. A high rate of effective protection for a good implies that the trade regime provides high incentives for production of that product. For a traded output, effective protection is defined by:



<sup>15</sup> A study for USAID/Morocco conducted by the author found that value added averaged 28-30 percent among industrial firms in that country. This average includes goods produced under processing arrangements.

$$EPR = \frac{VA^{local}}{VA^{border}} - 1,$$

where  $VA^{local}$  is the value added in the product measured in local prices and  $VA^{border}$  is the value added estimated in border prices.

When nominal protection on the final product is greater than that on its inputs, effective protection on the final product will be greater than nominal protection. In the opposite case, where nominal protection on the final product is less than that on its inputs — frequently the case for local goods that are exported — effective protection is less than nominal protection.

Effective protection measures incentives. In an industrial development strategy, the ideal trade regime provides a neutral set of incentives so that resources are drawn toward products with a comparative advantage. More typically, incentives are biased toward goods produced for the local market and toward inefficient goods. To make the incentive structure more neutral, policy makers aim for low and harmonized rates of effective protection. The best way to achieve that goal is through trade policy. If nontariff barriers are rare, tariff protection averages between 10 and 25 percent, and dispersion is low, the trade regime is generally judged acceptable.

Table 4 shows that, overall, effective protection rates in the light industry sector are not too much more than tariff protection rates. The major exceptions are wood furniture and cotton cloth. Processing output, kilims, wool blankets, and men's shoes have relatively low effective protection.

### Relative Ranking of Comparative Advantage

This study uses a rough measure of domestic resource cost to estimate comparative advantage for 10 light industry products. As noted above, Albania's markets and prices are too much in flux to allow much confidence in existing cost data. And the author is not aware of any efforts by analysts to shadow-price the major factors of production — labor, capital, and the exchange rate. To generate estimates for discussion, this study makes some simple assumptions on the relationships between nominal factor prices and the opportunity costs (expressed in shadow prices) of those factors. We define domestic resource cost as:

$$DRC = \frac{\sum (W^* + K^* + P^*)}{(VA^{border}) Xr}$$

where  $W^*$  is wages priced at the shadow price of labor,  $K^*$  is amortization and interest payments priced at the shadow price of capital,  $P^*$  is a standard measure for profits,  $VA^{border}$  is value added at border prices, and  $Xr$  is the equilibrium exchange rate.

< 25%	25% - 55%	> 90%
Kilims	Wool yarn	Wood cabinet
Shoe upper (p)	Kiosks	Cotton cloth
Blouse (p)	Electrodes	
Wool blanket		
Men's shoes		

p: processing

To get a sense of the robustness of the relative ranking of DRCs within the sample, we define a base case and four variations. Under the base case, the shadow price of labor is fixed at 75 percent of nominal value, the shadow price of capital is 15 percent, the cost of renewing the capital stock is estimated at 100 percent of the value of output, profits are estimated at 10 percent of the value of output, and the equilibrium exchange rate is the current rate devalued by 20 percent.<sup>16</sup>

How were these estimates reached? The high level of unemployment and emigration in Albania indicate that the shadow price of labor (the market clearing wage) is something less than the nominal wage. Seventy-five percent was taken as a starting point. Column 2 in Table 5 shows the impact of a reduction in the shadow wage rate to 25 percent of nominal levels. For capital, the 15 percent rate estimates the opportunity cost of capital. Column 3 in Table 5 shows the impact on comparative advantage if the opportunity cost of capital is 30 percent. The average profit rate is based on experience in other countries. Tariff protection results in an overvaluation of the lek that is estimated at 20 percent. Column 4 in Table 5 shows the impact of a total devaluation of 50 percent.

Each of these parameters can be questioned and adjusted. As shown in Table 5, if the shadow price of labor or capital declines or the exchange rate declines, the DRC falls.

When the DRC falls to a level less than 1.0, there is a comparative advantage in the production of that product. Of the scenarios presented, those in which the exchange rate is devalued by 50 percent or the shadow wage rate is reduced to 25 percent of the nominal rate have the most dramatic impact on comparative advantage. In these cases, six of nine goods appear to offer a comparative advantage.

The sample products are divided into three categories according to the DRC estimates: products with a strong comparative advantage, products with a borderline comparative advantage, and products whose production is relatively inefficient — that is, they show no comparative advantage.

**Group 1: Products with a Strong Comparative Advantage.** Three products appear to have a strong comparative advantage, irrespective of the shadow pricing hypothesis adopted. They are the two processing outputs — blouse assembly and sports shoe upper assembly — and kilim rug weaving. All three goods are highly labor-intensive. That they should be the most efficient outputs of the sample makes sense in the Albanian context of capital scarcity and labor surplus.

Group/Product	Base Case <sup>a</sup>	$W' = 0.25*W$	$K' = 0.30$	$Xr = 1.5$
(I) Shoe upper (p)	0.56	0.35	0.56	0.44
(I) Kilim	0.74	0.51	0.93	0.59
(I) Blouse (p)	<u>0.82</u>	0.54	<u>0.82</u>	0.65
(II) Kiosk	1.02	0.93	1.41	0.82
(II) Wool yarn	1.24	0.92	1.64	<u>0.99</u>
(II) Wool blanket	1.40	<u>0.99</u>	1.79	1.12
(II) Mens shoe	1.22	1.07	1.74	<u>0.98</u>
(III) Electrodes	1.40	1.34	2.18	1.12
(III) Wood cabinet	2.06	1.92	3.19	1.65
(III) Cotton cloth	5.98	4.72	7.47	4.79

<sup>a</sup> For the base case,  $W' = 0.75*Wage$ ,  $K' = 0.15$ ,  $P' = 0.10$ , and  $Xr = 1.2$

<sup>16</sup> Processing firms do not carry the costs of renewing their capital stock. Amortization is fixed at 0 for these firms.

The case of kilim rugs illustrates the difference between nominal price competitiveness and economic efficiency. On the international market, Albanian kilims are judged overpriced compared with kilims of the same quality produced in other countries, so kilim producers in Albania have considerable difficulty exporting their product. But this study shows that kilim production is an efficient use of Albania's resources and that kilims should be exportable. The different interpretation is because the DRC indicates efficiency when the markets for labor, capital, and foreign exchange are undistorted and at equilibrium. During the period of transition, Albanian prices are not in equilibrium and so goods in which the country has a comparative advantage may not be exportable over the short to medium run. As real wages adjust downward, kilim production should become competitive internationally.

**Group 2: Products with a Borderline Comparative Advantage.** If the priorities of policy makers are employment or better protection of local production, they can allow real wages to fall or the exchange rate to devalue. Under these conditions, a broader range of goods is competitive. In this sample, four goods that do not show comparative advantage under the base case do show borderline efficiency under scenarios where the shadow wage rate is reduced or the equilibrium exchange rate is lowered. Kiosk assembly, wool yarn and blanket manufacture, and shoe manufacture all show DRCs just under 1.0.

What differentiates these goods from those that are inefficient under all but the most extreme assumptions? One important factor is that the products in this group are all fairly efficiently produced — that is, their nominal value added as a share of production costs is about the same as value added measured at world prices. All of these products depend upon a fair amount of capital equipment. When the opportunity cost of capital is increased to 30 percent, none of the products is efficient.

Wool yarn and blanket production and shoe production rely on local sources for their main inputs. This dependence upon local inputs helps explain the increase in competitiveness that they experience with a devaluation.

**Group 3: Relatively Inefficient Production.** Three products — wooden furniture, cotton cloth, and electrodes — show no comparative advantage under the range of factor shadow prices presented here. Why? Cotton cloth and electrodes are both highly capital-intensive. They are also inefficiently produced; value added at local prices is high and at world prices is low.

It is difficult to understand why wooden furniture shows so little comparative advantage. A priori, the product's high dependence upon local wood and its relatively low capital requirements for production appear to make it an attractive option. But, because of the variety of parts and accessories that go into a wooden cabinet — the product studied in this survey — its value added is low. This survey indicates that perhaps simpler wood products, such as parquet flooring, can be produced more efficiently than complex pieces of furniture.

## PROSPECTS FOR DEVELOPMENT

### Traditional Production

The DRC analysis shows that some of Albania's traditional light industry production — kilims, wool yarn and blankets, and shoes — are competitive under some not so radical assumptions. These finished goods are now largely targeted toward the local market. As prices continue to adjust, they may find market opportunities overseas.

## **Inward Processing Production**

Inward processing is providing much needed foreign exchange and jobs during this difficult transition period. In addition, it is promising as a bridging activity until Albanian investors build up some capital and the environment for business is stable and attractive enough to bring in foreign investors interested in establishing a more durable relationship.

### **Benefits**

Some of the factors that make inward processing attractive to Albania and Albanians include the following:

- Jobs are relatively high paying — 4,500-7,000 lek per month compared with 3,500-4,500 lek per month in SOEs producing for the local market;<sup>17</sup>
- Inward processing offers a relatively low-risk introduction to international commercial standards and practices;
- Some processing contracts include provisions for the sale of new equipment to the Albanian firm; and
- Jobs in clothing and shoe making are filled almost entirely by women, who are generally believed to have been hardest hit by employment cutbacks.

### **Potential Drawbacks**

Some Albanians in government oppose promotion of inward processing. They argue that foreign firms that establish processing relationships with Albanian firms are exploiting Albania's poverty and its inexperience in international commerce. There is a related fear that partners will stay until wages rise, but, when that occurs and the partners move on to other parts of the world, there will have been no learning in the Albanian firms. Employees will have been so sheltered from the international market that they will be no more able than they are today to operate internationally. There are also concerns about the risks in contracting with little-known foreign partners. More than one firm contacted has had a bad experience with a foreign partner that withheld salaries or was late in providing inputs.

The more subtle concern cited by government officials and private citizens is that processing work is not real production. For example, several interviews revealed that people are uncomfortable that factories are sewing only shoe uppers rather than manufacturing the entire shoe. There is a good deal of pride in Albania's ability to manufacture a broad range of finished goods. That pride has taken a beating as factory after factory has shut its doors. Inward processing is perceived as yet another indicator of the decline of Albanian production strength and, as a result, is resisted.

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<sup>17</sup> Both wage estimates include a 60-lek-per-day transfer from the state to compensate for increases in food prices.

Even with these concerns, over the near term inward processing remains the most likely source of foreign exchange in the light industry sector. It should continue to play an important role throughout this transitional period.

## **ENVIRONMENT FOR BUSINESS**

The Albanian government has some largely fiscal tools with which it can shift incentives for production. In this section, some of those tools are examined. Three taxes are briefly reviewed: customs duties, the profits tax, and the turnover tax. Key elements of the investment code and Albania's two principal trade treaties are outlined.

### **Customs Duties**

All local firms can import machinery and equipment duty free. Other customs regulations vary according to whether the final output of the enterprise is exported or sold locally.

### **Inward Processing Production**

Recent revisions in the treatment of imports used in inward processing threaten to severely handicap the further development of this activity. Under a new law, enterprises that are new to inward processing or that are judged to be of questionable integrity by the Ministry of Finance are required to pay full duty on imported inputs. All but 1 percent of the import value is reimbursed at the time of export.

The new rule puts a heavy burden on the operating budgets of firms. For example, a 30 deutsche mark (DM) blouse will include 20 DM of cloth and 4 DM of Albanian processing. To earn that 4 DM, the Albanian firm must pay 35 percent duty — that is, 7 DM — on the 20 DM of material.

The new practice is nonstandard, subject to abuse — due to the subjectivity in its application — and presents a heavy financial burden on the affected firms. It will dissuade new entrants from this promising market. For nontextile products, the rule would appear to run counter to Article 6 of the agreement signed between the EU and Albania on trade and commercial and economic cooperation.<sup>18</sup> The motivation for this new rule is the concern that processing firms are diverting their raw materials onto the local market. This practice is a legitimate concern for Customs officials, but there are alternative control mechanisms that can be tried, such as bonded warehouses or security bonds.

### **Exporters**

Exporters of finished goods qualify for drawback of all the duties they pay on imported inputs. This duty drawback system reportedly works fairly well, with only moderate delays reported in reimbursement. Indirect exporters — that is, local producers of inputs for goods that are exported — do

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<sup>18</sup> Article 6 reads: ". . . the Contracting Parties shall furthermore grant each other reciprocal exemption from import charges and duties on goods admitted temporarily."

not qualify for drawback. They pass the duty they pay through to exporters, thereby indirectly taxing them.

### **Treatment of Producers for Local Market**

Producers for the local market are subject to tariffs that range from 10 to 35 percent on imported inputs. The relatively moderate and harmonized tariff structure reduces the distortions of this necessary fiscal measure.

Albania's tariff structure is unusual in that both inputs and final goods in a given subsector (classified at 2 digits in the tariff nomenclature) are taxed at the same rate. That means, for example, that cotton yarn and cotton cloth face the same tariff. This practice harmonizes the effective protection on value added with the rate of protection on the final good. On the other hand, the practice means that some firms pay 35 percent tariff on their raw materials — quite high on an international scale.

Tariffs for some goods are amplified by customs' reference prices. Customs agents use these reference prices as a base for calculating the duty owed on a standard import. If a local buyer imports a product with a price below the reference price, he or she is still required to pay the duty that would be charged at the reference price. Reference prices are generally applied to consumer goods. But one local entrepreneur reported that his imports of sheet metal were also subject to a reference price that raised the effective duty he paid on his imports.

### **Profits Tax**

All enterprises employing more than one person are subject to a 30 percent tax on profit. Sole proprietorships pay 3 to 10 percent of revenue in tax. Although the tax on sole proprietorships can work out to be a high percentage of profits, the tax on companies represents a substantial reduction from prior levels.

### **Turnover Tax**

Albania applies a 15 percent turnover tax at each stage of processing. In the future, this tax will be converted to a value added tax. In the meantime, because it is applied at more than one stage of production, its cost cascades through the marketing chain.

As an initial step toward its conversion to a value added tax, the turnover tax is eliminated for sales within an economic subsector. For example, when a local yarn factory sells its output to a local carpet factory, the tax is not applied. It is ultimately applied at a rate of 20 percent on the final sale outside the subsector — for example, when the carpet is sold to a merchant. This practice applies to all goods produced in the light industry sector.

In practice, firms in these integrated sectors do pay some turnover tax on their inputs, because the derogation applies only to sales of locally produced inputs. Firms that purchase inputs overseas or from intermediaries pay the turnover tax. As key elements in the domestic production chain shut down and firms look overseas for replacement sources, the downstream tax burden is rising. The turnover tax is not applied to export sales, but it is paid on inputs used in production of exports.

## **Investment Code**

The Albanian investment code provides a fairly attractive environment for foreign investors:

- All dividends, profits, proceeds from sales, wages, and payments for debt servicing can be fully repatriated at the prevailing exchange rate;
- No profits tax is paid for the first four years of a new investment;
- There are no limits on hiring of expatriates for senior management or technical positions. It is expected that all other positions will be filled by local personnel, but there are no restrictions on how these employees are hired; and
- Foreign investments are guaranteed full compensation at fair market prices in convertible currency in case of nationalization or expropriation.

There are some provisions in the code that could inhibit new investment. Employee firing is subject to local labor regulations. Investors must present a plan for increasing local value added over time. Land can only be rented, not purchased. A bewildering variety of ministerial approvals is required, varying according to the size and the sector of the investment. A decision from the responsible ministry must be provided within a fixed number of days.

## **Trade Treaties with the European Union**

Albania has concluded two trade treaties with the European Union. In addition, this year will prepare its application for accession to the General Agreement on Tariffs and Trade (GATT).

Albania has signed a general agreement on trade and commercial and economic cooperation with the EU. This agreement covers trade in all sectors except for textiles and for coal and steel. Under the terms of the agreement, Albania and the EU grant each other Most Favored Nation status. In addition, all but some minor quantitative restrictions applying to Albanian exports to the EU are lifted. These restrictions could be reinstated if, at some later time, trade volumes threaten one of the partners.

Textiles are a complicated subject in international trade. The main treaty for trade in this sector is the Multi-Fibre Agreement. Albania has chosen to negotiate a specific agreement with the EU to cover trade in textiles, clothing, and shoes. This treaty has not been signed, but is reportedly in vigor.

The draft treaty for textile trade calls for, in effect, full suspension of quotas on imports of textiles into the EU. The gesture is an easy one for the EU to make, because Albania's textile exports are negligible. The EU does not apply quotas on imports until they begin to threaten EU producers. That practice will likely continue for Albania unless some more global textile trade agreement supersedes EU policy.

The draft treaty does contain triggers for intervention down the road. Once Albania's exports of a given class of goods exceed the share of the EU market offered as the trigger point, negotiations for fixed quotas or voluntary export restraints will start.

## **CONSTRAINTS, OPPORTUNITIES, AND RECOMMENDATIONS FOR THE PROMOTION OF THE ALBANIAN LIGHT INDUSTRY SECTOR**

### **Constraints**

- Most reputable foreign investors will be reluctant to invest significant sums into Albanian industry until the environment for business is more stable and the domestic market is stronger.
- New and onerous customs regulations — applying customs duties to inputs used in processing production — are making processing production less attractive to the potential investor.

### **Opportunities**

- Processing production provides a foot in the door leading to the European market.
- Processing provides an opportunity for some training and limited exposure to the international market.
- To the extent that Albanian firms are able to acquire new equipment through their processing arrangements, they will be more able to market their services more broadly and build up independent reputations.
- At the same time, direct export of labor-intensive goods — for example, clothing and artisanal products — offers good potential for growth.

### **Recommendations**

Recommendations are divided between the Government of Albania and donors. The Government of Albania should consider the following actions:

- Promoting Albania's inward processing capacity overseas, and targeting countries, particularly Germany and the Benelux countries, that have a long experience with processing and are dependent on it;
- Promoting processing production within Albania. The dismissive attitude toward processing and the perception of processing as a second-rate form of production will not help reduce Albania's trade deficit;
- Eliminating duties (except for the 1 percent processing fee) on inputs used in processing production, and replacing that strategy with some other form of control for the processing inputs; and
- Encouraging foreign investors to purchase factories outright rather than to enter into a joint venture.

Donors, including USAID, should consider supporting the following:

- Studying alternative forms of control of processing imports;
- Providing additional technical assistance to the ministries charged with public enterprise oversight, to help in judging the quality of offers for processing contracts, joint ventures, and outright purchase; and
- Expanding this analysis to include other key sectors of the Albanian economy — for instance, agro-industrial products.

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**ANNEX**  
**LIST OF CONTACTS**

## LIST OF CONTACTS

### **Ministry of Trade and Foreign Cooperation<sup>1</sup>**

Artan Hoxha, Minister

Alan Osman, Advisor to the Minister

Larry McDonald, International Trade Policy Advisor

Emira Hakani, Director, Department of Trade

Anika Basi, Department of Multilateral Relations

Ahmet Stojna, Finance Department

Chief Statistician in Office of Papakostandini, Import/Export Department

### **Ministry of Industry, Mineral Resources and Energy**

Mentar Bujari, Director, Department of International Cooperation, Foreign Investment, and Privatization

Lindita Janqi, Textile Industries Division

Shoe Industries Division

Ellushe Husi, Confection Industries Division

Mihallaq Kongo, Electro-Mechanical Industries Division

Jeton Parapani, Director, Mechanical and Electro-Mechanical Department

Mrs. Burbuque, Artisanal Division

Sali Toro, Wood and Paper Industry Division

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<sup>1</sup> Later changed to the Ministry of Industry and Trade. All titles are those that applied at the time of the interview.

**Ministry of Finance**

Vaso Pano, Director, State-Owned Enterprises Tax Information

Romeo Mitri, Director, Tariff Policy

Luan Pustina, Chief, Tirana District Tax Office

David Gentry, Advisor, Budget Office

Hannes Dix, Senior Restructuring Advisor

**Customs Office**

Arben Petrella, General Director

Alfred Tristi, Vice Director

Sabrina Shyti, Tariff Division

**Albanian Center for Foreign Investments Promotion**

Arben Papparisto, Vice Director

**World Bank**

Joyce Steiner, Consultant

**Enterprises<sup>2</sup>**

General director, metalworks factory

Director, clothing factory

Director, shoe factory

Director, synthetic yarn and cloth factory

Director, wool yarn and cloth factory

Director, cotton yarn and cloth factory

Director, electrode factory

<sup>2</sup> Anonymity promised to interviewees.

Director, artisanal kilim factory

Chief engineer, shoe factory

Director, knitwear factory

Director of finance, shoe factory

Director, wooden furniture factory