DEVELOPMENT OF NONBANKING FINANCIAL MARKET THROUGH FISCAL INCENTIVES: ALBANIAN CASE

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Abstract:
An efficient financial market in any economy stimulates the economic growth through mobilizing the savings and promoting the investments. The Albanian economy has passed through a long period of transition which means a transformation of all the financial market and institutions. But not all the financial institutions are uniformly developed. Actually more attention is given to the transformation and development of the banking industry and less to the non-banking markets i.e. insurance, pension funds and securities market. Our paper is focused on these segments of the financial market, which account about 10 percent of the overall financial market. This little interest about these markets is explained by the mentality and culture of the population, the lack of knowledge about financial products, the passive role of government etc.
There are many ways to stimulate and promote the development of these markets by the government and the market operators as well. The economic literature and the world experience show that fiscal system is one of the ways the government can and should use to promote the development of the financial institutions. The inclusion of tax facilities in the fiscal system will positively affect the progress of these institutions.

Keyworks: *non-banking financial institutions, voluntary pension schemes, insurance, securities market*

The aim of our paper is to introduce various fiscal incentive systems resulting from the world experience (especially from the Eastern European countries) and to give some recommendations of using them in our non-banking financial institutions. We will separately analyze the fiscal incentives for each of the financial non-banking institutions: pension funds, life insurance companies and securities market.

This paper is structured as follows. The next section examines the role and the recent developments of the non-financial institutions. Section 2 lists some of the factors that affect the development of non-banking financial institutions in Albania. Sections 3,

4 and 5 look at more details the possible tax incentives respectively for pension funds, life insurance companies and securities market. Finally, section 6 concludes the paper.
1. Role of non-banking financial institutions in Albania

The most attributive index of an efficient economy is the extent with which it can mobilize the domestic and foreign savings in order to finance the investments. The process of fund transferring is carried out through the financial system.

The development of the private sector and the economic growth put pressure on the necessity of the financial services, which govern a balanced development of the financial markets in the future.

Highlighting the financial system's role in the economy and its necessity to expand, we have to point out that the banking market is the dominant part of the Albanian financial system. Actually, comparing to the other financial markets, the banking market has a vital role for the economy, regarding the intermediary process of saving's accumulation and investment's financing, and the payment system as well. The non-banking financial market is still underdeveloped in Albania. Among the non-bank financial institutions, the most developed are the insurance companies, while the others have an almost negligible share in the system's total. With reference to the data of Bank of Albania, we easily observe that the ratio of the total assets of the insurance market to the total assets of the banking market is 1:50.

As we are focusing the development of the private pensions, insurance and securities markets, we briefly point out:

Regardless the growth trend of insurance market in 2010, the motor cumpolsory insurance dominates this market. Life insurance is still underdeveloped; it accounts about seven percent of the overall insurance market.

Concerning to the private pensions market, the low level of development in 2009 has proceeded during 2010 as well.

While, the securities market is still predominated by the primary and secondary transactions of the government debt instruments (treasury bills and bonds). The stock market is still fairly underdeveloped and it is limited with some informal transactions of the shares of certain companies.

For the maintaining of a healthy and stable financial system, both banks and non-banking financial intermediaries have to be wee-developed and offer a varied range of financial products. The necessity of further developing the activity of the non-banking institutions is essential for any developing economy, including the Albanian economy. Through providing alternative and varied financial services, they assure the medium and long term financing, which represent often a challenge for the bank based economies.

2. Factors affecting the development of non-banking financial institutions in Albania

Consumer's lack of familiarity with financial products

As in all the Eastern European countries, the Albanian citizens do not know enough about the way the financial markets run. During the communism period it has been a rare thing to purchase a financial product which could shift their incomes from one to another stage of his/her life in order to meet his/her needs. Actually they do not know about the financial and saving instruments offered by the private subjects.

Population's mentality and culture

The Albanian people do not like to think over investments related to any possible disaster in their future lifetime. They believe that if they do, the disaster would occur to them.

As well in the past the individuals have depended on the state guaranteed benefits but in a free market economy the citizen should understand that the state has no more the responsibility to provide him with such benefits; the individual should take its own responsibilities to face the risk of its life.

Public confidence to the financial institutions

In Albania, public confidence is particularly fragile because of financial disasters that are still fresh in people's minds.

Role of government

The economic literature and the world experience show that fiscal system is one of the ways the government can and should use to promote the development of the financial institutions. The inclusion of tax facilities in the fiscal system will positively affect the progress of these institutions.

3. Tax incentives for the voluntary pension scheme

Tax incentives are largely used to promote retirement savings in funded pension plans as a response to public finance pressures caused by ageing populations and the impossibility of the first pillar to satisfy their needs during the pension period.
Tax incentives embedded in funded pension plans do indeed increase retirement savings.

On the one hand, tax incentives might change the total amount that individuals will save (income effect), on the other, given the incentive, individuals will change the composition of their saving portfolio.
In many countries individuals largely reallocate savings from other vehicles as a response of tax incentives, or they increase their new savings as result of tax incentives.

Some economists suggest that preferential tax treatment should also be applied, within limits, to voluntary schemes in order to encourage the involvement of the low income individuals in these schemes and to allow government to play a more active role in regulation and supervision.

Alternative taxation systems

The taxation of the transactions of the voluntary pension scheme, may involve one or all of the following phases:

- Investing phase - the amounts of contribution made to the pension fund, by employers and employees;
- Accumulation phase - the incomes generated from the investments and the capital gains;
- Withdrawal phase - the benefits received back by the contributor during the retirement period.

As result of the above mentioned possibilities, theoretically there are eight basic tax combinations. But the world experience, especially the Eastern European countries, suggests three main tax systems:

- TEE (tax-exempt-exempt) system. Under this tax treatment system, the contributions are taxed, while investment incomes and the benefits remain untaxed.
- EET (exempt-exempt-tax) system. Under this tax treatment system, the contributions and the investment incomes are taxed, and the benefits remain untaxed.
- EEE (exempt-exempt-exempt) system. Under this tax treatment system, all is untaxed the contributions are taxed, while investment incomes and the benefits remain untaxed.

It can be easily observed that the investment incomes are not taxed in all above mentioned systems because in all Eastern Europe countries this type of income is not taxed. While the contributions and the benefits are not totally taxed: several states have different tax applications in the form of deductions or limitations in percent or absolute terms.

As the private pension schemes serves as long term saving schemes, the incomes resulted from investments should not be taxed. The tax exemption of the investment incomes is due to the further development of the private voluntary pension market and the stimulation of the long term investments in economy. This practice is followed by all the countries of the Europe. As result we think that it should be accepted by our country and it should be applied to the third pillar of the pension scheme.

In a model–type setting, with a flat tax rate, the TEE system and the EET system are equivalent. The both consider a post-tax rate of return to saving equal to the pre-tax rate of return. They are neutral between consumption now and consumption in retirement (as the income time rate paid during work period is equal to the income tax rate paid during retirement period). Such a thing means that different individuals are equitable treated according to these systems: people who save for the future consumption pay the same tax as those who consume at the present. Regarding the government, both systems deliver the same net present value of revenues. All the same, the timing is different: under the EET system the revenues are deferred until retirement, while under the TEE system the revenues are received immediately.

But in a real-world setting, there are differences. From a political point of view, an EET treatment may be preferred, since the TEE approach may not be credible (because further taxation can be introduced in the future). Also if we accept the notion that public investments have a lower marginal product than private investments, EET treatment has the advantage of permitting and stimulating the fund to be invested by the private sector. Due to the handicaps posed to the development of the private pension scheme, the TEE system is not recommended to apply. Therefore, our proposals do not take in consideration this type of tax treatment system.

As the most part of the countries, use the EET system, with the tendency to move towards to the EEE system (the case of Bulgaria, Hungary, Serbia, India ect.), we initially propose the EEE system and than the EET system.

1st option

We propose the EEE system with two versions:

Version 1. An EEE system relieved from the social insurance and tax duties, but up to a defined limit as follows:

1/a. The money contributed to the voluntary private pension fund should be exempt from the personal incomes tax up to an amount of 10 percent of the monthly gross salary, but with an upper annual limit of 600 Euro (or lek equivalent). According to this version, the amount to be paid for the social insurance contribution should be calculated on the residual salary, after the private pension contribution having been deducted.

The placement of a monthly maximum exception, which will be free of taxes, is proposed in order to avoid a large shift of the saving toward to the third pillar, increasing the burden of the fiscal system. The selection of a limit of 10 percent is based on the proportion between the average wages of several countries in Europe with the respective tax deduction. The trend is as follows: the higher the average wage in absolute terms, the lower the amount exempt from the taxes.

The upper annual limit of 600 euro is fixed in order to avoid that individuals with high wages do not take advantages of these exemptions.

1/b. The expenses incurred by the employers due to the participation of their employees in voluntary private schemes should be deductible on purpose of taxes on business income. Also, a maximum limit should be fixed regarding the amount of deductible expenses: we propose a maximum limit of 50 euro per person per month, or 600 euro per year per person.

Version 2. An EEE system relieved from the tax duties, but up to a defined limit as follows:

2/a. The money contributed to the voluntary private pension fund should be exempt from the personal incomes tax up to an amount of 15 percent of the monthly gross salary, but with an upper annual limit of 800 Euro (or lek equivalent).

The modification of the quantitative indicators from 10 percent to 15 percent, or from 600 euro to 800 euro, is made due to the non-application of the social insurance payments deductions from taxable incomes.

2nd option

Although the most preferred option, regarding the stimulation of the fund orientation to the voluntary private pension schemes as above mentioned is the EEE regime, in case of its non implementing, we propose the EET system with two variants.

The impact of the EEE regime in the state budget

After having proposed the EEE system as the most favorable tax treatment regime to be implemented for the voluntary pension schemes, we have calculated the potential effect that such regime may have in the state budget. This type of system may be considered as a "generous tax treatment" system because it may be costly in terms of revenues foregone.

We have assumed a tax deduction of 15 percent of the monthly wage. Considering an average wage of 500 euro per month, the pension contribution is: 500 euro x 15% = 75 euro, which is the maximum proposed monthly limit.

To our opinion, it is very difficult that the contribution will be 75 euro since the first year of tax facility application.

Therefore let's assume an average contribution of 20 euro per month.

The tax saving (regarding the personal income) will be 24 euro per year per person.

The amount that individuals have saved from the taxation will be a cost for the government. If we assume that ten thousand individuals will be involved in the scheme in the first year, the revenues foregone by the government will be: 10.000 persons x 24 euro/person = 240.000 euro.

Let's assume now that the employers as well, will include about ten thousand persons in the scheme (they may be either the same persons or other persons). Their potential contribution may be no more than 10 euro per month per person. Then, the tax saving per person will be 12 euro.

The tax saving from the taxable business income is calculated to be: 10.000 euro x 12 = 120.000 euro.

Eventually, the total fiscal effect will be equal to 360.000 euros.

Also, we suppose that the increase rate of the contributions will be 30% for the next years:

Years		Impact in the state budget
1st year	360.000 €	360.000 €
2nd year	360.000 € x 0,3	468.000 €
3rd year	468.000 € X0,3	608.400 €

4. Tax incentives for the life insurance products

If we have a look at the world statistics, we observe that the ratio of the premiums written by the insurance business to the GDP were about 7.49 in 2007. More specifically this ratio was higher in life insurance business (4.41 percent) and less in non-life insurance business (3.08 percent). In absolute terms, in 2007, more than 4,000 billion dollars were written by insurance contracts or about 607.7 dollars per capita, of which 59 percent are written by life insurance contracts and the rest by non-life insurance contracts. The most part of the life insurance premium are written in Europe (43.29 percent), followed by North America (26.07 percent) and Asia (26.05 percent). Life insurance provides the economy and the individuals as well, a variety of fundamental financial services as:

First, the life insurance products stimulate the long tern savings and reinvesting of large amount in public and private sector of the economy. As part of the financial intermediaries, life insurance companies have became an important long term source of funds, influencing the development of capital markets.

Second, under the circumstances of urbanization growing, movement of the population and the formalization of the economic relations between individuals, families and communities, the life insurance represents a necessary device to manage the risk and uncertainty of our life. Therefore the life insurance may play an important role in providing financial security to the individuals and to the national development through the accumulation of private savings.

According to the results of study done by the United Nations Conference on Trade and Development (UNCTAD), a strong and efficient life insurance market can aid in overall economic development in the following ways:

Life insurance can contribute to social stability by permitting individuals to minimize financial stress and worry.

Life insurance can reduce the financial burden on the state of caring for the aged and for those made financially destitute because of the death of a family breadwinner.

Through the accumulation of thousands of policyholders of small amounts of private savings, life insurers can accumulate sums to be invested in the public and private sectors.

The life insurance business generates employment.

Life insurance can permit more favorable credit terms to borrowers – both individuals and business – and can decrease the risk of default.

By making available a variety of employee benefit plans . . . life insurance companies can promote employee/employer relations and can provide low-cost benefits to a broad spectrum of persons who may otherwise have been unable to obtain such protection.

In spite of the importance the life insurance has in world GDP and in the world insurance market, it is still fairly undeveloped. The low development of the life insurance market is evident from the clear domination of non-life insurance market in total insurance business: life insurance accounted only 7 percent of the total premium volume written by all insurance companies in Albania. This low volume of life insurance business stems, apart the above mentioned factors, from the role played by the government provident schemes. The state's involvement varies widely from one country to another.

Because of the beneficial effects of life insurance provision, tax policy may be used to encourage citizens and business to purchase and maintain life insurance policies with regard to shifting national savings to life insurance and promoting long term savings.

All OECD countries provide some tax concessions in the purchase, maintenance or execution of a life insurance policy. The extent and the nature of these concessions vary from one country to another. The exploration of the tax treatment of life products is structured around life insurance cash flow components: premiums, living, benefits and death benefits.

According to the experience of other countries and as the research reveals, the elements of a possible life product tax system could include a deduction or credit premiums paid by individuals, especially on the survivorship contracts: endowment and annuities. Premiums paid by employers for reasonable levels of life insurance funded employee benefits could be deductible to employers and not taxable to employees.
Living benefits paid under life insurance policies generally could be accorded some tax concessions, as much to avoid the administrative complexity of doing otherwise as to promote life insurance. Thus neither policy dividends nor the interest credited on policy cash values should be directly taxable.

Death benefits of life insurance policies whose premiums were not subject to tax relief should not be subject to income taxation but should be subject to any estate duties.

Life insurance product taxation should not be considered in isolation from taxation of life insurers. Life insurance companies taxation typically is of two types: premium taxation and net income taxation.

The most part of the OECD countries do not levy tax on taxes on insurer's premium revenues or they levy some stamp duties. According to the literature, the premium tax approach should be used only if the need for administrative simplicity dominates the goals of equity and neutrality. Actually, in Albania, the insurance companies are exempt of VAT.

Regarding the corporate income tax, it is a logical means of taxing life insurers as taxing other corporations. Governments should tax insurers and other financial intermediaries equivalently.

5. Tax incentives for the securities market

The securities market remains underdeveloped. It consists of the formal market (Tirana Stock Exchange), dealers licensed to trade securities and informal market of joint-stock companies shares transactions.

Rapid development of the economy raises the need of intensifying the process of securities market development. In this context, the Government may play an important role towards encouraging the development of this market mainly through privatizing any package of shares of state-owned strategic companies in the stocks market or, by means of providing various fiscal and legal incentives to encourage domestic business to utilize this market as a financing alternative by listing in the stock exchange.

In this paper we propose some opinions regarding the inclusion of some fiscal incentives for the companies enrolled in the licensed security market.

The proposals consider the followings:

1. Building of fiscal concessions for the stock companies which have been quoted in the licensed security market. If the taxpayer is quoted in the licensed securities market, the income tax must be reduced to 50 percent, for a period of three years, starting from the moment of registration. If the licensed securities market excludes the taxpayer from the quotation, he would have no more the right of tax facilities and he would be enforced to pay the respective tax, according to the actual prices.
2. Differentiation of the tax rates applied to the incomes incurred from the securities transactions in the licensed market, where: the incomes incurred from the difference between the selling price and the purchase price of the securities issued from quoted companies in the licensed securities market, be taxed to a range from 0% to 5 %.
3. Tax exclusion for the bonds issued by local government. We propose the bonds issued from the local government have to be except of interest tax payment.

6. Conclusions

The process toward the modernization of the financial system is essential for the success of the economic transformation; it causes the growth of productivity and improves the efficiency, and contributes for a better allocation of the financial sources which constitutes the fundamental condition for the growth.

In order to get a balanced evolution of the financial markets in the future, parallel with the development of the banking system, other conditions have to be satisfied such as: the coordination of all efforts in order to have a positive impact on the non-banking market as well; the strengthening of non-banking financial institutions; the increasing of the public' confidence toward these institutions.

Therefore, the role of the government in promotion of the non-baking financial market in Albania will be more evident through the application of fiscal facilities on the transactions performed by these institutions.

According to the information we have, certain bills regarding the regulation of non-banking financial market are just preparing. Therefore, we think that the proposals made in this paper should be taken in consideration by the bill drafters, who have to be consulted with relevant specialists.

It's just time to act.

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