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# 2019 Economic Reform Programmes of Albania, Montenegro, North Macedonia, Serbia, Turkey, Bosnia and Herzegovina and Kosovo\*

The Commission's Overview  
& Country Assessments

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European Commission

Directorate-General for Economic and Financial Affairs

Directorate-General for Neighbourhood and Enlargement Negotiations

Directorate-General for Employment, Social Affairs and Inclusion

# **2019 Economic Reform Programmes of Albania, Montenegro, North Macedonia, Serbia, Turkey, Bosnia and Herzegovina and Kosovo\*:**

The Commission's Overview and Country Assessments

\*This designation is without prejudice to positions on status, and is in line with UNSCR 1244/1999 and the ICJ Opinion on the Kosovo declaration of independence.



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## INTRODUCTION

Economic governance has become one of the three key aspects of the EU enlargement process over recent years, mirroring moves in the EU to strengthen economic policy coordination and multilateral surveillance under the European Semester. In its 2013 and 2014 enlargement strategies the Commission outlined a new approach to economic governance. It involved clearer guidance on the reforms needed to foster macroeconomic stability, deliver fiscal sustainability and support long-term growth and competitiveness. In the same vein, the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey has provided targeted policy guidance for each enlargement country since 2015.

This dialogue is based on medium-term Economic Reform Programmes (ERP) submitted annually by enlargement countries. The ERPs include a macroeconomic and fiscal policy framework as well as structural reform plans to boost competitiveness and long-term growth. The ERP exercise also aims to help enlargement countries develop their institutional and analytical capacities and to prepare them for participation in the EU's multilateral surveillance and economic policy coordination procedures once they become Member States of the EU.

In 2019, enlargement countries submitted their fifth annual Economic Reform Programmes covering the period 2019-2021 <sup>(1)</sup>. They have been assessed by the European Commission and the European Central Bank. Based on these assessments, joint conclusions with country-specific policy guidance <sup>(2)</sup> were agreed and adopted at the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey. The dialogue was held in the margins of the Economic and Financial Affairs Council meeting of 17 May 2019.

This paper contains the Commission staff's assessment of the ERPs for 2019-2021 submitted by Albania, Bosnia and Herzegovina, Kosovo<sup>(\*)</sup>, Montenegro, North Macedonia, Serbia and Turkey. The assessment also takes stock of the implementation of the country-specific policy guidance adopted last year. The cut-off date for the assessment was 10 April 2019.

The assessment reflects joint work by Commission staff from several Directorates-General. In particular, DG ECFIN analysed the macroeconomic and fiscal frameworks; DG NEAR was responsible for assessing structural reforms; while DG EMPL covered employment and social policy-related aspects.

Comments would be gratefully received and should be sent to:

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<sup>(1)</sup> The Economic Reform Programmes can be found at [https://ec.europa.eu/neighbourhood-enlargement/policy/policy-highlights/economic-governance\\_en](https://ec.europa.eu/neighbourhood-enlargement/policy/policy-highlights/economic-governance_en)

<sup>(2)</sup> This paper includes at the end of each country assessment the country-specific policy guidance adopted in May 2019.

<sup>(\*)</sup> This designation is without prejudice to positions on status, and is in line with UNSCR 1244/1999 and the ICJ Opinion on the Kosovo declaration of independence.



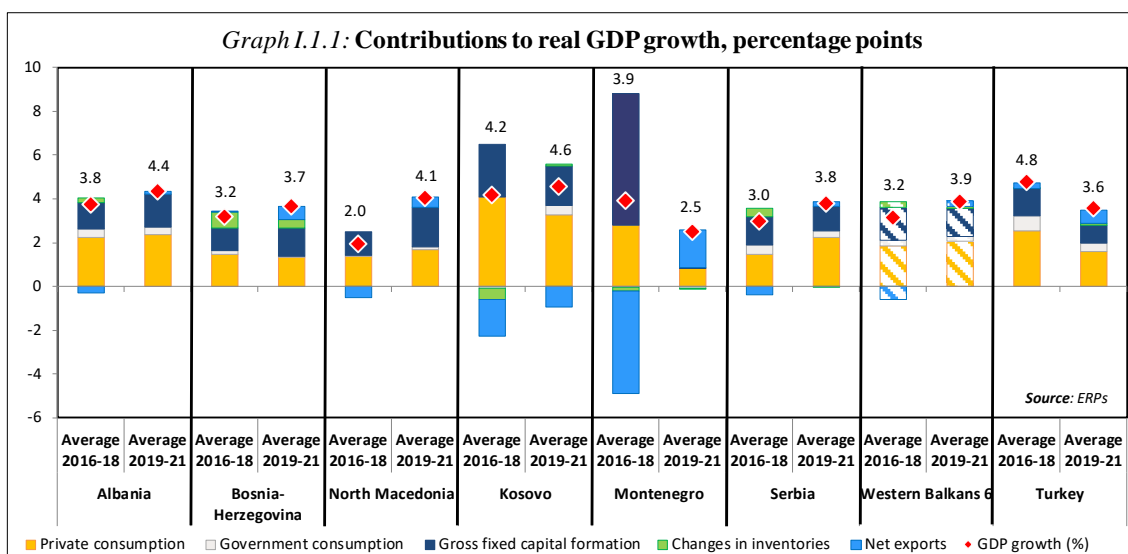
# Part I

Horizontal Overview of the 2019 Programmes

# 1. HORIZONTAL OVERVIEW OF THE 2019 PROGRAMMES

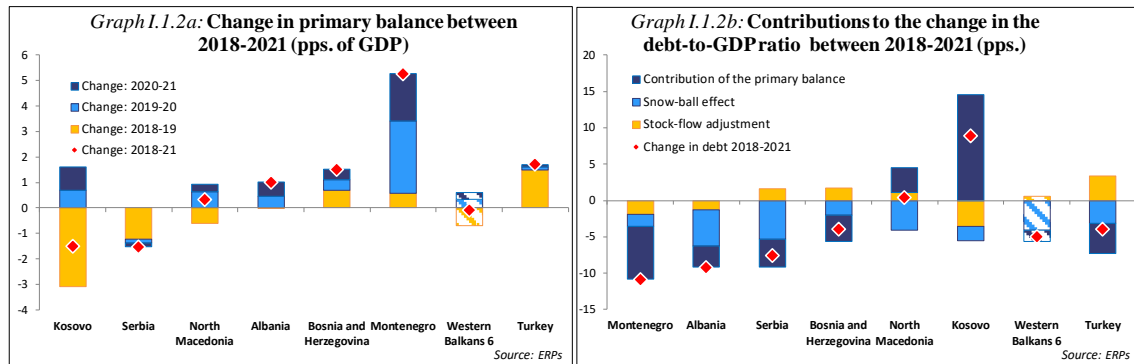
## 1.1. ECONOMIC OUTLOOK AND CONTEXT

The economic reform programmes (ERPs) of the Western Balkans expect economic growth to remain robust and Turkey to quickly recover from the recession triggered by the Turkish lira crisis. Real GDP growth across the Western Balkans is projected to increase to 3.9% per year in 2019-2021, up from 3.2% in 2016-2018 (see Chart 1). Private consumption and investment are expected to remain the region's main growth drivers, while the contribution of net exports is set to shift from negative to slightly positive across the Western Balkans. Comparisons between countries reveal significant differences in expected growth rates. Montenegro is the only country forecasting a slowdown of economic activity, which is due to the maturing of an investment cycle largely driven by a major highway project. All other Western Balkan economies are set to grow more strongly than over the past 3 years. North Macedonia projects the largest increase in GDP growth, as the improved political outlook is expected to boost investor confidence and stimulate capital spending. In Turkey, growth in 2018 was significantly lower than expected. The economy started to lose momentum in the second quarter, and entered into a deep recession in the second half of the year following the sharp depreciation of the lira and the resulting strong deterioration of financial conditions. While the ERP has adjusted the growth outlook for 2019-2020 downwards compared to last year, it is still significantly above the Commission's autumn forecast. Turkey's ERP expects a strongly positive net trade contribution to lead the recovery in 2019, and for the economy to fully gain traction in 2021.

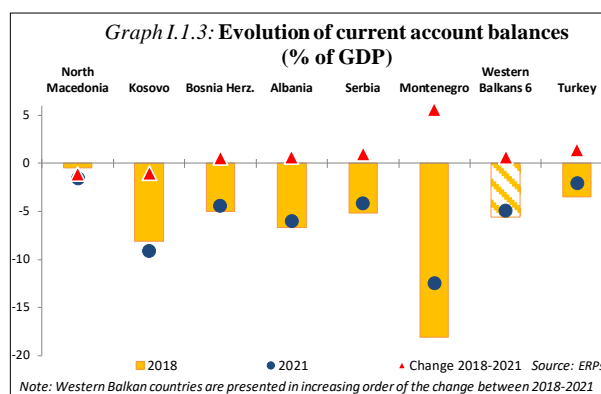


**In general, the ERPs' baseline growth projections appear too optimistic and face considerable downside risks.** The Western Balkan economies are characterised by small production bases and a high import content of consumption and investment. Therefore, the expected rise in the growth contribution of both improved domestic demand and net trade would require deep structural changes in these economies. Given weaknesses in public investment management and the recent negative track record on the implementation of public-sector infrastructure projects, the projected strong growth of investment in Albania, North Macedonia and Kosovo, partly resulting from plans to step up public capital expenditure, also appears too optimistic. A stronger-than-expected slowdown in the EU, the main trade and investment partner of the Western Balkans, could also hurt growth prospects through lower demand for exports and lower inflows of remittances and foreign direct investment. Turkey's economic outlook currently faces the greatest uncertainty. Following a credit-fuelled boom in recent years, the indebtedness of the non-financial corporate sector has increased from 52% of GDP in 2013 to 80% in 2018, and corporate balance

sheets need to be repaired if sustainable growth is to return. The policy space to support growth is limited due to the need to rebuild monetary policy credibility and boost domestic savings.



**Most authorities expect to improve their primary budget balance and reduce the debt-to-GDP ratio in 2019-2021.** Kosovo and Serbia are the exceptions, since they are set to lower their headline and primary balances in 2019-2021, despite continuing momentum in their economies (see Chart 2). Kosovo still has low, albeit increasing, debt, and large investment needs. It plans to finance a significant increase in capital spending using privatisation proceeds and funds obtained from donors, which its fiscal rules exclude from its 2%-of-GDP deficit cap. Serbia has carried out successful fiscal consolidation in recent years, and its headline budget surplus allows a slight pro-cyclical relaxation over the ERP period. Montenegro projects the biggest improvement in its primary balance (5.3 percentage points over 3 years), as investment spending related to a costly highway segment is phased out. Debt ratios are mostly set on a downward path (see Chart 3). The ERPs of North Macedonia and Kosovo are the only ones expecting an increase in the debt ratio between 2018 and 2021, due to negative primary balances, although North Macedonia's public debt is set to stabilise towards the end of the period. For all others, the ERPs project that both primary surpluses and a favourable snowball effect will contribute to debt reduction, albeit by different degrees. In Montenegro, Bosnia and Herzegovina, and to a lesser extent Turkey, the biggest contribution to lower debt is from the primary balance. Serbia and Albania rely more on the favourable snowball effect to reduce their debt burden. Lower than expected economic growth, failure to contain current spending, and the realisation of contingent liabilities constitute major downside risks to the fiscal outlooks, as explained below.



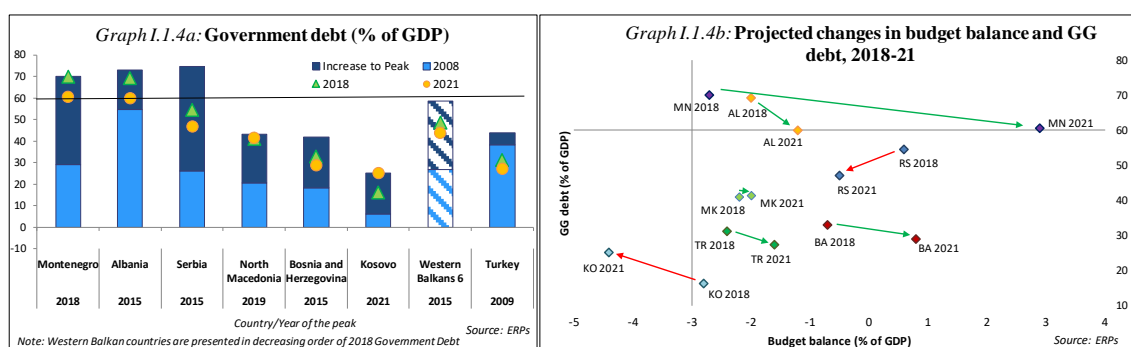
**Current accounts are forecast to remain in deficit.** Most ERPs assume an improvement in the trade balance, but waning momentum in the main export markets coupled with the risk of higher-than-expected import growth might lead to a worse outcome. The biggest improvement in the current account balance is anticipated in Montenegro (see Chart 4) due to an expected drop in investment. Turkey's current account is currently undergoing a sharp adjustment driven by a recession-induced compression of imports.

Turkey’s ERP expects a relatively strong economic recovery, however, which is hard to reconcile with the projected further improvement of the current account balance.

**Inflation is projected to remain modest in the Western Balkans, while Turkey faces continuing substantial price pressures and significantly above-target inflation.** Monetary frameworks in the Western Balkans are varied, and range from outright ‘euroisation’, to currency boards and pegs, to inflation targeting with more or less freely floating exchange rates. However, all economies have experienced low inflationary pressures in recent years because of low imported inflation and the lack of domestic price pressures, despite the cyclical upswing. In spite of some emerging bottlenecks, especially as regards the availability of skilled labour, the ERPs realistically expect inflation to remain muted in 2019-2021. Turkey stands out, with high inflation and a depreciating real effective exchange rate. The strong depreciation of the lira in 2018 and increasingly unanchored inflation expectations have fed into an inflation rate that jumped to 25%, well above the target of 5%. The economic fallout that followed the strong tightening of financial conditions led to a quick and steep fall of the output gap into negative territory, which has helped stabilise inflation. The ERP expects the inflation rate to fall back to 7.9% in 2021, which is likely to require a continued tight monetary policy stance in the face of still high inflation expectations and the remaining risk of lira volatility.

## 1.2. MAIN CHALLENGES

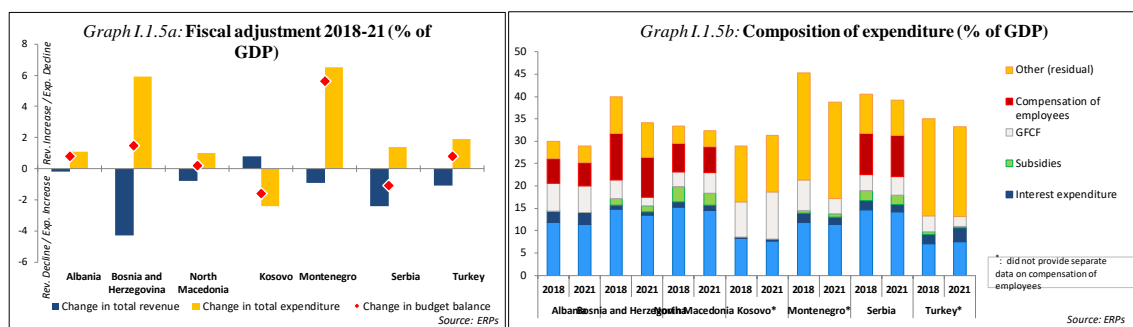
**Against the current macro-fiscal background, all the economies may benefit from stepping up efforts to sustainably raise potential growth and resilience.** From the point of view of recent economic developments, policy action is most needed in Turkey. Actions required are (i) the removal of crisis measures that limit the functioning of the market economy and (ii) the implementation of a long-awaited reform agenda. The ERPs, and the Commission’s assessments, cover the areas that are key to strengthening macroeconomic stability and removing major bottlenecks to growth. Implementation of last year’s policy guidance has been only limited or partial across the region. Given the current phase of the economic cycle and developments in major trading partners, the urgency of reform implementation has only increased. The financial conditions are ripe for reaping benefits before external conditions lead to a turn in the economic cycle.



**Fiscal consolidation is still necessary to safeguard debt sustainability.** Rebuilding fiscal space is particularly important because many Western Balkan economies lack other stabilisation tools, in particular an independent monetary policy. Only Serbia has managed to significantly reduce the debt ratio from its post-crisis peak. Montenegro and North Macedonia have yet to achieve debt stabilisation (see Chart 5). Montenegro has implemented fiscal consolidation measures in recent years, and the completion of one major investment project is expected to bring the budget into a large surplus, reducing the debt ratio (see Chart 6). Albania’s debt burden has started declining but remains high. The expected consolidation is back-loaded in Albania and North Macedonia. Failure to contain current spending, especially on public wages and pensions, has been a recurrent problem across the region, and could again

derail fiscal adjustment efforts. Fiscal risks also stem from contingent liabilities associated in particular with public-private partnerships, which often lack transparency, and with still sizeable state-owned enterprises that perform poorly and lack proper oversight. Weak tax compliance and widespread tax exemptions point to scope for improving revenues across the region, which would also provide more resources for priority spending, including investment.

**More effort should be made to shift budgets towards a more growth-oriented composition.** Fiscal adjustment plans, where they exist, are based mostly on containing expenditure, while a reduction in revenue ratios is expected to lead to upward pressure on the deficit (see Chart 7). In practice, spending restraint is often achieved by under-executing the capital budget. The composition of expenditure continues to lean towards social transfers, public wages and subsidies across the region, in particular in Bosnia and Herzegovina, Montenegro, Serbia and North Macedonia (Chart 8). Fiscal space, especially in Kosovo and Bosnia and Herzegovina, is also taken up by relatively generous categorical benefits that do not target poverty alleviation. There is substantial scope, therefore, for making spending more growth enhancing and better targeted. On the revenue side, high taxes on labour, especially in Bosnia and Herzegovina, Montenegro and Serbia, discourage employment and contribute to high levels of informality.



**In last year’s dialogue between the EU and the Western Balkans and Turkey, special attention was paid to the importance of fiscal rules and frameworks in improving fiscal governance.** The ERP process supports an expansion of the planning horizon to the medium term, and authorities can build on this by introducing proper medium-term budget frameworks. Well-designed fiscal rules, supported by independent fiscal bodies, could better guide fiscal policy and bring transparency to the budgetary consequences of ad hoc policy-making. Jointly agreed policy guidance exists which specifically targets these types of improvement, but there has been only limited implementation.

**Current account imbalances should be reduced by increasing domestic savings and implementing productivity-boosting reforms.** The Western Balkans and Turkey have a history of current account deficits, given their large investment needs and limited domestic savings. While the Western Balkan economies mainly finance their current account deficits with foreign direct investment (FDI), Turkey continues to depend on more volatile forms of capital flow. This creates significant vulnerabilities, as demonstrated by the recent lira crisis. The challenge for all economies is to increase domestic savings in order to lower external vulnerabilities, and to implement reforms in product and labour markets that attract FDI into tradable sectors, raise productivity and boost exports. There should also be more effort to better disseminate the benefits of FDI inflows to the wider economy. The challenge of reducing external imbalances is even more pressing for countries with ageing populations: in all economies for which data are available, the old-age-dependency ratio will double in the next three decades, to more than 40%. Turkey’s large current account deficit, which has been the target of policy guidance for several years in a row, corrected abruptly as domestic demand plummeted following the sharp deterioration of financing conditions in August 2018. As a sizeable emerging economy, Turkey had benefited from very benign global financing conditions and built up significant debt liabilities, partially in foreign currency. The high inflation following the lira depreciation passed on a significant part of the real debt burden to creditors

through inflation. Like the Western Balkans, Turkey will have to implement policy actions that raise domestic saving and boost productive investment. Distortions caused by an excessively accommodative monetary policy and quasi-fiscal support to boost bank lending need to be eliminated.

**Despite improved headline figures, the Western Balkans still need to strengthen financial stability, while Turkey needs to contain the impact of the currency crisis on the banking sector.** In recent years, the ratio of non-performing loans to total loans outstanding has halved in the Western Balkans. In Turkey, the ratio has been low for some time, but has recently begun to increase as the collapse in domestic demand, changing financing conditions and the lira depreciation work their way through the economy. Capital adequacy ratios continue to be well above minimum standards in the Western Balkans and Turkey. Credit growth has picked up in Serbia and Kosovo, however, with some market segments experiencing especially strong expansion, requiring increased supervisory vigilance. In Turkey, real credit growth has turned negative following years of exuberant growth, but there was a large push in March 2019 to restart lending, in particular by state-owned banks. State-owned banks in Serbia also continue to have more risky characteristics. Special attention is also warranted for small banks in the Western Balkans, a region that is broadly characterised by overbanking. In Montenegro, the performance of small local banks is uneven and requires close and decisive supervision by the central bank. Widespread euroisation in the Western Balkans exposes banks to credit risks in the event of currency volatility.

**All seven economies face challenges in their business environments.** For most, the regulatory and institutional environment remains a key obstacle to private-sector development and competition. Several also face problems with still sizeable and unprofitable state-owned enterprises, which create unfair competition for private companies. All seven economies struggle with corruption and legal unpredictability, which make them less attractive to foreign and domestic investors alike. Overcoming these challenges requires extensive structural reform to improve the business environment and investment climate, including significant efforts to strengthen the rule of law and institutions, and to fight corruption.

**There is a very large informal sector in all seven economies.** While there is a lack of reliable data, the informal economy accounts for 25-35% of GDP in all seven economies. Informality is a great problem, since it leads to unfair competition, obstructs the efficient allocation of state and private resources and reduces tax revenues. Undeclared work leads to reduced job security and safety at work, and the lower pay associated with it can lead to inequality and poverty. Many underlying causes and factors facilitate a high level of informality. Weak inspections and tax audits are a clear problem, as is the high share of cash transactions in the economies, while high unemployment levels force workers to accept the poorer conditions of undeclared work. The low level of trust in government, and the perceived low quality of public services, discourage tax compliance. To overcome these challenges, there is a need to incentivise tax compliance through measures such as public awareness-raising, simplification of administrative procedures and lower thresholds for cash transactions. Law enforcement in this area needs to improve.

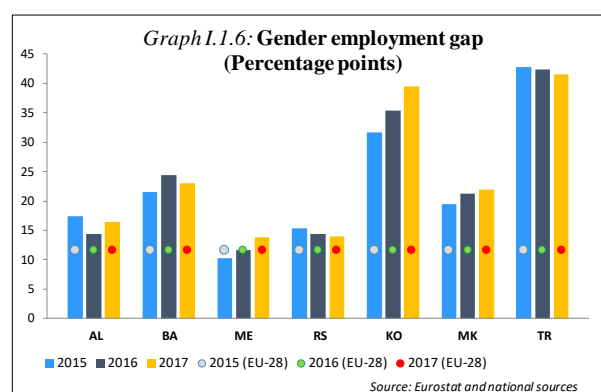
**Inefficient energy use and insecurity of energy supply are among the main obstacles to competitiveness.** The underdeveloped energy market is one of the key challenges in Albania, Kosovo and Serbia, although the other economies of the region face similar issues. The liberalisation of the energy market in Serbia and Albania is lagging, despite its being an obligation under the Energy Community. Electricity tariffs still do not reflect actual costs in most economies. Progress in establishing the regional electricity market is slow, and still hampered by bilateral disputes. High energy imports are one of the sources of the large trade deficits in the region. The economies have great potential for developing renewable energy sources, which would allow them to further diversify the energy mix and reduce pollution. While construction and maintenance of infrastructure are important, focus should be on tapping the potential for renewable energy generation and energy saving, and on fully opening up electricity markets to competition. Discontinuing subsidised energy tariffs is a priority that should be combined with energy efficiency incentives and social protection schemes to prevent energy poverty.



**The lack of regional economic integration in the Western Balkans prevents the region from realising its growth potential.** All Western Balkan partners are committed to boosting regional cooperation and creating a regional economic area. Such an area would improve competition and allow economies of scale and associated productivity gains. A regional market would provide a stimulus for intra-regional trade, and this extended customer base would make the Western Balkans a more attractive investment destination. Market integration based on EU rules and standards will help create opportunities for new value chains, and will increase the region’s attractiveness for foreign direct investment – including from the EU – in tradable sectors. Better connectivity in transport and energy will speed up integration of the region into pan-European networks, while strengthening competitive energy markets and developing economic corridors over the region. The creation of a digital space and more integrated labour markets would also offer new possibilities for young people in the region.

**Low activity, including the marginal presence of women in the labour market, and poorly targeted active labour market policies remain key challenges.** Labour markets in the region continue to be characterised by low activity and employment rates, as well as high unemployment. Even though labour market outcomes are improving generally, labour resources are still largely underutilised. Women, young people and minority ethnic groups are poorly integrated into the labour market. The gender employment gap in 2017 ranged from around 14 percentage points in Albania, Montenegro and Serbia to over 41 percentage points in Turkey, well above the EU28 average of 11.5 percentage points. There is limited outreach and coverage of support services for jobseekers. Active labour market policies are insufficiently targeted at categories most in need, such as the long-term unemployed, and only a small range of measures is on offer. Undeclared work makes up 20-30% of the workforce. No comprehensive strategies have been implemented so far to address the issue. There is no regular consultation of unions and employers on the design and implementation of economic, employment and social policies, and social dialogue between employers and employees, including collective bargaining, is underdeveloped.

**The level and structure of social spending do not address the needs of the poorest segments of the population.** Despite continuing positive economic trends in recent years, high levels of poverty remain a problem in all economies. Social assistance schemes are underfunded, and do not cover those most in need. The low support levels are ineffective in reducing poverty, thus further increasing income inequality, which remains high in most cases. Some other types of relatively generous non-means tested social benefits – to war veterans for instance – might, on the other hand, create disincentives to work. Social care services are not yet provided everywhere, with rural areas a particular problem. This prevents the social inclusion of vulnerable people.

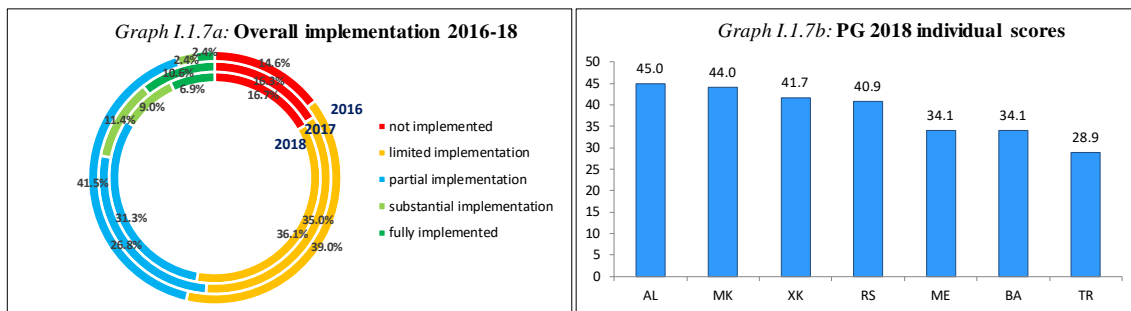


**Structural skills mismatches persist due to underinvestment in human capital and weak education systems.** The education systems in the Western Balkans and Turkey face challenges from early childhood education and care (ECEC) up to the transition to the labour market and adult education. Enrolment in ECEC is particularly low when compared with the EU, and potentially affects long-term education

outcomes, especially of children with a less favourable economic background. Efforts to increase pre-school education are a first step in the right direction. New curricula are being introduced in basic education, but the mismatch between the provision of secondary and higher education and the needs of the labour market often impedes a smooth transition from school to work. The lack of awareness in the population of the need to acquire qualifications in lifelong learning also remains an issue. The training of teachers for all levels of the education system remains a challenge for most economies.

### 1.3. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED IN 2018

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey has adopted targeted policy guidance (PG) for all the authorities. The guidance represents the participants’ shared view on the short-term policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The underlying rationale of the PG is similar to that of the country-specific recommendations adopted under the European Semester for EU Member States. Implementation of the PG is evaluated by the Commission in the following year’s ERP assessments <sup>(3)</sup>.



**Assessment of the implementation of last year’s policy guidance points to persistent difficulties in turning reform commitments into action.** The average score across the Western Balkans and Turkey has declined from 41 out of 100 last year to 38.4 this year <sup>(4)</sup>. As in previous years, more than half (52.8%) of the PG adopted last year saw no or only limited implementation (see Chart 10). Only 16% of the PG has been substantially or fully implemented. In terms of individual performances, the dispersion of scores has decreased markedly <sup>(5)</sup>, as sluggish performers have caught up somewhat while others with a better implementation record have regressed. In contrast to previous years, none of the authorities has achieved a score higher than 50 (see Chart 11).

<sup>(3)</sup> The detailed evaluation of individual PG items can be found in Annex A of the Commission’s ERP assessments.

<sup>(4)</sup> For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission’s Overview and Country Assessments of the 2017 Economic Reform Programmes available at [https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments\\_en](https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en)

<sup>(5)</sup> The standard deviation of individual scores fell to six from 13-15 seen in the last 2 years.

Table I.1.1:

<b>Economic Reform Programmes 2019 - Key indicators</b>							
	2015	2016	2017	2018e	2019	2020	2021
<b>Real GDP growth (% change)</b>							
Albania	2.2	3.4	3.8	4.2	4.3	4.4	4.5
North Macedonia	3.8	2.9	0.2	2.8	3.2	4.0	5.0
Montenegro	3.4	2.9	4.7	4.1	2.8	2.3	2.4
Serbia	0.8	2.8	2.0	4.2	3.5	4.0	4.0
Turkey	6.1	3.2	7.4	3.8	2.3	3.5	5.0
Bosnia and Herzegovina	3.8	2.9	3.4	3.3	3.5	3.7	3.8
Kosovo	4.1	4.1	4.2	4.3	4.7	4.2	4.8
<b>Unemployment rate (% , LFS)</b>							
Albania	17.5	15.6	14.1	12.8	11.7	10.7	9.8
North Macedonia	26.1	23.7	22.4	21.2	20.1	19.1	18.1
Montenegro	17.8	18.0	16.1	14.8	14.5	14.0	13.8
Serbia	17.7	15.9	14.1	12.7	11.8	10.6	9.0
Turkey	10.5	10.9	10.9	11.3	12.1	11.9	10.8
Bosnia and Herzegovina	27.7	25.4	20.5	18.4	17.4	16.4	15.5
Kosovo	32.9	27.5	30.5	:	:	:	:
<b>Current account balance (% of GDP)</b>							
Albania	-8.6	-7.6	-7.5	-6.7	-6.3	-6.1	-6.0
North Macedonia	-2.0	-2.7	-1.0	-0.5	-1.5	-1.7	-1.6
Montenegro	-13.2	-18.1	-16.1	-18.1	-17.0	-15.9	-12.5
Serbia	-4.7	-3.1	-5.2	-5.2	-5.0	-4.5	-4.2
Turkey	-3.8	-3.8	-4.5	-3.5	-2.7	-2.3	-2.1
Bosnia and Herzegovina	-5.3	-4.2	-5.0	-5.0	-4.8	-4.6	-4.4
Kosovo	-8.6	-8.3	-6.8	-8.1	-9.6	-9.0	-9.1
<b>Inflation (CPI, annual % change)</b>							
Albania	1.9	1.3	2.0	2.1	2.7	3.0	3.0
North Macedonia	-0.3	-0.2	1.6	0.0	0.5	0.0	0.0
Montenegro	1.4	0.4	2.4	2.9	1.8	1.8	1.9
Serbia	1.4	1.1	3.1	2.1	2.3	3.0	3.0
Turkey	7.7	8.5	11.1	16.3	18.4	13.3	7.9
Bosnia and Herzegovina	-1.0	-1.1	1.3	1.3	1.2	1.4	1.5
Kosovo	-0.5	0.3	1.5	1.0	1.3	1.3	1.3

Sources: Economic Reform Programme (ERP) 2019 for 2017-2021, CCEQ for 2015 and 2016.

Note: CCEQ: DG ECFIN publication 'EU Candidate and Potential Candidate Countries' Economic Quarterly'

Table I.1.2:

**Economic Reform Programmes 2019 - Key indicators**

	2015	2016	2017	2018e	2019	2020	2021
<b>Real GDP growth (% change)</b>							
Albania	2.2	3.4	3.8	4.2	4.3	4.4	4.5
North Macedonia	3.8	2.9	0.2	2.8	3.2	4.0	5.0
Montenegro	3.4	2.9	4.7	4.1	2.8	2.3	2.4
Serbia	0.8	2.8	2.0	4.2	3.5	4.0	4.0
Turkey	6.1	3.2	7.4	3.8	2.3	3.5	5.0
Bosnia and Herzegovina	3.8	2.9	3.4	3.3	3.5	3.7	3.8
Kosovo	4.1	4.1	4.2	4.3	4.7	4.2	4.8
<b>Unemployment rate (% , LFS)</b>							
Albania	17.5	15.6	14.1	12.8	11.7	10.7	9.8
North Macedonia	26.1	23.7	22.4	21.2	20.1	19.1	18.1
Montenegro	17.8	18.0	16.1	14.8	14.5	14.0	13.8
Serbia	17.7	15.9	14.1	12.7	11.8	10.6	9.0
Turkey	10.5	10.9	10.9	11.3	12.1	11.9	10.8
Bosnia and Herzegovina	27.7	25.4	20.5	18.4	17.4	16.4	15.5
Kosovo	32.9	27.5	30.5	:	:	:	:
<b>Current account balance (% of GDP)</b>							
Albania	-8.6	-7.6	-7.5	-6.7	-6.3	-6.1	-6.0
North Macedonia	-2.0	-2.7	-1.0	-0.5	-1.5	-1.7	-1.6
Montenegro	-13.2	-18.1	-16.1	-18.1	-17.0	-15.9	-12.5
Serbia	-4.7	-3.1	-5.2	-5.2	-5.0	-4.5	-4.2
Turkey	-3.8	-3.8	-4.5	-3.5	-2.7	-2.3	-2.1
Bosnia and Herzegovina	-5.3	-4.2	-5.0	-5.0	-4.8	-4.6	-4.4
Kosovo	-8.6	-8.3	-6.8	-8.1	-9.6	-9.0	-9.1
<b>Inflation (CPI, annual % change)</b>							
Albania	1.9	1.3	2.0	2.1	2.7	3.0	3.0
North Macedonia	-0.3	-0.2	1.6	0.0	0.5	0.0	0.0
Montenegro	1.4	0.4	2.4	2.9	1.8	1.8	1.9
Serbia	1.4	1.1	3.1	2.1	2.3	3.0	3.0
Turkey	7.7	8.5	11.1	16.3	18.4	13.3	7.9
Bosnia and Herzegovina	-1.0	-1.1	1.3	1.3	1.2	1.4	1.5
Kosovo	-0.5	0.3	1.5	1.0	1.3	1.3	1.3

Sources: Economic Reform Programme (ERP) 2019 for 2017-2021, CCEQ for 2015 and 2016.

Note: CCEQ: DG ECFIN publication 'EU Candidate and Potential Candidate Countries' Economic Quarterly'

# Part II

Country analysis

# 1. ALBANIA

## 1.1. EXECUTIVE SUMMARY

**Albania's economic reform programme (ERP) projects economic growth to accelerate to 4.5% by 2021 based on strong private domestic demand.** GDP growth in 2018 was robust at 4.2%. Private demand is expected to continue driving economic growth in 2019-2021, based on greater employment, rising wages and favourable lending conditions for households. Private investment activity is projected to pick up significantly in this period, driven by emerging capacity constraints and favourable financing conditions. Net exports are expected to make only a marginal contribution to the economic expansion. The growth outlook appears optimistic in light of a worsening external environment, continued low levels of lending to businesses, and enduring weaknesses in the business environment.

**The ERP expects Albania to cut public debt from 67% to below 60% of GDP by 2021 by reducing current expenditure and stabilising tax revenue.** The 2018 budget deficit has turned out lower than planned with estimated 1.5% of GDP, mostly due to lower than expected capital spending. The ERP expects the budget deficit to fall to 1.2% of GDP in 2021 by reducing current expenditure but does not provide details of a fiscal consolidation strategy. The relatively low public expenditure does not allow for significant expenditure cuts which partly explains the moderate pace in debt reduction. The relatively low tax revenue is planned to stabilise without major reforms outlined and will thus remain below potential. Public investment is set to increase to over 6% of GDP by 2021, but achieving this increase could be difficult due to weaknesses in the planning and management of capital expenditure.

The main challenges Albania faces are outlined in the bullet points below.

- **Public debt is still high, and large financing needs are weighing on debt sustainability; tax collection is also below potential.** The planned debt reduction strongly depends on high economic growth until the end of the programme period. Advancing the fiscal consolidation can mitigate the risk of not achieving the debt reduction target in case of lower growth in coming years. Stronger fiscal rules on timing, enforcement, correction measures, and monitoring by an independent fiscal institution could all help in reaching the medium-term debt target. The high level of undeclared work and tax evasion provides ample scope for increasing tax revenues without raising tax rates. Unrecorded arrears and contingent liabilities undermine the credibility of the public debt position.
- **The ERP assumes rising investment, but does not address conditions necessary for increasing private investment or for improving the efficiency and growth impact of public investment.** Private investment in Albania is hampered by shortages of skilled labour and the low quality of public services accessible to entrepreneurs. Entrepreneurs also lack productive and entrepreneurial know-how, financial literacy, and access to finance. Albania's investment in education and health has been below the regional average, and the ERP plans to decrease even further the share of budget allocations to education and health. The increases planned for public investment should also be used to finance education, health and research, and this investment must be more efficient and more effective.
- **Albania's competitiveness continues to be hampered by inefficiencies in the energy sector, including insufficient security of supply.** The dependence on hydropower for electricity generation (98%) makes the economy vulnerable to climate change and hydrological conditions. In addition, Albania is a net importer of electricity contributing to the considerable trade imbalance. Investment in energy efficiency could contribute to lowering these vulnerabilities. Albania has adopted

legislation on the liberalisation and unbundling of the gas and electricity markets in line with the EU's third energy package, but it is not yet fully implemented.

- **The tourism sector in Albania has a great potential, but it is underdeveloped.** A comprehensive tourism strategy has been developed, but it has seen significant delays in its adoption, which jeopardises the sustainable development of this sector, in spite of its significant potential to contribute to economic development and to offer competitive export growth. There is a need to develop relevant Vocational Education and Training (VET) programmes in the tourism field.
- **High youth unemployment and inactivity, low female employment, high share of informal and vulnerable employment, insufficient social care services and low quality of education are key obstacles.** Active labour market policies need to better target vulnerable jobseekers, provide more upskilling and be more relevant to labour market needs. Social assistance allowances are not sufficient to lift the poor above the extreme poverty line. Social care services for inclusion of vulnerable people are insufficient and many local government units lack capacities and resources to plan and deliver them. Educational outcomes are weak at all levels and the VET reform is delayed. Early childhood education suffers from very low investments and low enrolment for children from vulnerable families. Participation in adult education is particularly low.

**The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2018 has been partially implemented.** Progress was partial on the reduction of public debt through fiscal consolidation measures. The number of taxpayers increased but at the same time a number of tax exemptions were introduced. The value-based property tax was not fully implemented. The ERP reported on future payment obligations to PPPs but not on their fiscal risk assessment. There has been some legal progress in unbundling the electricity and gas markets but the Power Exchange has not been established. Some progress has been made in broadening the energy mix but not in promoting energy efficiency. There has been some progress with registration of property, while no progress has been made on setting up the e-cadastre and land consolidation. Human resources at the Directorate of Employment and Skills Development Policies remain limited. More activation support was provided to (ex)-beneficiaries of economic assistance, but their coverage is still low. The State Labour Inspectorate improved detection of undeclared work, but its capacities were not increased. The curricular reform in basic education is almost finalised, but teachers need further support.

**The ERP sets out reform plans that are partially in line with the priorities identified by the Commission.** The programme's macro-fiscal framework is slightly optimistic. The achieved debt-ratio and the reconfirmed commitment to lowering public debt are in line with the Commission's recommendation in previous years but the approach to achieving the fiscal targets could be more strategic. The diagnostic on structural obstacles focuses on access to finance, agricultural land ownership, business regulation, and trade facilitation. However, it does not cover issues like diversifying the production base, property rights, entrepreneurship support and contract enforcement. The measure on pre-university curricular reform does not address the need for continuous support to teachers. VET reform and modernisation of public employment services respond to challenges, but their pace needs to be sustained. The measure on social protection does not address low capacity and resources of local government units. Three new measures in the area of education are not sufficiently developed and seem to address structural issues only partially.

## 1.2. ECONOMIC OUTLOOK AND RISKS

**The ERP projects that economic growth will gradually accelerate from 4.3% to 4.5% over 2019-2021, helped by strong private consumption and investment.** The pace of economic growth increased to 4.2% in 2018, driven by private consumption, rising employment, low interest rates, and low inflation. For 2019-2021, the ERP expects that the main contributions to growth will come from private consumption (increasing by an average of 2.4 pps over the period), and investment (increasing by an average of 1.5 pps over the period). The ERP expects private consumption to be supported by higher rates of employment, rising wages, and favourable lending conditions for households. Private investment is projected to increase significantly, partly in response to an already high level of capacity utilisation. Net exports are expected to only marginally contribute to the economic expansion, as strong annual growth in exports (of 7% per year on average) is forecast to be offset by a relatively strong growth in imports (of 4.7% per year on average) in line with investment-related needs. The ERP projects strong growth in agriculture and industry, but services are expected to remain the main driver of labour demand. Increasing labour force participation will boost labour supply. However, only slight improvements are expected for labour productivity, on which the ERP provides no details. Employment is projected to grow on average by a rather robust 2.7% per year, bringing the unemployment rate gradually down to 9.8% by the end of the programme period. The ERP estimates that the current negative output gap will close in 2019 and turn slightly positive in the following 2 years.

In addition to the described baseline scenario, an ‘optimistic’ and a ‘pessimistic’ scenario are presented (including deviations in terms of lending to the economy, euro-area growth, and the pace of structural reforms). The negative scenario assumes that shocks bring growth down to 2.8 -3%, which would result in a fiscal deficit of 2.3 -2% of GDP. The optimistic scenario forecasts growth 1 pp. above the baseline and fiscal deficits dropping to 1.3 -0.7% of GDP over the programme period

**The baseline scenario appears optimistic on the projected increase in both exports and investment in the current external environment.** The expected acceleration of growth is partly based on a benign external outlook for global and EU growth, which is more optimistic than recent forecasts by the IMF (WEO, January 2019) and European Commission (Autumn Forecast 2018). In particular, the economic outlook for Italy, Albania’s main export destination and investment partner, deserves particular attention. Moreover, the programme’s assumption for oil prices appears too high. Projections for less volatility in metal prices, in the wake of the Chinese economic slowdown and international trade disputes, do not appear to be sufficiently reflected in the ERP. These developments in the prices of oil and metals could significantly affect Albania, which is a primary commodity exporter of oil and chrome. The expected acceleration in investment growth to around 6-7% over the programme period would be about 2 pps higher than in any year since 2011. Such an acceleration seems optimistic, given the low levels of bank lending to private businesses and the slowdown in implementation of reforms after the administrative restructuring. The planned increase in public investment to 6% of GDP would be in line with the country’s needs, but would require significant efforts to improve institutional capacity for the planning and execution of public investment. The programme does not provide arguments for its projection that agricultural production will make a stronger contribution to growth than it has done in recent years.

**The ERP expects inflation to return to target by 2020 based on rising domestic inflationary pressures.** The annual average of the consumer price index rose by 2.1% in 2018, considerably below the 3% target of the central bank, and marking the seventh consecutive year of below-target average annual inflation. Over the last year, the stable rate of inflation mainly reflected the disinflationary impact of the increase of the lek’s value. For the most part, it was domestically produced goods (like unprocessed food items) that contributed 1 pp. to the inflation rate. The value of the lek increased by 8% in real effective terms in 2018. This was greater than the increase that was expected from improving fundamentals which prompted the central bank to intervene temporarily on the foreign exchange market to contain the disinflationary impact of the currency appreciation. The central bank expects the exchange rate pressure



on prices to dissipate over 2019 and that instead inflationary effects of domestic demand will dominate which could bring inflation in line with its target by 2020. The ERP's technical assumption that the nominal exchange rate will remain unchanged at its average of 2018 does not seem to reflect that the recent strong appreciation is expected to dissipate. The ERP lacks an analysis of the possible impacts on Albania's external competitiveness of future fluctuations of the lek, increasing wages and inflation.

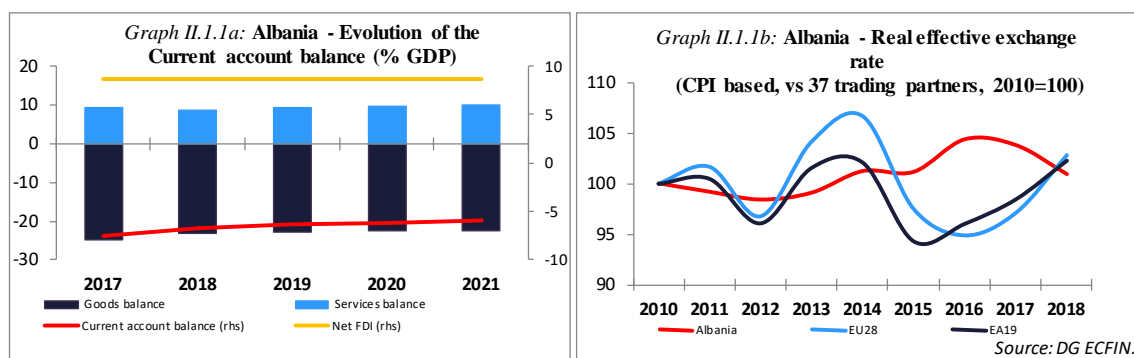
Table II.1.1:

**Albania - Comparison of macroeconomic developments and forecasts**

	2017		2018		2019		2020		2021	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
<b>Real GDP (% change)</b>	3.8	<b>3.8</b>	4.1	<b>4.2</b>	3.9	<b>4.3</b>	3.9	<b>4.4</b>	n.a.	<b>4.5</b>
<i>Contributions:</i>										
- <b>Final domestic demand</b>	5.0	<b>4.1</b>	4.7	<b>3.8</b>	4.3	<b>4.3</b>	4.4	<b>4.0</b>	n.a.	<b>4.4</b>
- <b>Change in inventories</b>	0.0	<b>0.9</b>	0.0	:	0.0	:	0.0	:	n.a.	:
- <b>External balance of goods and services</b>	-1.2	<b>-1.2</b>	-0.6	<b>0.4</b>	-0.4	<b>0.0</b>	-0.4	<b>0.4</b>	n.a.	<b>0.1</b>
<b>Employment (% change)</b>	3.3	<b>2.7</b>	1.7	<b>2.1</b>	0.6	<b>2.8</b>	1.3	<b>2.6</b>	n.a.	<b>2.6</b>
<b>Unemployment rate (%)</b>	13.7	<b>14.1</b>	12.7	<b>12.8</b>	11.1	<b>11.7</b>	10.6	<b>10.7</b>	n.a.	<b>9.8</b>
<b>GDP deflator (% change)</b>	1.4	<b>1.4</b>	3.8	<b>1.9</b>	2.4	<b>2.0</b>	2.3	<b>2.2</b>	n.a.	<b>2.5</b>
<b>CPI inflation (%)</b>	2.0	<b>2.0</b>	2.3	<b>2.1</b>	2.6	<b>2.7</b>	2.8	<b>3.0</b>	n.a.	<b>3.0</b>
<b>Current account balance (% of GDP)</b>	-7.5	<b>-7.5</b>	-6.3	<b>-6.7</b>	-6.4	<b>-6.3</b>	-6.4	<b>-6.1</b>	n.a.	<b>-6.0</b>
<b>General government balance (% of GDP)</b>	-2.0	<b>-2.0</b>	-2.0	<b>-2.0</b>	-1.9	<b>-1.9</b>	-1.7	<b>-1.6</b>	n.a.	<b>-1.2</b>
<b>Government gross debt (% of GDP)</b>	70.1	<b>70.1</b>	69.9	<b>69.1</b>	67.6	<b>65.5</b>	65.2	<b>63.6</b>	n.a.	<b>59.9</b>

Sources: Economic Reform Programme (ERP) 2019, Commission Autumn 2018 forecast (COM).

**The current account deficit is expected to continue to fall and be mainly financed by Foreign Direct Investment (FDI).** In 2018, high electricity exports and a decreasing share of commodity imports reduced the traditionally high trade deficit by 3 pps to an estimated 21.6% of GDP. Net FDI (which mainly financed the current account deficit) grew exceptionally strongly, thanks to one-off inflows of investment in energy projects. Over 2019-2021, imports of goods are expected to stabilise, keeping the trade deficit at around 21% of GDP. Services exports are projected to benefit from continued strong growth in foreign tourism, but the services surplus is expected to slightly decrease in 2019-2021 compared to previous years. The current account is also projected to benefit from continued inflows of remittances from the Albanian diaspora, although these remittances are forecast to grow at a slower pace compared to their growth in more recent years. Overall, the current account deficit is expected to decline at a slower pace than in 2017-2018, falling from 6.7% to 6% of GDP over the programme period. This projection is subject to downside risks (i.e. the real decline may be smaller) due to: (i) the volatility of hydropower-based electricity production, (ii) the uncertainty over the share of imports in quickly-growing domestic demand, and (iii) the possibility of slower-than-expected growth in Albania's main trading partners. The ERP projects that net FDI will grow by between 6% and 7% in 2019-2021, less than in 2018, and will cover on average 130% of the current account deficit.



**External vulnerabilities are mitigated by improved external debt metrics and solid forex reserves.** A slowdown in the European economy — and in particular the Italian economy — may negatively affect the net flow of remittances. This would have a negative impact on the current account and on net FDI inflows, which would affect financing of the current account. Gross external debt stood at 64.5% of GDP at the end of September 2018, down from 68.4% at the end of 2017. About 80% of the external debt stock is long-term. More than half of this external debt is owed by the government and most of the rest consists of intercompany lending between direct investors and subsidiaries. Although the external debt is sizeable, its composition means that it is not a cause for immediate concern. Foreign-exchange reserves provide a good safeguard against adverse shocks, and are expected to rise by around 10% a year over the next 3 years. Foreign reserves totalled EUR 3.0 billion (25.7% of GDP) at the end of 2018, and comfortably cover more than 6 months of imports of goods and services. The central bank assesses external debt sustainability as being more vulnerable to exchange-rate risks than to interest-rate shocks, but it states that its reserves are sufficient to mitigate those risks.

**Bank balance sheets are expected to improve further, but poor collateral execution and the dominance of foreign currencies pose risks. Financial intermediation also remains shallow.** Banks are well capitalised, highly liquid, and predominantly funded by deposits. However, the stock of non-performing loans remains high, and has continued to act as a drag business lending. This has made financing conditions more onerous. The low financial literacy of SMEs and large number of ‘unbankable’ business plans contributed to sluggish credit growth. The ratio of non-performing loans (NPL) to total gross loans declined by 3 pps to 11% at the end of 2018, mainly as a result of mandatory write-offs. This ratio is now expected to decline below 10% over the programme period. However, collateral execution remained weak and might hamper the further reduction in NPLs. The share of foreign-exchange loans in total loans fell only slightly to 55.1% in 2018, while foreign-exchange deposits increased slightly to 52.2% of total deposits<sup>(6)</sup>. The banking sector holds over 20% of its assets in government securities, exposing it to sovereign risks. In addition, a quarter of domestic loans and deposits remain exposed to exchange-rate risks. The banking sector could be made more stable by the planned strengthening in the resolution function at the central bank and by bringing the macro-prudential framework closer to EU standards. Overall, financial inclusion remained low, with only 40% of adults and about 75% of SMEs holding bank accounts. There is a high rate of physical-cash use. The central bank has drawn up a plan for increasing financial inclusion, which is important for reducing remittance fees, illicit financial flows, and the size of the informal economy. A stronger development of the still very small non-banking financial sector could support financial inclusion as well as access to finance for SMEs.

<sup>(6)</sup> The effect of the strong exchange rate appreciation in 2018 is likely to distort the actual changes in forex loans and deposits.

Table II.1.2:

**Albania - Financial sector indicators**

	2014	2015	2016	2017	2018
<b>Total assets of the banking system (EUR million)</b>	9244	9435	10248	10768	11 398
<b>Foreign ownership of banking system (%)**</b>	87.1	84.1	82.6	81.4	80.8
<b>Credit growth* (%)</b>	2.0	-2.8	0.4	0.2	0.5
<b>Deposit growth</b>	4.6	2.6	5.2	0.7	1.3
<b>Loan-to-deposit ratio</b>	59.0	57.4	57.2	57.0	52.3
<b>Financial soundness indicators</b>					
- non-performing loans	22.8	18.2	18.3	13.2	11.1
- net capital to risk-weighted assets	16.8	16.0	15.7	16.6	18.2
- liquid assets to total assets	10.5	10.9	12.8	13.0	14.8
- return on equity	10.5	13.2	7.1	15.7	13.0
- forex loans to total loans (%)	61.5	60.0	57.8	55.7	55.1

\* Adjusted for loan write-offs

\*\*of total sector assets

Sources: Economic Reform Programme (ERP) 2019, IMF, Bank of Albania, ECFIN CCEQ.

### 1.3. PUBLIC FINANCE

**The 2018 fiscal balance improved more than planned, largely due to underspending on the capital budget.** The budget deficit is estimated to have narrowed from 2% of GDP in 2017 to 1.5% in 2018. The deficit turned out lower than the initially forecast 1.9% of GDP, mainly due to underspending on the capital budget, with an implementation rate of below 70% (in November 2018). Also, current spending was lower than planned (86% in November 2018), due to lower personnel, social insurance and interest expenditure. At the same time, tax revenues were more than 10% below forecasts, as the unexpectedly fast appreciation of the currency affected income from VAT and excise duties on imports.

**The deficit is forecast to remain below 2% in 2019, mainly by maintaining expenditure at current levels.** The ERP contains the same deficit target (of 1.9% of GDP) as the medium-term fiscal framework (MFF). However, Chapter 4 of the ERP also mentions a revised target of 1.7% of GDP. Based on the preliminary data from 2018, both targets would lead to a widening deficit. The ERP also plans to reduce total spending from 30% of GDP to below 29.6% of GDP, due to a decreasing current expenditure ratio. The ERP also forecasts that the share of capital expenditure will increase to 6.2% of GDP. Multiple tax exemptions and ad hoc expenditure items (such as a bonus for giving birth) were introduced for 2019. It is estimated that this will reduce revenues by 0.28% of GDP and increase expenditure by 0.43% of GDP. Tax revenue as a share of GDP (excluding social insurance contributions) is forecast to shrink from 16.9% to 16.6% in 2019 due to: (i) lower revenue from production and imports, and (ii) lower growth in VAT revenue than in recent years.

Table II.1.3:

**Albania - Composition of the budgetary adjustment (% of GDP)**

	2017	2018	2019	2020	2021	Change: 2018-21
<b>Revenues</b>	27.7	28.0	27.8	27.8	27.8	-0.3
- Taxes and social security contributions	22.2	22.4	22.2	22.3	22.4	0.0
- Other (residual)	5.5	5.6	5.5	5.4	5.3	-0.3
<b>Expenditure</b>	29.7	30.0	29.6	29.3	28.9	-1.1
- Primary expenditure*	27.7	27.5	27.3	26.8	26.2	-1.3
<i>of which:</i>						
Gross fixed capital formation	5.5	6.2	6.2	6.0	5.9	-0.3
Consumption	9.4	9.3	9.1	9.0	8.7	-0.5
Transfers & subsidies	12.1	11.9	11.7	11.6	11.3	-0.5
Other (residual)	0.7	0.2	0.2	0.3	0.3	0.1
- Interest payments	2.1	2.5	2.4	2.5	2.7	0.2
<b>Budget balance</b>	-2.0	-2.0	-1.9	-1.6	-1.2	0.8
- Cyclically adjusted	-1.6	-1.8	-1.9	-1.7	-1.2	0.5
<b>Primary balance</b>	0.1	0.5	0.5	0.9	1.5	1.0
- Cyclically adjusted	0.4	0.7	0.5	0.9	1.4	0.7
<b>Gross debt level</b>	70.1	69.1	65.5	63.6	59.9	-9.2

\* Excluding arrears clearance

Sources: Economic Reform Programme (ERP) 2019.

The ERP outlines plans for a back-loaded fiscal consolidation in 2019-2021, while aiming to increase capital expenditure as a share of GDP. The small primary surplus is expected to remain unchanged in 2019 (compared to the initial plan for 2018) and improve in the next 2 years, rising from 0.5% to 1.5% of GDP in 2021. The cyclically adjusted budget balance also suggests a restrictive stance in 2020 and especially in 2021, in line with the expected positive output gap. Over the programme period, total spending will drop by close to one percentage point of GDP (from 30% to below 29% of GDP), due to a slight decrease in current expenditure and an increase in capital expenditure to an average of 6% of GDP. The revenue-to-GDP ratio is forecast to remain broadly unchanged despite the significant potential to increase tax revenue and social contributions by fighting informality and tax evasion. Overall, tax revenue is forecast to stabilise at 16.6% of GDP, thus remaining below the regional average. Despite the government's plan to fight informality and the forecasts for strong employment growth, social insurance contributions as a share of revenue are expected to remain unchanged. This means there is little prospect of a reduction in the social insurance deficit. The ERP envisages debt reductions of 1.9 pps from 2019 to 2020 (to 63.6% of GDP) and 3.7 pps between 2020 and 2021 (to 59.9% of GDP). This would mean shifting the bulk of the adjustment to the last year of the government's legislative term.

*Box II.1.1: The budget for year 2019*

On 26 October 2018, the government presented the draft budget for 2019 to parliament. Parliament adopted the budget on 3 December 2018. The budget targets a deficit of 1.9% of GDP and a primary balance of 0.5% of GDP.

Main measures in the budget for year 2019	
<p><b>Revenue measures*</b></p> <ul style="list-style-type: none"> <li>• VAT exemptions of certain activities in the tourism sector (-0.02 pps of GDP)</li> <li>• Personal income tax reduction for about 15 400 employees (-0.02 pps of GDP)</li> <li>• Reducing the dividend rate from 15% to 8% (increasing revenues by 0.25 pps of GDP due to expected higher rates of declaration)</li> <li>• National tax revenues reduced by 1 pp. of GDP due to: (i) restricting gambling (-4 billion leks), (ii) changes in taxes on plastic packaging (+0.5 billion leks), and (iii) an increase in royalties on chrome exports (+0.03 pps of GDP)</li> <li>• Increase in excise revenues due to higher excise duties on packets of cigarettes and on other tobacco products (+0.04 pps of GDP)</li> <li>• Increase in customs-duty revenues of 5.6% due to: (i) an increase of taxable imports, and (ii) customs tariff unification (of tariff band category 8418) to 10% (0.002 pps of GDP)</li> <li>• Net revenue gain from new tax measures: 0.28 pps of GDP</li> </ul>	<p><b>Expenditure measures**</b></p> <ul style="list-style-type: none"> <li>• New wage policy (0.1 pps of GDP)</li> <li>• New pension policies (0.14 pps of GDP)</li> <li>• Baby bonus (0.11 pps of GDP)</li> <li>• Contingency reserve for justice reform (0.08 pps of GDP)</li> <li>• Expenditure increase from new policy measures: 0.43 pps of GDP</li> </ul>
<p>* Estimated impact on general government revenues. ** Estimated impact on general government expenditure. <i>Source: ERP/MFF</i></p>	

\* Overall, tax revenue is expected to increase by 1.3 pps of GDP due to: (i) increasing revenues from VAT, personal income tax, and social security contributions (all due to economic growth); (ii) higher rates of formal employment; and (iii) improved collection efficiency. New tax measures will also boost tax revenues by 0.28% of GDP. The main revenue measure is the reduction of the dividend tax rate, which is expected to increase

*(Continued on the next page)*

*Box (continued)*

tax revenues by +0.2 pps of GDP thanks to increasing tax declarations, although overall taxes on profits are expected to turn out lower in 2019 (-0.018 pps of GDP) compared to 2018.

\* Overall expenditure is expected to grow by 5.1% and reach a share of 29.6% of GDP (down from 30% of GDP in 2018). Current expenditure is set to increase by 1.1% of GDP, mainly for personnel expenditure (0.27% of GDP) and social insurance outlays (0.47% of GDP). Expenditure for new policy measures would come to 0.43% of GDP. Capital expenditure (of central government) is to increase by 0.35% of GDP to a share of 4.7% of GDP, no details are provided on investments of local governments.

**High public debt remains a key concern but the government's target of reducing debt to below 60% of GDP by 2021 seems within reach.** In recent years, the public debt ratio has been declining gradually, in compliance with the fiscal rule. This decline has continued even though the target date for reaching a debt level (including guarantees) of below 60% had been postponed for the last three consecutive years. The 2019 programme sticks to the target date of 2021, stipulated in last year's programme. Supported by the appreciation of the lek, the gross-public-debt-to-GDP ratio in 2018 was most likely less than originally estimated (67% instead of 69.1%)<sup>(7)</sup>. With this lower estimated starting base in 2018, a reduction of about 7.5 pps of GDP over 3 years appears feasible. However, the pace of debt reduction over the ERP horizon is back-loaded, with no significant fiscal adjustment planned for 2019. The current benign growth outlook provides scope for a more front-loaded debt-reduction path over the ERP cycle.

**Despite successful measures to prolong maturity, short-term debt and gross financing needs remain a risk to debt sustainability.** Short-term debt still accounts for 35% of the total, but interest-rate risks were lowered as the share of domestic debt with variable interest rates was reduced. Gross financing needs remain above 20% of GDP and pose a risk to debt sustainability. The domestic market, mainly banks, is expected to remain the main financing source. External sources are expected to finance up to 25% of the government's gross financing needs, mostly through concessional and semi-concessional project loans from bilateral and multilateral sources that do not pose sustainability risks. However, with the increasing share of commercial financing through the planned eurobonds, sustainability risks might rise. Externally held debt has increased as a percentage of public debt, but is set to decrease by about 2% per year in terms of GDP, mainly due to currency appreciation. Key objectives of the debt-management strategy are to: (i) shift public debt to longer maturities, and (ii) reduce roll-over risks. These two objectives will partly be achieved by increasing the share of debt that is denominated in foreign currencies, but limiting foreign-currency-denominated debt to 55% of total debt.

**The main risks to fiscal consolidation are: (i) a slowdown in economic growth and (ii) the underestimation of fiscal risks from both contingent liabilities and weaknesses in public financial management (both at central- and local-government level).** The risk analysis of the ERP confirms that the fiscal consolidation targets may not be achieved if there is a significant slowdown in economic growth. Key risks to debt reduction are the underestimation of fiscal risks related to both contingent liabilities from public enterprises and the growing number of PPPs. PPPs have now reached a value of 31% of GDP, with additional projects planned that would increase the total value by 15 pps of GDP for 2019 (IMF 2019). At the same time, there has not been a corresponding increase in the numbers of staff

<sup>(7)</sup> This is a preliminary figure, which might still be subject to minor modifications. The Albanian debt calculation includes public guarantees (which are usually not included in the deficit defined by the Excessive Deficit Procedure EDP), but does not include arrears (which are included in the IMF calculation of the deficit). The debt ratio is based on the IMF forecast of nominal GDP according to the budget law.

available to monitor and assess these complex contracts and projects. This means that the public financial obligations related to the PPPs are not being comprehensively assessed and statistically recorded. Information on publicly guaranteed debt differs between the figure given in the ERP (3.3% of GDP rising to 5-6% of GDP in the medium term) and the MFF (2.9% of GDP, forecast to decrease to 2.6% of GDP by 2021). There does not appear to be any risk analysis of this publicly guaranteed debt. Weak management of the public finances has led to a stock of arrears on debt payments by local governments and from VAT refunds. The IMF estimated that these arrears were worth 1.5% of GDP by the end of September 2018. There were also arrears in public energy corporations and possibly other public entities. These arrears are not accounted for in the MFF, but their correct inclusion as expenditure would certainly increase the fiscal deficit, and possibly also increase financing needs.

#### Box II.1.2: Debt dynamics

The main debt-increasing component are interest payments, while GDP growth, and from 2018 onwards the positive primary balance are contributing to the declining debt ratio. The stock-flow adjustments reflect the Eurobond issuance in 2018 and the planned issuances in 2020 and 2022. According to the risk analysis in the ERP, external debt sustainability is more vulnerable to exchange-rate fluctuations than to global interest-rate movements. The dynamics show that debt reduction is most sensitive to economic growth, a finding which is in line with the results of the IMF's latest debt-sustainability analysis. There has recently been a shift towards a greater share of the country's debt being held outside Albania, and this trend looks set to continue. This means there will be an increase

Table:

Albania - Composition of changes in the debt ratio (% of GDP)					
	2017	2018	2019	2020	2021
<b>Gross debt ratio [1]</b>	<b>70.1</b>	<b>69.1</b>	<b>65.5</b>	<b>63.6</b>	<b>59.9</b>
Change in the ratio	-2.2	-0.9	-3.6	-1.9	-3.7
<i>Contributions [2]:</i>					
<b>1. Primary balance</b>	<b>-0.1</b>	<b>-0.5</b>	<b>-0.5</b>	<b>-0.9</b>	<b>-1.5</b>
<b>2. "Snowball" effect</b>	<b>-1.6</b>	<b>-1.6</b>	<b>-1.8</b>	<b>-1.6</b>	<b>-1.6</b>
<i>Of which:</i>					
Interest expenditure	2.1	2.5	2.4	2.5	2.7
Growth effect	-2.7	-2.8	-2.8	-2.7	-2.7
Inflation effect	-1.0	-1.3	-1.4	-1.4	-1.5
<b>3. Stock-flow adjustment</b>	<b>-0.6</b>	<b>1.2</b>	<b>-1.3</b>	<b>0.7</b>	<b>-0.6</b>

[1] End of period.

[2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).

The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other effects.

Source: Economic Reform Programme (ERP) 2019, ECFIN calculations.

in exchange-rate risk. However, the large foreign reserves and the appreciation of the currency in recent years means that the impact of this can be contained. In 2018, the actual debt ratio is likely to be 67.2% of GDP, and the primary balance is likely to be 0.7% of GDP. This shows that the debt reduction was significantly greater than initially assumed in 2018, due mainly to the currency appreciation and under-expenditure on the budget. The debt-reducing effects of the primary balance are likely to continue, opening more space to front-load the debt reduction.

**Albania's public finances continued to suffer from relatively low levels of tax collection and high levels of informality.** Although significant progress was made in tax collection and administration, tax revenue as a percentage of GDP remains below the regional average, and the social insurance system is suffering from a large deficit. The low revenue mobilisation is mainly due to the large size of the informal economy, but is also attributable to widespread evasion of tax or social contributions — even in the formal economy (e.g. by using lower prices or wages for tax declarations). VAT evasion is estimated at

30-40% of potential VAT, and roughly 30% of employments are estimated to remain undeclared. Moreover, the recent introduction of tax exemptions as investment incentives further undermines revenue collection and promote tax fraud, because they complicate the taxation system and make it less transparent.

**The link between policy objectives and corresponding budgetary allocations remains weak.** In general, public investment has focused on physical infrastructure to address Albania's large infrastructure gap, which is mainly in energy but also in water supply. However, actual investment allocations fluctuated greatly between sectors from year to year. Allocations for health and education are below the regional average, and social protection coverage is low. The government plans to further decrease the already-low allocations to education (which will fall from 2.5% to 2.2% of GDP), health (which will fall from 3.0% to 2.7% of GDP) and social protection (which will fall from 9.0% to 8.6% of GDP) over the programme period. These allocation plans do not help to tackle the brain drain and shortages of skilled labour. Nor do they help to encourage convergence to European standards in these fields. While current expenditure will remain at a reasonable level, the government's hiring plans for staff in the public sector seem to be under-executed. This might lead to shortages in staff (and subsequent quality problems for public finances and public investment management) at a time when the budget plans to increase capital expenditure.

**Albania's fiscal framework lacks strong enforcement mechanisms and an independent fiscal institution.** The fiscal rules in Albania provide for a long-term target of 45% of debt to GDP, with an obligation to decrease this ratio each year compared to the previous year until the target is reached. Budget plans for 2019 comply with the fiscal rules on debt reduction, the deficit target (the deficit must be lower than the capital expenditure), and the limit on payments to PPPs. The contingency reserve for exchange rate fluctuations (0.2% of GDP for 2019 and 0.4% for 2020 and 2021) is overall low but in line with the requirement of the budget law, namely 0.7% of total expenditure. The main weakness of the existing framework is that it does not prescribe a timeline or minimum requirements for the consolidation path. There is no independent fiscal institution to monitor fiscal policy and the implementation of the fiscal rule. The authorities do not envisage the establishment of such an institution over the programme horizon due to capacity constraints. However, an independent fiscal body, even if small, could help strengthen the current rules-based framework by assessing compliance or by providing independent budget analysis or revenue forecasts. The quality of fiscal data is improving and alignment with European System of Accounts (ESA) 2010 standards is ongoing with support from Eurostat.

#### 1.4. STRUCTURAL CHALLENGES AND REFORM PRIORITIES

**Much of Albania's growth and export potential is linked to nature-based sectors such as coastal tourism, agriculture, hydropower and mining.** At the same time, this dependence on natural resources coupled with a dependence on volatile water resources, creates vulnerabilities. Albania's exposure to, and sensitivity towards, the quality of natural assets, natural disaster risks, and climate change affect important sectors such as agriculture, energy and tourism and, therefore, the livelihoods of large parts of the population, especially the less well-off. Furthermore, the uncertainty on property titles remains a serious impediment to investments, including in tourism and the agricultural sector, but also limits private sector investment and access to finance.

The Commission has conducted an independent analysis of the Albanian economy to identify the key structural challenges to boost competitiveness and inclusive growth, drawing from Albania's ERP itself but also using other sources. This analysis of the economy shows that Albania experiences several structural weaknesses across many sectors. However, the main challenges in terms of boosting competitiveness and long-term and inclusive growth are (i) improving the labour market relevance, quality and targeting of active employment policies, including upskilling of adults and VET, (ii) tapping



renewable and energy saving potentials and fully opening the energy market as well as (iii) ensuring sustainable development of the tourism sector.

#### 1.4.1. Key challenges

##### ***Key challenge #1: Improving the labour market relevance, quality and targeting of active employment policies, including upskilling of adults and VET***

Active labour market policies show some improvements in 2018, especially in job mediation, but remain insufficiently targeted, underfunded, limited in scope and unavailable in rural areas. Employment promotion programmes (EPP) are not targeted or tailor-made enough for unemployed people who are more in need such as long-term unemployed, women with family responsibilities, beneficiaries and ex-beneficiaries of economic assistance, older people, low qualified, and Roma/Egyptian. Overall, the programmes do not provide an adequate support to vulnerable jobseekers to transit into higher productivity jobs or to integrate the labour market in a sustainable way. Another type of active employment policies are vocational training courses, which are generally of a too low quality for a successful transition to the labour market. Young people (15-29) face a challenging labour market transition, with almost 30% of them not being in employment, education or training (NEET). Vulnerable youth is also insufficiently targeted by EPP. While the number of students enrolled in secondary vocational education and training (VET) has increased over the last years, it is still low. The labour market transition from VET is rather low (46.9% employed one year after graduation). The reform of secondary VET is delayed, including improvement of the quality at offer and its relevance to the labour market, linkages to the private sector and accessibility. Reintegration of vulnerable people is insufficient as social care services, responsibility for which was decentralised to the local level, are missing in many areas or are underdeveloped. Many local government units lack capacities and resources to plan and deliver social care services and almost half of them lack experience due to the inexistence of such services in their territory. The central government does not seem to devote enough attention to this issue. Early childhood education and care (ECEC) suffers from lack of policy framework, very low investment and low enrolment of children from vulnerable families. The lack of ECEC and social care services puts an additional obstacle to the employment of women whose employment rate is 14 pps lower than that of men.

##### ***Key challenge #2: Tapping renewable and energy saving potentials and fully opening the energy market***

**The Albanian economy is hampered by the inefficiency of its energy market and the insecurity of its energy supply.** Albania depends almost exclusively on hydropower for its electricity generation (98%), which has a positive contribution to decarbonising its electricity sector but makes it highly vulnerable to unfavourable hydrological conditions in the summer, as well as to the impact of climate change. As a result, Albania is in most of the recent years a net importer of electricity (up to 40% annually) and the sustainability of its power supply poses a challenge. The government plans to convert the currently inactive oil-fired Vlora thermal power plant into gas-fired use in the mid-term after connection to the Trans Adriatic Pipeline (TAP). This would stabilise the generation of electricity during droughts in the southern part of Albania. Albania is part of the trans-Adriatic pipeline project, which aims to connect Albania, Italy and Greece with a single gas pipeline. Although the project is progressing on schedule, Albania is still not connected to any international gas networks. It has an outdated pipeline network of almost 500 km, which is mostly not operational. This means businesses and industry rely heavily on the electricity sector.

**Given its natural endowments, Albania has the potential to develop renewable energy sources.** In addition to hydropower potential, and expected gas interconnection, Albania is endowed with solar irradiation and wind speeds, which would make solar photovoltaic and onshore wind cost competitive in many locations (IRENA, 2017). The exploitation of these renewable energy sources has only just begun,

but, Albania already held the first renewable energy auction of the Energy Community in November 2018. However, the current installed capacity of these technologies is very small. The implementation of feed-in tariffs provides a promising opportunity for the future, but has had only a limited impact on the development of solar energy so far because of the small size of the auctioned capacities. The government has announced plans for the implementation of 120 MW of solar and 70 MW of wind power capacity by 2020. The support schemes offered for renewable energy are of limited range and both private households and SMEs have a limited access to the relevant technologies.

**Albania's focus on hydropower disregards some significant risks.** The government plans to increase energy generation focus on the construction of new hydro-power plants, which raises serious concerns about the wider environmental impact and could have significant negative effects on local communities and on tourism. Moreover, in view of the expected increase in tourism and intensification of the agricultural sector, as well as the impact of climate change, the water resources of Albania may come under strain. Therefore, it will be necessary for Albania to widen its strategic approach by diversifying its electricity generation through increased investments in solar and wind power, as well as developing a comprehensive water management strategy, accounting for all competing uses.

**Energy efficiency should receive greater attention from the government.** In spite of some progress in recent years, electricity distribution losses in 2018 remained high at 24.4%. In implementation of the energy efficiency law, Albania has adopted an action plan for the period until 2020, aiming at reducing energy use by 6.8%. However, the implementation of the action plan is lagging. Albania's economy remains three times more energy intensive than the EU 28 average. Improving energy efficiency will decrease the energy needs of the economy, and therefore reduce production costs, improve energy security and reduce the trade deficit. The transport and residential sectors, which are responsible for up to 70% of the final energy consumption, should be the main target for energy efficiency measures.

**Albania has adopted legislation on the liberalisation and unbundling of the electricity and gas markets in line with the EU's third energy package, but it is not yet fully aligned and implemented.** Some progress has been achieved in the legal unbundling of distribution from supply activity, but functional unbundling has not yet been finalised. Electricity prices are still regulated but should be gradually liberalised once legislation is implemented. The electricity market remains closed by regulated wholesale contract between state-owned generation and distribution companies, which needs to be phased out.

### ***Key challenge #3: Ensuring sustainable development of the tourism sector***

**Albania has the potential to become an important tourist destination in Europe, but the sector remains underdeveloped.** The tourism sector in Albania has emerged as a significant contributor to growth with almost 6 million inbound tourists in 2018 compared to 4 million in 2015 (4.7 million in 2016, 5.1 million in 2017) and directly generated 8.5% of GDP in 2017. The sector, together with the satellite services, contributes an estimated 26.2% to GDP and 24.1% to total employment. The World Travel and Tourism Council (2016) forecasts annual average growth rates of 6.2% until 2027. In 2016, travel and tourism directly supported 85,500 jobs (7.7% of total employment), but this is expected to rise by about 3% annually to reach 120,000 jobs or 10.1% of total employment in 2027 (WTTC, 2016). Indeed, the tourism sector can have a multiplier effect on employment through side services and related sectors. However, if tourism is to reach its full potential, the government must overcome several critical structural obstacles.

**The lack of standardisation in the tourism sector – linked to weak coordination and planning - hampers the development of tourism.** Tourism faces challenges of coordination, planning and undisciplined development. The competitiveness of the sector is weakened by the lack of well-defined rules and regulations of tourism activities. The quality of the provided services would improve by introducing a system of harmonised classification, licensing, certification and monitoring. Moreover,

according to Albania's ERP 2017-2019, the unfair competition due to high level of informality puts additional pressure on the process of standardisation. More efforts are also needed to enable access to market information, and to develop marketing as well as a destination management system.

**The underdeveloped infrastructure further constrains the development of tourism.** The lack of accommodation facilities with large capacities and high air transport prices in comparison to neighbouring countries negatively affect the competitiveness of the sector. The government provides fiscal incentives for the construction of four and five star hotels. Recent investors' interest may lead to some improvements of accommodation capacity in the medium term.

**Seasonality poses another clear challenge.** Tourism demand (particularly foreign) is mainly concentrated in the summer months, with 50% of visitors arriving in July and August. There is a strong need to diversify, expand and integrate tourism by offering a variety of attractions, activities and services, which would enhance opportunities for tourists all year round and increase their average spending with 3.5% to 5% annually. The promotion of green and rural tourism would support this diversification.

**The tourism sector also suffers from weaknesses in the business environment.** Uncertainties over property ownership and poor access to basic infrastructure, energy and waste management affect the tourism sector in particular. There is also a lack of skills relevant to the tourism sector due to a lack of a well-planned platform for vocational training. In spite of some improvements, the overall business climate, including the weak access to finance, prevents small and medium sized enterprises (SMEs) from keeping pace with the increasing number of tourists and meeting their requirements. To stimulate growth and development of domestic tourism enterprises, the government will need to develop a platform for supporting the private sector and stimulating innovation, know-how transfers and the provision of business advice. Improving the business environment would also attract more FDI in the sector.

**The government is committed to the development of tourism and has made important steps, but further efforts are needed.** The government has been working with the support of international partners on developing a tourism strategy, but it has not yet been adopted. Current plans focus on the development of yacht ports, 5-star hotels and agri-tourism. The government and the tourism service providers should work to enhance the attractiveness of Albania as a tourist destination, including its rich cultural heritage and under-visited inland. There has been limited cooperation between the government, local authorities, civil society and the private sector on how to prioritise actions to improve quality and innovation and how to ensure sustainable development.

**There is limited understanding in Albania of responsible tourism.** As a result, environmental damage has occurred by the unmanaged tourism growth (particularly on the coast). The economic and social opportunities have not always been maximised or fairly distributed. Preserving natural resources is key for securing the income sources of households and firms in sectors relying on natural endowments such as agriculture, energy, water, extractive industries and tourism. The government should ensure that society is benefiting from the boom in the tourism sector especially in rural and inland areas.

#### 1.4.2. Labour market, education and social policies

##### Labour market developments

**Positive overall developments on the labour market continued in 2018.** Between 2017 and 2018, the labour force participation rate for people aged 15-64 increased by 1.2 pps to 68.3%, the unemployment rate decreased by 1.3 pps to 12.8% and the employment rate improved by 2.1 pps to 59.5%. Employment is high in comparison to the region, but it hides a high underemployment. At the beginning of 2018, job creation was identified as one of five major cross-sectoral priorities of the current government. A comparison between Albania and the EU average based on 2017 figures shows a labour force participation rate lower by 6.5 pps and an unemployment rate higher by 6.3 pps, resulting in an

employment rate lower by 10.3 pps. Between 2014 and 2017, the gap with the EU has narrowed by around 4 pps for both labour force participation and employment rate indicating a potential for convergence.

**Female employment gap remains unchanged, young people continue to face major difficulties on the labour market despite significant recent improvements, and high structural unemployment persists.** The gender employment gap (15-64) at 14 pps (2017) is wider but not far from the EU average (10.5 pps). However, no clear improvement has been observed over the past years. Low availability of early childhood care and social care services for elderly increases vulnerability of women in terms of their labour market integration. The employment rate of young people (15-29) improved by 10.3 pps since 2014 to 38.5% in 2018 and their unemployment rate dropped by 9.4 pps to 23.1% over the same period. However, these rates are still 21 pps lower, respectively 11.3 pps higher, than for the whole population aged 15-64. Albania remains among the worst performers in the region in the number of young people not in employment, education or training (NEET). One in four young people (15-24) is NEET increasing to almost 30% for 15-29 years old (2017). The NEET rate peaks at 37.7% for the age group 25-29, pointing at a very challenging labour market transition for young people. A high proportion (65% or 125,675 individuals) of all NEETs in 2017 were inactive non-students not looking for a job. There is a high structural unemployment, with two thirds of unemployed being long-term unemployed, and skills mismatches. Inactivity rate (15-64) is high for low-skilled (36.4% in 2018), followed by people with secondary education (31.4% in 2018).

**Active labour market policies (ALMPs) show some improvements in 2018, but remain insufficiently targeted, underfunded, limited in scope and unavailable in rural areas.** Financing of ALMPs is at low 0.065% of GDP with no increase since 2016. The main measure is job mediation with a 50% annual increase in the number of placed jobseekers (23,136 in 2017 versus 34,669 in 2018), resulting in 46% of all registered jobseekers employed through this ALMP in 2018. However, only 5.16% (3,858) registered jobseekers enrolled newly in 2018 in another ALMP, the Employment Promotion Programmes (EPP). Despite apparent focus on female and young jobseekers, these programmes do not adequately target the most vulnerable youth and do not necessarily provide women with an adequate support to transit into higher productivity jobs. They also insufficiently target other vulnerable categories such as women with family responsibilities, older, low qualified, (ex)-beneficiaries of economic assistance and Roma/Egyptian unemployed. Targeting of long-term unemployed improved in 2018, but remains low. The majority of EPP are pure wage subsidies, which limits the prospects of upskilling and of sustainable integration into formal labour market. Another category of ALMP is short-term, supply-driven training provided in vocational training centres (VTCs) with 7,064 jobseekers benefitting in 2018 (decline from 9,461 in 2017). However, impact of VTCs on improving skills and integrating the labour market is low. There has been no progress as regards availability of employment services in rural areas. The newly adopted Employment Promotion Law (March 2019) and the expected establishment of the National Agency for Employment and Skills within 90 days has a potential to allow a swift progress in the reforms of ALMPs, including a reinforced analysis of prospective needs of the labour market and a reform of vocational training for adults.

**The structure of employment and a high level of informality excludes more than every second worker from enjoying labour rights.** A high share (52.9% in 2017) of own-account workers and contributing family members indicates a high degree of vulnerability (no access to full employment rights, social security or health insurance) and a significant underemployment (seasonal, ad hoc, home and casual workers). Agriculture employs 42.4% of people (LFS 2017) including also those engaged only in subsistence agriculture. The biggest challenge is a large extent of undeclared work, be it work without a contract, non-payment of social contributions or underreporting of wages. The share of informal employment in the non-agricultural sector is 30.3% (LFS 2017). The State Labour Inspectorate (SLI) has occasionally increased controls, which led to a higher detection. However, structural challenges related to SLI functioning remain unaddressed. Despite the pressing need, only isolated measures/campaigns have

been undertaken by SLI and the General Directorate of Taxation in the absence of a comprehensive cross-sectoral approach or a strategy for tackling undeclared work.

**Social dialogue remains very weak both in the public and private sector.** The mandate of the National Labour Council (NLC) was renewed in March 2018, but clear representativeness criteria are still under discussion in the tripartite working group established by the responsible Ministry. The Secretariat of the National Labour Council is not yet fully staffed. Consultations in the NLC take place without adequate preparation and remain limitedly meaningful. The establishment of regional tripartite councils is still expected. Bipartite social dialogue is underdeveloped. Finally, the amicable labour disputes resolution system needs further consolidation.

*Box II.1.3: Monitoring performance in light of the European Pillar of Social Rights*

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights on equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion to benefit citizens in the EU. Since the 20 principles are essential for countries if they are to achieve fair and well-functioning labour markets and welfare systems, they are equally relevant for candidate countries and potential candidates. The new reinforced social dimension for the Western Balkans includes an increased focus on employment and social reforms through greater monitoring of relevant policies (EC, 2018). The Western Balkans Ministers' Declaration on improving social policy in the Western Balkans (6 November 2018) confirms that they will use the Pillar to guide the aligning of their labour markets and welfare systems with the EU's.

**Albania faces challenges with regard to a number of indicators of the Social Scoreboard<sup>(1)</sup> supporting the European Pillar of Social Rights.** This is the case for equal opportunities, access to the labour market and social protection and inclusion. There have been some improvements in employment and unemployment rates. However, Albania faces substantial underemployment. As regards the share of young people not in employment, education or training (NEETs), despite improvement over the last years Albania remains among the worst performers in the region. The gender employment gap (15-64) is wider than EU average (14 pps vs 10.5 pps) and has not improved in recent years. Poverty projections indicate still high poverty rates, affecting particularly the unemployed, the low-skilled, people in rural areas, elderly, vulnerable women, persons with disabilities, Roma and Egyptians.

ALBANIA		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Worse than EU average, improving
	Gender employment gap	Worse than EU average, no change
	Income quintile ratio (S80/S20)	N/A
	At risk of poverty or social exclusion (in %)	N/A
	Youth NEET (% of total population aged 15-24)	Worse than EU average, improving
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-64)	Worse than EU average, improving
	Unemployment rate (% of population aged 15-74)	Worse than EU average, improving
	GDHI per capita growth	N/A
Social protection and inclusion	Impact of social transfers (other than pensions) on poverty reduction	N/A
	Children aged less than 3 years in formal childcare	Worse than EU average, trend N/A
	Self-reported unmet need for medical care	N/A
	Individuals' level of digital skills	N/A

**Albania also struggles with very low education outcomes on all levels of education, which is partly due to its low financing.** There are high rural and socioeconomic differences in access to education. Despite investments in VET, the system remains insufficient to address the skills mismatch. Lifelong learning and skills development outside formal education system are very weak and inadequate, especially outside urban areas.

**The social protection system is not adequate and targeted to cover those in need.** While social assistance exists, the amount of allowances is insufficient to prevent poverty. Effects of reform of social assistance on better targeting still need to be assessed. Capacity of local governments, to which the responsibility for provision of social care was decentralised, is too low. The pension system has an almost universal coverage, albeit with low pensions. The coverage of health care insurance is very

low and even less so for some vulnerable categories.

**Data availability is a particular issue in the area of social protection and inclusion.** The last measurement of poverty and exclusion was carried out in 2012. The low availability of statistics as well as reliable and timely data significantly affects the ability to conduct thorough analyses and impact assessments as a basis for evidence-based policies and measures. Employment data are regularly measured both in the Labour Force Survey and by the National Employment Service.

<sup>(1)</sup> The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance (<https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators>). The 12 indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-28 average (performing worse/better/around EU-28 average) and a review of the trend for the indicator based on the latest available 3-year period for the country (improving/deteriorating/no change). Data from 2014-2017 are used.

*(Continued on the next page)*

*Box (continued)*

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### Social protection system

**Poverty rates are presumably high and recent reliable data is crucially missing.** Despite collection of Statistics on Income and Living Conditions (SILC) since 2016, no poverty data have been published so far. The poverty rate was last measured in 2012 and stood at 39.1%. The poverty rate estimate for 2018 is 35.2% (World Bank). Groups reportedly at higher risk of poverty are the unemployed, the low-skilled, people in rural areas, elderly, vulnerable women, persons with disabilities as well as Roma and Egyptians. The highest level of poverty is observed in the northeast of the country.

**The social protection system does not provide for adequate protection of those in need.** Unemployment benefits in Albania reach only a small fraction of registered unemployed (2.7%). A reformed economic assistance scheme was rolled out countrywide in January 2018 to improve targeting, administrative efficiency and to reduce fraud. While available data (November 2018) show increased share of new beneficiary households among the recipients since January 2018, there is a lack of evidence/analysis on whether improved targeting of those most in need is being achieved. The relative financial weight of the scheme is only 0.025% of GDP (2018). The effectiveness of the scheme is questionable, as the allowance remains below the extreme poverty threshold, and only a small share of persons living in poverty are covered. As regards disability benefits, a new assessment system will be piloted in two administrative units in Tirana in 2019, which should result in improved targeting and efficiency.

**Activation of vulnerable people has received more attention, but inclusion through social care services is insufficient and many local governments lack capacities and resources to plan and deliver them.** In 2018, more activation support was provided to beneficiaries and ex-beneficiaries of economic assistance with 3,958 people employed through job mediation and additional 648 people enrolled in vocational training courses. Attendance in the latter is newly supported through a specific employment promotion programme approved in 2018. The activation support coverage is still very low and insufficiently tailor-made to this target group. Another dedicated employment promotion programme covered 21% of registered disabled job seekers in 2018. The figure is however not representative of inactive disabled people who require more tailor-made support. A particularly challenging area are social care services which are undeveloped, underinvested and lacking in many areas. With the ongoing reform, local government units are expected to assess needs in their territory and to prepare social care plans, but they lack capacities and resources and almost half of them (27 out of 61) lack experience due to inexistence of such services in their territory.

**Enrolment in pre-school education has increased significantly, whereas a policy framework for early childhood education and care (ECEC) is missing.** Policy attention focuses on enrolment in the last pre-school year that currently stands at 88% of all children with an objective of reaching 98% within five years. The share of children aged 3-4 attending early childhood education was 73% in the school year 2017-2018 which is a significant increase by 18 pps over the last 10 years. However, these figures hide a significantly lower (by more than 20 pps) enrolment rate of children from more vulnerable families compared to children from wealthier families or from parents with a university degree. Attendance of Roma children (3-6 years) in early learning services increased substantially to 66% in school year 2016-2017 compared to only 26% in 2011. Only 5% of education budget goes to ECEC, which is around 0.16% of GDP, significantly below the EU average of 0.7% of GDP. Kindergartens in urban centres have

insufficient capacity and are non-existent in some remote areas. Only 15% of children aged 0-3 years have access to organised day care or pre-school services. One third of municipalities do not have nurseries, leaving the rural population with no access to this service.

**Pensions are almost universal, but low, and health insurance coverage is very low.** The pension system used to be segmented between rural and urban areas and the average pension represents 37% and 65% of average salary respectively (2017). The ratio of contributors to beneficiaries constantly increased from 0.98 in 2013 to 1.21 in 2017, but the social insurance scheme continues being in deficit and the general state budget funds around 40% of its expenditure. Only 46% of women and 37% of men benefit from public health insurance coverage. There are very pronounced differences in coverage depending on geographical location, educational attainment and personal income.

### Education and skills

**Albania continues to struggle with low quality of education.** Public education expenditure is low at 3.1% of GDP (2017 and 2018), 1.5 pps lower than EU average (2017). Despite consistent and substantial improvements, Albania continues to occupy low ranks in PISA tests (2015): 50.3% of students perform poorly in reading and 53.3% in mathematics. Lacking these basic competences, young people face difficulties with their further learning and life challenges later on. Early school leaving rate dropped significantly from a high of 42% in 2007 to 19.7% in 2017, but continues to be high, partly due to socio-economic needs, lack of sufficient financial means, traditional cultural values, and access issues, such as remoteness. Due to resource and capacity limitations, educational professionals may be forced to provide a reduced curriculum. Resource constraints also affect pupils with special needs and mixed abilities. Schools in rural, mountainous and isolated areas face additional problems.

**Albania has made progress on curriculum reform in primary education, but teachers need more support.** A new curriculum for the fifth grade will be introduced in the school year 2019-2020 thus finalising the curricular reform for grades 1-9. Teachers have received basic training, but new curricula require skills they did not learn at university and adequate mentoring and ongoing support are missing. New university curricula for teachers in grades 1-9 will be introduced in the academic year 2019-2020. Resources related to infrastructure, facilities and teaching material are insufficient. In higher education, some progress was made in performance-based financing, institutional and programme accreditation. There are however issues, many of which were raised during recent student protests, linked to high tuition fees, insufficient scholarships, lack of investment in dormitories, libraries and laboratories, insufficient assessment of lecturer performance, corruption and plagiarism, and lack of cooperation with and financial contribution from companies. Public higher education has become more expensive and less accessible also due to competition for public funding from private universities.

**The reform to improve vocational education and training (VET) is delayed.** The public VET sector is very small, but the proportion of VET enrolment in secondary education increased from 13% in 2013 to over 20% in 2018. Despite increased attention and budgetary allocations in support of VET, multiple challenges remain such as skills mismatches, poor quality of offer and relevance of training, unequal access, and weak linkages to the private sector. Some northern/north-eastern and southern parts of Albania are completely uncovered by any type of VET provision. Tracer studies of VET graduates confirm their unsatisfactory integration in the labour market (46.9% employed, 27.6% unemployed not in education or training in the year following graduation). The adoption of secondary legislation to the VET law of 2017 is delayed. Activities are ongoing but lack a proper legal framework. The adoption of the Employment Promotion Law (March 2019) is expected to unblock the slow pace of reform. There have been positive developments in form of openings of new two-year postsecondary/non-tertiary VET programmes and private training provision. Both have the potential to expand further. Bylaws for the Albanian Qualification Framework (AQF) have been drafted, but not yet adopted, and the capacities for full AQF implementation are currently weak.



**There are few opportunities for lifelong learning and skills and career development.** Problems include the lack of adequate adult training facilities and offers, especially outside bigger urban centres. Adults, especially older workers, do not consider it worthwhile to invest in further training. Adult (25-64) participation in formal or non-formal education and training is extremely low (0.9% last 4 weeks, 9.2% last 12 months in 2017) compared to the EU average (10.9% last 4 weeks in 2017, 45.1% last 12 months in 2016). The generally low skills base discourages exploration of further avenues of learning. Suitable strategies to fight unemployment and exclusion need to address people's basic skills issues and include remedial education measures.

#### 1.4.3. Competitiveness and sectoral issues

##### Business environment

**Albania's business environment continues to suffer from structural weaknesses and progress is slow.** The economy's competitiveness improved in comparison to the year before (4.9), but is still below the SEE average (5.50) ranking at 5.02 on a 1 to 10 scale (EBRD, 2018). There was only limited progress in the World Bank Doing Business report 2019 as Albania improved two ranks compared to the previous year and still ranks 63rd among 190 economies, which is lower than most regional peers. The top three business environment obstacles identified by Albanian firms were electricity issues; competitors' practices in the informal sector; and corruption (BEEPS V, 2015). There are additional issues with insufficient clarity of land ownership (see analysis of agriculture sector below). This issue continues to affect agriculture, tourism and infrastructure development, investment and access to finance and contribute to informality.

**The entrepreneurial skills and financial literacy of the population remain underdeveloped and affect the access to finance.** Only 40% of adults and about 75% of SMEs are holding bank accounts. Despite the historically low interest rate and the decreasing ratio of NPLs, the credit growth to the corporate sector, especially SMEs, is not picking up. Further efforts are needed in particular to improve the financial literacy among the population and financial inclusion, as well as fight informality. Creating a network for business support services aiming at improving access to finance and scaling-up of existing firms is key to increasing the number of jobs in the private sector.

**Weak contract enforcement and the large regulatory burden continue to hamper private sector development.** Albania needs to significantly streamline its business regulations, including better impact assessments of legislative proposals, regular stakeholder consultations and strong monitoring mechanisms. More could also be done on the harmonisation of regulations with the Code of Administrative Procedures and on eGovernment to facilitate access to administrative procedures. The public financial management reform strategy for 2014-2020, which aims at strengthening policy implementation, underwent a mid-term review in 2018. The revised priorities include improving budget planning and management and strengthening internal control implementation across government, as well as preventing arrears at central and local government level. They also aim to follow up on internal and external audit recommendations, improve investment planning and management, and public procurement review and compliance with procurement rules. Finally, focus is also on granting more institutions online access to the treasury and analysing the fiscal risks of state-owned enterprises.

**Strengthening the rule of law is key for improving the business environment and fighting corruption in Albania.** The ambitious justice reform, which is currently under implementation, is expected to promote an effective and independent judicial system. Independent judicial institutions are crucial for the effective fight against corruption and informality. It is also a prerequisite for creating an environment that is investment and business friendly. Effective measures to further strengthen the rule of law, ensure adequate and timely contract enforcement and increase the transparency of legal changes would positively impact the business environment and contribute to an increase in productivity and competitiveness.

### Informal economy

**The informal economy continues to constrain the economic development of Albania.** In spite of measures taken to address the informal economy, it is estimated to account for at least one third of GDP. This is causing tax revenue losses, a lack of labour protection and unfair competition among firms. The significant informality, as well as the substantial share of unpaid family workers in the agricultural sector, negatively impact the quality of the labour market and undermines the social protection system. Around 32% of the workforce is estimated to be undeclared (ACER, 2016). Around 40% of employees declared not to have a written contract with their employer, while 30% of employees declared that they do not pay for social and health security benefits in 2016. The number of employees without a written contract is well above the average of the rest of the countries in southeast Europe. The government introduced a country-wide campaign on fighting informality in 2016. However, the design of the measure was rather broad and focused mostly on mobilising additional budget revenues. They were implemented through an increased number of controls and inspections rather than offering incentives for regularisation of activities of companies and employment.

### Research, development and innovation

**Albania's capacity in research, development and innovation (RDI) is low and has few positive effects on the economy.** According to the Global Innovation Index 2018, Albania ranks 83<sup>rd</sup> in the world out of 126 countries with an efficiency ratio of 0.44, which ranks it 110<sup>th</sup>. About 0.1% of the population work in research in 2018, which is less than one-third of the EU average. The low level of innovation in the economy limits the potential of the country to increase its productivity and engage in medium to high value added products. The number of patent applications increased from 3 in 2011 to 21 in 2017, but still remains modest. With a national target for 2018 of 0.6% of GDP, the R&D spending is lower than in most of the Western Balkan countries and far below the EU average of 2%.

**Exports remain predominantly low value added and industrial innovation needs more support.** Albania does not yet have a business incubator, or any science or technology parks. However, there are a few institutional support services promoting innovation and linking universities and research centres with innovative SMEs. A Triple Helix Competition took place in 2015-16 and Albania participates in the donor-supported Entrepreneurship Programme for the Western Balkans. Albania's RDI institutions are not well-integrated into global RDI programmes and it has a low success rate in Horizon 2020. There is only very low engagement of the private sector in RDI programmes.

### Digital economy

**Digitalisation is hampered by the low penetration of fixed internet services and weak digital skills.** While Albania performs reasonably well in terms of mobile broadband penetration (around 63%), fixed broadband penetration in households remains a challenge. Approximately 38% of the population has access to fixed internet. Moreover, the gap between internet access in rural and urban areas remains huge with around only 1% of the population in rural areas having access to broadband internet.

**The development of e-commerce is hindered by challenges in consumer protection legislation and a lack of promotion by the government.** In 2017 only 7.7% of enterprises used internet for e-commerce. The lack of digital skills negatively affects both demand and supply sides of digital products and digital skills need to be better integrated in the education system. Digitalisation and development of digital skills have a potential to contribute to tackling high unemployment, especially in the rural areas and could create positive spill over effects on other sectors of the economy such as tourism and facilitate exports.

## Investment activity

**Investment has stabilised at the level of one quarter of GDP in recent years, driven by FDI, as well as domestic investment.** FDI inflows have increased significantly in the last ten years following the liberalisation of the markets and the reforms on improving the business environment. In 2018, net FDI is estimated to reach 8.1% of GDP, which is one of the highest levels in the region. Better integration of the economy into global supply chains would help boost productivity and create more and better jobs. The EU remains the main source of FDI into Albania and held 56% of the total stock at the end of third quarter of 2018. The FDI flows during the first half of 2018 increased by almost 27% as compared to the same period in 2017, reaching almost EUR 500 million. The main countries of origin for FDI stock were Greece, Switzerland, the Netherlands, Canada and Italy, with the EU accounting for 56% of the total stock by the end of 2017. Most foreign direct investments are concentrated in the energy sector and transport infrastructure. However, the implementation of the main energy projects, namely the hydropower plants on the river Devoll and the Trans Adriatic Gas Pipeline, slowed further following a peak of activity in the first half of 2017. Albania has a great potential to attract more FDI notably in the tourism sector, energy and agriculture, which would contribute to job creation and economic growth.

**The key obstacles to increased investments are weaknesses in the business environment, insecure property rights, an underdeveloped real estate market and increasingly shortages of skilled labour.** Domestic investment is constrained by muted bank lending to private businesses and many of the SMEs face problems accessing bank financing. Micro-enterprises (less than 5 employees) often cannot access microfinance due to their lack of know-how and because of informality. The low level of public technical support (e.g. extension services, certification, standardisation) to SMEs and farmers also poses a challenge for businesses aspiring to grow or to export. The lack of clarity in land ownership (the absence of a cadastre) and the poor functioning of the land market hold back private investment in the country further and affect the implementation of large public projects.

Public investment, amounting to about 4-5% of GDP, experienced a significant increase in the recent years, but has been hampered by weaknesses in the public investment management framework with regular underspending compared to originally planned budgets. Key weaknesses of the public investment management system are linked to the planning process, which lacks prioritisation and transparency, shortcomings in the project preparation stage, and insufficient monitoring during the implementation stage. New Public Investment Management guidelines were approved in March 2018, which need to be fully implemented and rolled out across government.

## Trade performance

**Despite its relative openness to trade, the Albanian economy is not well-integrated in global supply chains.** The exports of goods and services amounted to around 78% of GDP in 2018 and the overall trade volume has been continuously increasing during the last years. During 2018 the exports of goods grew by 13.7% and imports of goods grew by 2.4%. The trade deficit for goods was 6.3% lower than in 2017, accounting for about EUR 2.6 billion. EU countries remain the main destination for both exports and imports, accounting for 65.9% of total trade in goods in 2018. Italy (34.1%), Greece (6.9%), Germany (6.6%) and China (6.3%) are the main trade partners. 92% of Albanian products can access the EU market without customs duties. Albania is mainly exporting manufactured goods (footwear, garments), minerals and construction materials. Service exports amounting to 58% of total exports are dominated by tourism and related services. Albania has historically run a large goods trade deficit, which is partly offset by a surplus in the balance of services. Goods exports continued to show little diversification in terms of products and destinations while the potential for agricultural exports remained untapped. The trade in goods with the Western Balkan countries increased by 6% in 2018, mostly on account of the increase in trade with Kosovo by 23% in 2018, but still is not reaching its full potential.

**Trade remains constrained by non-tariff barriers with complex and unsynchronised border procedures.** Non-tariff barriers, as well as limited quality certification services and laboratories available, continue to restrict trade. There is a large untapped potential for trade growth subject to cross-regional connectivity improvements and elimination of technical barriers to trade. The authorities recognise the challenges and have started to implement measures that mostly focus on liberalising trade with the neighbouring countries within the framework of the Regional Economic Area (REA).

**Albania is encouraged to continue implementing all the aspects of the REA Multiannual Action Plan (MAP).** The REA MAP is based on EU standards and will facilitate Albania's integration in regional and European value chains and will also help increase the attractiveness of the economy for FDIs in tradable sectors. Further connectivity with neighbouring countries in transport and energy will further strengthen the access to, and integration in, the regional market. The creation of a regional digital space and of more integrated labour markets with neighbouring economies will offer new possibilities for the country's youth, which is also important in light of the high youth unemployment.

### Transport

**Given the geographical location of the country, Albania's transport sector is strategically important for competitiveness and economic growth.** Albania is ranked 109<sup>th</sup> out of 140 countries for transport infrastructure in the World Economic Forum's Global Competitiveness Report 2018, which is below its regional peers. Rail transport is inefficient. The Albanian railway network operates below its actual capacity, due to lack of investment, maintenance operations, and outdated network. The unbundling of train operations from infrastructure management has not yet been achieved. Implementing legislation is under preparation for the establishment of relevant structures and agencies, in particular the Railway Regulatory Authority. Maritime infrastructure is underdeveloped with inadequate capacity. The low quality of its transport infrastructure is an impediment to Albania's integration into regional and global supply chains and has a direct impact on the development of tourism and transit services.

**The lack of infrastructure combined with improper maintenance leads to a very high number of road traffic accidents.** The Albanian vehicle fleet has increased dramatically within the last ten years, and the overall number of fatal traffic accidents after some decrease in the past has stagnated in the last 2-3 years. The estimated rate of fatality in Albania is 136 deaths per million inhabitants, which is almost three times the EU average of 49 deaths per million (WHO Global Status Report 2018). Almost 40% of all persons killed on the roads are pedestrians, compared to about 21% in the EU. There is no data on the cost of accidents, but they are likely to have a significant impact on the economy, due to their frequency.

### Agriculture

**Agriculture is characterised by low productivity and land fragmentation, which continues in the absence of a comprehensive land register.** Overall, the contribution of the agricultural sector to GDP is estimated at 18.4% in 2018. The share of the labour force employed in agriculture still stood at 42.4% in 2017 (LFS 2017), but remains high even by regional standards with a high share of women. Farmers suffer from low access to credit, which hampers their ability to invest in new technology and in acquiring new skills. Improving the advisory system in agriculture, for the farming and agro-processing sector as well as channelling investment into agriculture, agro-processing and diversification could raise productivity and rural income as well as agricultural exports.

### Industry

**Albania's industrial sector is weak and exports are concentrated in a few product groups and are of low sophistication and value added.** The ERP does not provide any information or analysis of the industry in the country, nor does it propose any measures or policies. Industry accounted for around 13.9% of GDP in 2017, or 23.9% including construction. Manufacturing generates about 6% of GDP.

Metallurgy, textile, mining and extraction of petroleum are the sectors with the largest output and main industrial exports are clothing, chrome, oil and refined fuels.

### Services

**The economic growth of Albania is driven by the services sector.** Services represent an estimated 54.4% of GDP in 2017 and is the biggest contributor to employment with 40.4%. The services sector has been developing well in recent years backed by the significant increase in tourism and construction. The positive developments in the exports of services allowed to generate a higher trade surplus on the services side and positively contributed to offsetting the structural trade deficit in goods. The diversification of the services sector, namely development of services in the financial and ICT sectors would allow decreasing vulnerabilities caused by the reliance on tourism and its exposure to external shocks such as political risks, weather and seasonality. Besides tourism, the ERP does not provide any diagnostic on the services sector despite its significance for the country's economy.

## 1.5 IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2018

Overall: Partial implementation (45.0%) <sup>(8)</sup>	
2018 policy guidance	Summary assessment
<p><b>PG 1:</b></p> <p>Introduce further fiscal consolidation measures with a view to meeting the indicated medium-term target of reducing public debt to below 60% of GDP in 2021.</p>	<p>There has been <b>partial implementation</b> of PG 1:</p> <p>The decrease in the debt ratio was larger than expected (from 70% to 67% of GDP - preliminary data), but this was mainly due to the accelerated appreciation of the lek and the under execution of the capital budget, not due to fiscal consolidation measures. The ERP confirmed the debt target of below 60% of GDP for 2021 but slower-than-expected economic growth and contingent liabilities could derail fiscal adjustment plans.</p>
<p><b>PG 2:</b></p> <p>Support fiscal consolidation by strengthening tax administration further:</p> <p>broadening the tax base and avoiding new tax exemptions:</p> <p>fully implementing the valuation-based property tax:</p>	<p>There has been <b>partial implementation</b> of PG 2.</p> <p>1) <b>Limited implementation:</b> No detailed information in the ERP, but the programme for reform of public financial management is continuing, and this reform also affects the revenue administration.</p> <p>2) <b>Partial implementation:</b> The tax base has been broadened, as formal employment increased and the VAT registration threshold was lowered. However, fiscal packages for 2018 and 2019 (the 2019 package was approved in 2018) introduced a number of tax exemptions on profits and buildings. They also introduced: lower VAT rates for 4-star and 5-star hotels and certain services in tourism; lower tax rates for software developers; VAT exemptions for certain imports; and reduced income tax for agricultural cooperatives and certified agri-tourism.</p> <p>3) <b>Partial implementation:</b> A value-based property tax was introduced. but the instructions on the calculation of the property value are still outstanding. A fiscal registry for the valuation-based property tax is being created, as is a property agency. However, neither will be fully in place until 2019. So far, the value-based property tax is being collected in a few pilot municipalities on the basis of existing documentation not yet integrated in the fiscal registry.</p> <p>4) <b>Limited implementation:</b> Use of cost-benefit</p>

<sup>(8)</sup> For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission's Overview and Country Assessments of the 2017 Economic Reform Programmes available at [https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments\\_en](https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en).

<p>ensuring that new Public-Private Partnerships are only contracted on the basis of solid cost-benefit analyses and fiscal risk assessments</p>	<p>analysis as basis of the selection of PPPs has not been reported in the ERP. Early 2019, a legal amendment has been presented to parliament which foresees increasing the quality of feasibility studies on PPP projects. The fiscal risk statement on the 2018 budget assessed that the amounts of direct public payment obligations stemming from PPP contracts are compliant with the budget law. There is no assessment of the fiscal risks from PPPs. During the ERP mission, the MOFE reported that it aims to strengthen and institutionalise its fiscal risk assessment of PPPs as of 2019 with tools provided by the World Bank.</p>
<p><b>PG 3:</b></p> <p>Conduct monetary policy in line with reaching the inflation target</p> <p>Increase the transparency of monetary policy communication by publishing time series on core inflation and inflation expectations.</p> <p>Implement the remaining measures of the NPL resolution strategy, also with a view to addressing factors hampering access to finance for corporates.</p> <p>Based on regular analysis of relevant indicators and impact assessment, explore other measures in line with the Memorandum of Cooperation to increase the use of the national currency at all levels.</p>	<p>There was <b>substantial implementation</b> of PG 3:</p> <ol style="list-style-type: none"> <li>1) <b>Full implementation:</b> The monetary policy stance was kept appropriately accommodative, as inflation and inflation expectations remained below target and credit growth remained subdued.</li> <li>2) <b>Full implementation:</b> The central bank of Albania started to publish core inflation and inflation expectations (of consumers, businesses and financial agents) on its webpage in February 2019.</li> <li>3) <b>Substantial implementation:</b> The authorities have made further progress in implementing the NPL action plan, including by creating an out-of-court restructuring scheme. Nevertheless, some important issues have yet to be implemented (drafting the by-laws to the bankruptcy law, resolving the deadlock around the private bailiffs' scheme, and improving the credit registry).</li> <li>4) <b>Partial implementation:</b> The share of loans in foreign currencies has decreased (possibly supported by the currency's appreciation), while the share of deposits in foreign currencies has not changed. The central bank has followed up with a number of measures, but the government has not yet started to investigate potential follow-up measures</li> </ol>
<p><b>PG 4:</b></p> <p>Ensure effective liberalisation of the energy market</p> <p>and functioning of the power exchange.</p>	<p>There was <b>limited implementation</b> of PG4:</p> <ol style="list-style-type: none"> <li>1) <b>Limited implementation:</b> Legal unbundling of distribution system operator OSHEE SA from its supply activity with the establishment of three new companies has taken place, but functional unbundling has not yet been finalised. The unbundling model was approved by the supervisory council of OSHEE and the Minister of Energy and Industry.</li> <li>2) <b>Limited implementation:</b> The legal amendments allowing the creation of a Power</li> </ol>

<p>Adopt the legal provisions to effectively implement the national energy strategy</p> <p>and further broaden the energy supply mix, focusing on incentivising energy efficiency</p> <p>and renewable energy production beyond hydropower</p>	<p>exchange were adopted in February 2018. However the Council of Ministers decision for the establishment of APEX Company was not adopted within the legal deadline 30 September 2018.</p> <p>3) <b>No implementation:</b> Amendments to the law on Power sector have been adopted in February 2018 that postpone the deadlines for further liberalisation in the electricity sector.</p> <p>4) <b>Limited implementation:</b> The TAP project is progressing on time and will, when completed, allow a broadening of the energy mix. There was no progress in implementing energy efficiency legislation.</p> <p>5) <b>Partial implementation:</b> The revised national renewable energy action plan for 2018-2020 envisages that 38% of gross final energy consumption will come from renewable energy sources. In June 2018, the Government approved some support measures for the promotion of the use of electricity from renewable sources of sun and wind, as well as procedures for selecting projects for their benefit. The Government has approved the construction of small photovoltaic plants with a total capacity of about 30 MW. The developer of the first photovoltaic plant has been selected through an auction. A net metering scheme for photovoltaic (PV) or wind energy with a capacity of up to 500 kW is being put in place, but is not yet operational.</p>
<p><b>PG 5:</b></p> <p>Further strengthen the process of cadastral, land and property registration, including clarification on land ownership, with a special emphasis on defragmentation and consolidation of agricultural land, and swift case handling in case of court procedures.</p> <p>Reinforce measures to finalise the property restitution and compensation process.</p>	<p>There was <b>limited implementation</b> of PG 5:</p> <p>1) <b>Limited implementation:</b> the process of property registration has continued, but defragmentation of ownership is not taking place due to lack of land market and adequate policies in that respect. In order to clarify the judicial review options, in 2018 the High Court has set out a list of categories of cases subject to judicial jurisdiction.</p> <p>2) <b>Partial implementation:</b> the compensation and restitution process continues based on the 2015 legislation, but no legal actions have been taken to facilitate the finalisation of the process. In view of the progress made by the authorities over the last few years with the domestic compensation mechanism, the Council of Europe ended in 2018 its supervision of the enforcement by Albania of domestic decisions on restitution or compensation.</p>
<p><b>PG 6:</b></p> <p>Ensure sufficient capacities for the implementation of employment policies, in particular for youth and women,</p>	<p>There was <b>partial implementation</b> of PG6:</p> <p>1) <b>Limited implementation:</b> Despite efforts to implement the National Employment and Skills Strategy (NESS), the human resources available in</p>



<p>and improve linkages between active and passive employment measures.</p>	<p>the Directorate of Employment and Skills Development Policies at the Ministry of Finance and Economy remain limited and do not allow for a proper implementation of the strategy.</p>
<p>Address undeclared work, including by strengthening the labour inspectorate.</p>	<p>2) <b>Partial implementation:</b> The new action plan for NESS until 2022 is under finalisation. In 2018, more activation support was provided to beneficiaries and ex-beneficiaries of economic assistance with 4,752 people employed through job mediation or after attendance in vocational training courses (VTCs). A new employment promotion programme was introduced which enables (ex)-beneficiaries of economic assistance to attend freely VTCs and receive a stipend during their attendance. Nevertheless, the quality and labour-market relevance of these VTCs are generally too low to significantly improve employability.</p> <p>3) <b>Partial implementation:</b> The budget of State Labour Inspection (SLI) has been increased by 11% in 2018 compared to 2017 and used for example to modernise equipment of inspectors. However, despite repeated requests by SLI, the number of staff, including inspectors, has not been increased. Inspections can annually cover only about 6% (about 10,000) out of the total of about 160,000 companies. Nevertheless, SLI has been able to detect more cases of undeclared work in 2018 compared to 2017.</p>
<p>Support the development of basic education and increase the investment in initial teacher training.</p>	<p>4) <b>Substantial implementation:</b> Curricular reform of grades 1-9 is almost finalised with 5<sup>th</sup> grade being piloted in school year 2018-2019 and to be implemented countrywide in school year 2019-2020. Current teachers received training for implementation of competence-based curricula before their deployment for each grade. Further training, adequate mentoring and ongoing support to teachers are however missing. The review of the content and structure of curricula for initial teacher training in higher education institutions has started, and their introduction is expected in the academic year 2019-2020.</p>

## 1.6. THE 2019 POLICY GUIDANCE

### **JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TURKEY**

The Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

Brussels, 17 May 2019

[...]

In light of this assessment, Participants hereby invite Albania to:

1. Capitalise on the expected growth momentum to advance fiscal consolidation in 2019. Develop a medium-term consolidation plan to lower the debt ratio below the limit stipulated in the organic budget law. Develop a comprehensive medium-term revenue mobilisation strategy to effectively guide an increase in revenue, among others by addressing informality and tax evasion.
2. Ensure a systematic and complete recording of fiscal liabilities stemming from Public-Private Partnerships and of arrears at all government levels in the regular fiscal reports and the Macro-Fiscal Framework. Improve planning and execution of public investment. Increase spending on education and research in percentage of GDP in line with the government's policy objectives.
3. Explore potential measures for developing the market for currency derivatives that would enable economic agents to hedge themselves against exchange rate risk. Ensure the fully operational implementation of the remaining measures of the non-performing loan resolution strategy, also with a view to ensuring improved access to finance for corporates. Implement measures in the realm of the government in line with the Memorandum of Cooperation to increase the use of the national currency.
4. With a view to improving the investment climate, continue strengthening the justice system by implementing the justice reform and improve the provision of technical support services for micro, small and medium-sized enterprises, including through the development of a support network to help them upscale, invest, innovate, digitalise and export. To increase investments in tourism in particular, adopt the tourism strategy and start its implementation, focusing on sustainability through natural resource management. Provide for vocational education and training in line with the investment needs of SMEs and the tourism sector.
5. Ensure effective liberalisation of the energy market, with complete unbundling and a functioning power exchange. Finalise implementation of the law on renewable energy sources to ensure their integration into the market. Adopt the secondary legislation for the laws on energy efficiency and energy performance of buildings, including the setting up of the Energy Efficiency Fund.
6. Improve the targeting of active labour market policies and implement the prepared Vocational Education and Training reform package. Under the steer and with financial support from central government, establish capacities at the level of all local government units for assessing social care needs and preparing social care plans. Increase investment in early childhood education and care, especially for increasing enrolment of children from vulnerable families.

## ANNEX A: ASSESSMENT OF THE STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP

### **Measure 1: Further liberalisation of the energy market**

The measure to further liberalise the energy market is rolled over from the previous ERP, and is in line with the obligations under the EU Third Energy Package and Albania's own strategies. However, the measure is not embedded in the overall framework of accompanying actions, such as strengthening of the regulatory body, demand management, energy efficiency, or price reforms. The price and tariff reform will require further efforts, while bill collection rates have improved significantly. Energy demand management, including activities to stimulate investment in energy efficiency would contribute to improving the economy's competitiveness and energy security.

No timeline is given for the completion of the liberalisation activities, while some of them are delayed from the previous year and are also lagging behind the government's legal obligations. No explanation is provided for the delays of implementation in 2018 in particular the non-completion of the functional unbundling and the establishment of the power exchange. The costing provided, showing no budgetary impact of the liberalisation activities, appears questionable. The overall impact on competitiveness is well-developed while the impact on employment is discussed only in general terms. The potential risks to implementing the reform measures are well developed, while mitigating measures remain general.

### **Measure 2: Diversification of energy sources**

The measure on diversification of energy sources is rolled over, but has been supplemented, in line with the economic analysis to include the promotion of the use of renewable energy sources beyond hydropower. The addition is welcome in view of the significant potential the country presents for photovoltaic and wind energy production, as well as the low share of those energy sources in the energy balance of the country. However, the ambition of the outlined measure is limited and the environmental impact of the energy policy as a whole is not discussed. A net metering scheme for the buy-in of excess energy produced by households is not in operation.

The planned connection of the country to the international gas network to create conditions for gasification in line with the development of the Trans Adriatic Pipeline project will contribute to energy diversification. Implementation of planned activities is progressing in line with the presented timeline. The cost of implementing the measure has not been properly accounted for. If efficiently implemented, the measure is expected to strengthen competitiveness in the long term by diversifying the supply, ensuring supply security and potentially lowering energy costs. The absence of potential risks is justified by the measure's secured funding, but ignores non-financial risks such as environmental risks and lack of coordination.

### **Measure 3: Rehabilitation and reconstruction of the railway segment Durres-Tirana International Airport-Tirana**

The transport measure is rolled over and still does not address the regulatory and structural needs related to the connectivity agenda, which would have a more direct impact on competitiveness. The implementation of the measure aiming at rehabilitating and extending the Durres-Airport-Tirana railway will allow the development of intermodal transport, but its estimated competitiveness impact appears over-optimistic, especially in view of the underdeveloped railway infrastructure. The construction project is broadly on track and its practical realisation is expected to start in 2019. The expected impact is to double travel speed for passenger and freight transport between Tirana and Durres, which should boost the traffic and reduce congestion on road.

The main risks to implementation of the reform measure are outlined, and mitigating measures are proposed. However, no concrete information is provided on the land acquisition plan, which is

indispensable for the completion of the project, and no mitigating measures are planned to cover the expropriation risks.

#### **Measure 4: Consolidation and defragmentation of agricultural land**

The planned consolidation and defragmentation of agricultural land, rolled-over from the previous programme, shows no progress due to the lack of legal, institutional and administrative basis. The reform activities envisage a partial digitalisation of the agricultural land register. However, the activities planned for 2018 were only partially implemented. No activities are planned to establish the necessary conditions for land consolidation like clarify of property rights and development of a comprehensive land cadastre, territorial planning, environmental protection etc.

The budgetary impact assessment and cost per activity are insufficiently developed. The estimated impact on competitiveness is quite ambitious and can rather be expected in the medium- to long-term. The real gender issues related to agricultural land ownership (issuing of certificates mostly to the male members of the family) are not discussed. The key performance indicators are not properly selected, neither to reflect the activities implemented, nor the possible short-term outcomes of land consolidation. The potential risks section correctly points out the possible opposition from land owners and rural communities. However, other risks, such as delays due to the lacking legal framework or property rights disputes should also be considered.

#### **Measure 5: Reform of the water and wastewater sector**

Water resources are crucial for the development of the economy of Albania and in particular the sectors of energy generation, tourism and agriculture. As such, the rolled-over measure on water and waste water is appropriate. The measure is in line with actions to combat informality and aims to ensure good governance and effective investments. However, integrated water resource management, taking into account the needs of the whole economy, is not properly targeted. The activities planned for 2019 are overambitious, while there is little information on the intended improvements in the outer programme years, which are vague and insufficient. Delays in the implementation have been reported, and some of the activities not implemented in 2018 have not been included in plans for the following years.

The measure appears quite ambitious, given the investment required and the administrative capacity needed to implement this investment. The cost of the reform is still under development, which points at a lack of maturity of the project. The impact on competitiveness focuses mostly on social outcomes, rather than the potential impact on competitiveness. The key performance indicators are very ambitious and the deadline for their attainment is not clear. The potential risks and respective mitigating measures are broadly defined, but do not specify the potential risks in rural areas, where water supply utilities are managed by local authorities.

#### **Measure 6: Property tax reform and establishment of fiscal cadastre**

The measure is rolled over from the ERP 2018-2020. The implementation of the property tax is an instrument that strengthens the overall domestic revenue mobilisation and public finance management, but its relation to improvements in the business environment is not specified.

The full implementation of the market value based property taxation is expected to be applied to all 61 municipalities in 2020. Activities planned in the ERP 2018-2020 related to the adoption of the relevant legislation in 2018 are mostly completed while staffing of the fiscal cadastre unit remains to be completed in 2019. The piloting of the fiscal cadastre in four municipalities planned in 2019 is no longer in the current ERP with no specific explanation for why it has been removed. The potential implementation risks are correctly identified. The indicators for monitoring the activities are not well defined and there are only general targets at the end of the implementation of the measure in 2021.

### **Measure 7: Reduce regulatory burden to business**

The reform measure on reducing the regulatory burden to businesses is rolled over from the previous ERPs, and it needs to be implemented in the broader context of tackling the other challenges identified in the sector. The timeline for implementing the reform measure was prolonged until 2021, pointing to some delays in implementation. The expected impact on competitiveness and social outcomes, address the main shortcomings in the business environment. The potential risks are correctly assessed, while mitigating actions require further elaboration. The activities in 2019 do not indicate the areas that will be affected by the simplification activities. Indicators for the measures are not directly related to the outlined actions and no numerical targets have been set. The costs of implementation in 2019 remain the same as in 2018 while there is no clear indication on the budget costs for 2020-2021. Table 10a and 10b on costing and budgeting do not reflect the narrative part. Measures 7 and 8 are very similar and should be merged in next year's ERP.

### **Measure 8: Reduce red tape and increase the efficiency of the institutions offering services to citizens and entrepreneurs**

This is a new measure, which encompasses some of the business obstacles related to bureaucracy within state institutions and corruption. It aims to increase the level of e-services to citizens and businesses and improve the quality of services. The expected impact on competitiveness clearly set out. The measure is aligned with other national strategies, like the 2015-2020 Public Administration Reform Strategy, and the corresponding 2018-2020 action plan. Given the track record, the political prioritisation of this issue, the donor support received and the actions foreseen in the action plan, this is a realistic measure. The implementation is going to be financed through the state budget and costing and budgeting are properly reported. However, the indicators are formulated in a general way and no baseline is offered in order to measure success. The potential risks, are generally considered.

### **Measure 9: Effective implementation of the national plan to reduce the level of NPL in the banking sector**

This is a rolled over measure which addresses a significant obstacle for business competitiveness: access to finance. The programme does not discuss alternative sources of financing and broader credit growth issues. The activities planned in 2018 have been substantially implemented except for the establishment of the credit registry, the contested bailiff fee schedule and the bankruptcy bylaws. The measure clearly sets out the expected impact on competitiveness and considers social outcomes. The potential risks are correctly assessed. As the level of NPLs are decreasing, Albania could consider broadening this measure in next year's ERP to include access to finance for the private sector. The key performance indicators need to be better elaborated.

**Measure 10: Providing a single and transparent investment legal regime in the country**

This is a rolled over measure from the previous ERP, which is relevant and coherent with Albania's commitments under the Regional Economic Area multiannual action plan. Its impact on the investment climate and therefore on competitiveness is well-defined. While the measure aims to provide a single and transparent legal regime for investment, it is not clear how/whether this investment regime would have any role in the increased transparency of the public procurement procedures.

On the expected risks, the ones related to engaging various stakeholders, policy makers and interested parties have a significant impact, which have caused the prolongation of the timeline for its implementation until 2021. Therefore, the instruments to mitigate these risks need to be better elaborated. The finalisation of the scanning of sectors with a direct link to smart specialisation should be considered already in 2019 or 2020 as the process of scanning has already started in late 2018 with the establishment of an inter-institutional working group. The Regional Economic Area multiannual action plan targets an earlier deadline for the design of smart specialisation platforms at national level. Costing and budgeting of the measure has not been provided, which puts at risk its implementation.

**Measure 11: Improve the institutional capacity of research and innovation system**

The measure aiming at improvement of the institutional capacity of the research and innovation system is rolled over and could address some constraints in the area. The activities planned for 2018 were only partially implemented. The activities for 2019-2021 are defined too broadly without clear objectives. The costing has been further developed and the planned budget is better aligned than it was in the previous ERP with the ambitious level of the measure. However, the sources of funding remain unclear. Some risks are identified, and devising a strategic framework for the sector is offered as a mitigating measure. Progress has been achieved in the engagement of the private sector, which should improve the implementation of the Triple-Helix Model.

**Measure 12: Adoption of the legal and regulatory framework for the development of the broadband infrastructure**

The rolled-over measure on implementation of the legal and regulatory framework for developing the broadband infrastructure is in line with Albania's 2020 Digital Agenda, and addresses key obstacles to competitiveness and growth. The proposed activities have been developed since the previous programme to include the establishment of broadband infrastructure in pilot areas, which is a positive development. No funding is planned for the intended infrastructural development, which puts at risk the implementation of the measure. The activities planned for 2018 have been implemented to a good extent, focusing on drafting of the legal base. The expected impact on competitiveness are broadly identified, as are social outcomes and potential risks, except for financing risks. However, no mitigating measures are proposed.

**Measure 13: Facilitate the implementation of national trade facilitation measures and MAP REA**

The rolled-over trade facilitation measure is highly relevant and in line with national priorities and regional initiatives, such as the connectivity agenda and CEFTA Additional Protocol 5. Its implementation is a crucial step towards regional trade facilitation, which is also part of the Regional Economic Area multiannual action plan. The activities planned for 2018 have been partially implemented, while some of them have been partially rolled over to 2019. The measure includes the regional SEED+ project financed by the EU and the promotion of an authorised economic operator programme in Albania, as well as the establishment of a National Single Window for exports. The strengthening of the capacity of the National Committee for Trade Policy Coordination and Facilitation is also planned as part of the measure, but on concrete details are provided.

The expected impact on competitiveness is only discussed in general terms, as are potential social outcomes and risks. No funding is presented for the implementation of the National Single Window project. To ensure greater impact on competitiveness this measure needs to be combined with efforts to expand the country's industrial base in order to diversify tradeable goods.

#### **Measure 14: Finalisation of the pre-university curricular reform, training and hiring of teachers**

The measure is a relevant continuation of previous years. It mainly focuses on implementing new competence-based curricula for grades 1-9 to close the process of curricular and textbook reform for pre-university education. There are plans for adapting initial teacher training curriculum in public universities to match with the curricular reform. Current teachers also received training, but new curricula require skills they did not learn at university and additional training, adequate mentoring and ongoing support are missing and are not planned. Absence of such additional support can decrease the effectiveness of the reform. The key activity is planned for 2020 when the assessment of the implementation will take place. This would be followed by necessary reforms if needed.

#### **Measure 15: Inclusive education**

The measure refers to a reduction in the number of students attending multi-grade and low-quality classes in rural areas and an increase in the number of special education teachers in the public education system. The measure does not clarify how the transfer of additional 3,000 rural pupils per year to nearby better-quality schools will be ensured, especially considering the poor quality of roads and a lack of public means of transport, and does not include any budget for this activity. The plan to increase the number of special education teachers per 100 each year until 2021 is positive and the cost for 2019 is estimated at EUR 6.8 million. However, no further analysis is developed on the ratio children in need/support teachers. The need for strengthening of inspection function to monitor quality and inclusiveness and reaching out the remote and rural areas is not addressed.

#### **Measure 16: Expanding adoption of digital skills to schools**

Over the course of three years, 120,000 students and 8,000 teachers are planned to be equipped with digital and coding skills. This is a donor-led measure and it is unclear how it is linked to the revised curricula of the targeted grades. It is also unclear whether these revised curricula need to be revised again and how sufficient equipment will be ensured. Since overall basic competences and quality in education are weak, the feasibility of implementation is unclear. There are no targets/KPIs explained. It is uncertain to what extent the measure is sustainable and what is the Government's ownership. The lack of adequate infrastructure in schools to enable continuous and sustainable development of digital skills beyond this project are a matter of concern.

**Measure 17: Modernisation of the pre-school education system financing**

The measure concentrates on the reform of financing of pre-school education, responsibility for which was transferred to the local level. Roles and coordination in the area remain to be clarified and assessed. Despite the title of the measure which would suggest a more holistic approach, its focus seems to be limited to the injection of additional finances in the system to increase the number of teachers by 10% (440) from 2019 onwards with a goal of reducing the children-to-teacher ratio. This has a potential impact on improving the quality, in particular in major urban centres which suffer from high children/teacher ratio. However, the much needed increase in enrolment rates, especially for children from vulnerable families, is not targeted. No incentives are in place to invest in quality kindergartens, especially in rural areas where they are often missing. With regard to the schedule, it is overambitious to monitor over the first year the effects on the improvement of the quality of pre-school education.

**Measure 18: Improve the quality and coverage of VET while ensuring linkages with the labour market**

This is a relevant continuous measure from previous years with limited implementation so far. Important activities planned for 2018 were not finalised. Secondary legislation to implement the VET Law from February 2017 is still not adopted, pending the establishment of National Agency for Employment and Skills, which is expected in June 2019 after the adoption of the Employment Promotion Law in March 2019. The overall budget is not detailed and the total cost of modernising the VET system seems underestimated. A tracer study has shown that the VET system in the country is still partly out of tune with labour market demand and students' aspirations. Clarity is missing as regards access to VET for vulnerable groups and in rural areas where delays in implementation are noted in the mid-term review of the National Employment and Skills Strategy.

**Measure 19: Modernising public employment services, increasing employment of women, youth and vulnerable people**

This is a continuous measure from previous years. The suggested activities are very ambitious but relevant for the continuous modernisation of the National Employment Service (increase in quality of services and their availability in rural areas, training of staff, quality of short-term vocational courses and their relevance to labour market needs). There have been delays in activities planned for 2018: Employment Promotion Law not adopted on time (only in March 2019); National Agency on Employment and Skills not established (expected in June 2019); modernisation of some employment offices not finalised. Employment promotion programmes need to be better tailored to the needs of some vulnerable categories of people. As most measures are at regional level, lack of cooperation between different actors involved, including social partners, poses challenges to implementation.

**Measure 20: Strengthening social protection, and social inclusion measures**

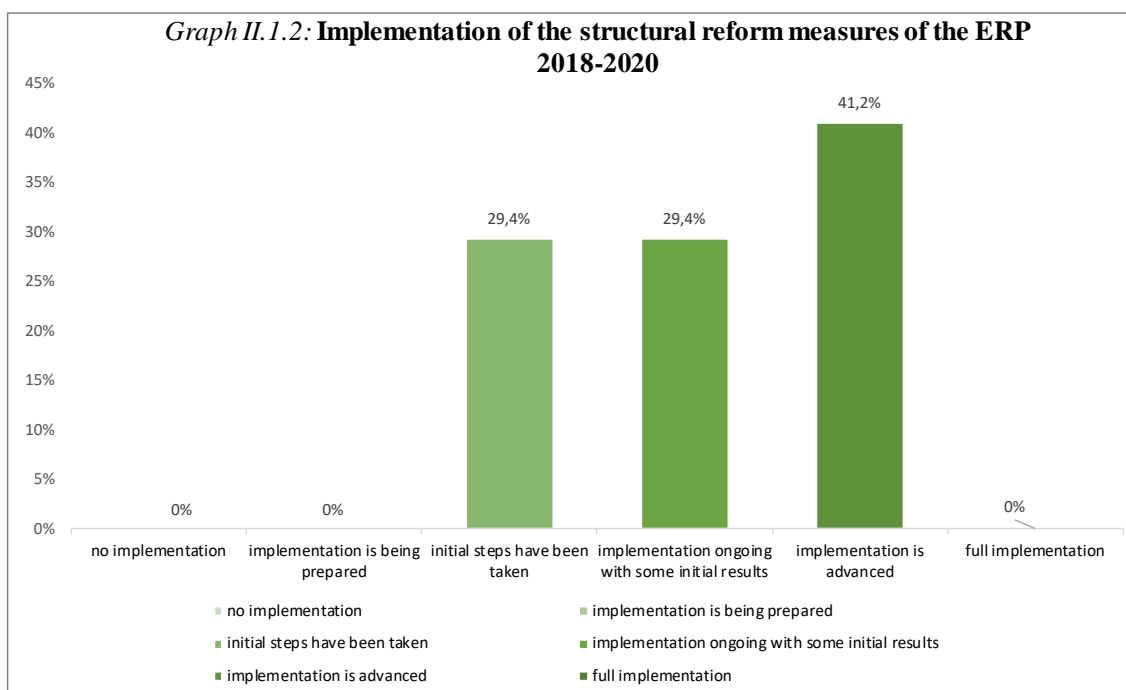
This is a continuous measure from previous years, but links are lacking to what was planned in ERP 2018-2020. There was progress in 2018 as regards adopted legislation, preparations for piloting of new bio-psycho-social model for disability assessment and countrywide deployment of reformed economic aid scheme. On the latter, information is missing on whether people in need are better targeted. Local government units (LGUs) are expected to assess needs for social care services and to ensure their delivery, but many LGUs lack capacity and resources. This is recognised as a risk, but no mitigation is proposed. While the measure targets very relevant structural issues, as in previous years it is too broad to bring effective and targeted implementation and proper follow-up of the implementation. Lack of updated data on poverty and exclusion hinders evidence-based policy-making.



## ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM ERP 2018-2020

There was mixed progress in the implementation of the measures in 2018, with an average score of 3.4 out of 5. The reporting on the implemented activities is good but uneven, with some measures not covered. For some activities the scoring provided is high, but overall the provided information presents an adequate description of the level of implementation.

Implementation is stronger for some measures, such as measure 6 on the establishment of fiscal cadastre, measure 7 on reducing regulatory burden; measure 9 on reducing NPLs; measure 12 on developing broadband infrastructure and measure 20 on strengthening social protection. Implementation is weaker for other measures, such as measure 1 on liberalisation of the electricity market, measure 4 on defragmentation of agricultural land and measure 5 on reform of the water and wastewater sectors.



## ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The 2019-2021 Economic Reform Programme was adopted by the government on 25 January 2019 and submitted to the Commission on 30 January. No components of the ERP are missing and its structure partly follows the Commission guidance note.

### *Inter-ministerial coordination*

The programme was coordinated by the Ministry of Economy and Finance. All relevant line ministries contributed to the drafting exercise, however, the level of ownership and commitment in responsible ministries varied. The programme suffered significantly from institutional weaknesses due to the government restructuring.

### *Stakeholder consultation*

A draft ERP was disseminated for consultation to international organisations and partners, diplomatic missions to Albania, business associations and chambers of commerce. The ERP includes the written comments provided by stakeholders but they are not reflected in the Programme itself. The ERP was not discussed separately with the social partners.

### *Macro framework*

The programme is in line with the medium-term budgetary framework and the Budget Law of Albania. Information about implementation of the policy guidance 2 is incomplete. The ERP does not provide an analysis of productivity developments, the sectoral growth contributions or the investment environment. Results of analytical work by international institutions that contain this kind of analysis are not reflected in the programme.

### *Fiscal framework*

The ERP does not make clear a link between the analysis of the challenges the economy faces, the proposed reforms, and the corresponding budget allocations. The fiscal policy objectives are not consistent throughout the ERP document and do not take into account the preliminary budget outturn for 2018. The fiscal consolidation targets are not supported by detailed expenditure and revenue plans. Measures for improving tax collection and fighting tax evasion remain vague. There is only limited information on the contributions to and spending by the social insurances. Information on the increasing arrears, local-government revenues and expenditure is largely missing. Fiscal data do not meet ESA 2010 requirements on: the valuation of foreign debt; the consolidation of financial and non-financial transactions; the recording of arrears, of PPPs and of capital transfers and loans within the public sector. With the support of Eurostat, the statistical office is making gradual progress in aligning its fiscal statistics with EU requirements.

### *Structural reforms*

Some of the structural reforms sections diverge from the guidance note, and the measures presentation is of varying quality. The analysis of the structural reform challenges is not comprehensive, and is sometimes not updated from last year. Table 11 in the Annex is incomplete with significant gaps for some measures. The number of measures is limited to 20 while the page limit (40 pages) for Section 4 has been significantly exceeded. The tables on budgetary impact are more comprehensive than the previous year, but are still only partially completed or are not in line with the descriptive part. There is only limited reporting on the implementation of the policy guidance in the area of education, employment and social protection.

## 2. MONTENEGRO

### 2.1. EXECUTIVE SUMMARY

**Montenegro's economic growth is expected to decelerate.** After recording several years of strong growth, the Economic Reform Programme (ERP) projects a reasonably cautious baseline scenario of moderation in public investment and consumption, which would dampen output growth to around 2.5% on average in 2019-2021. Lower domestic demand and the subsequent decline of import needs are projected to reduce the very large current account deficit, which is expected to remain financed to a large extent by foreign direct investment inflows. Financial sector indicators improved but the position of some smaller domestic banks remains difficult.

**Fiscal policy targets have been softened, but the end of spending related to the building of the Bar-Boljare highway is expected to swing the budget into surplus and reduce public debt from its peak of more than 70% of GDP.** Supported by fiscal consolidation measures adopted previously, the budget deficit declined significantly in 2018, but spending overruns caused the deficit target to be missed by a broad margin. The ERP's medium-term consolidation path is less ambitious than in last year's programme, but sufficient to ensure a relatively fast pace of debt reduction towards the fiscal rules' threshold of 60% of GDP. Total expenditure is set to decline markedly thanks to the fall in capital spending related to the highway. However, important reforms of the public sector and the pension system have been delayed or postponed, making it more difficult to restrain current expenditure.

The main challenges in these respects include the following.

- **Maintaining commitment to debt reduction targets is key to lowering vulnerabilities and rebuilding fiscal space.** The envisaged decline of the debt ratio and improvement of the budget balance relies mainly on completing one major investment, on restraining public consumption and on improving tax compliance. However, contingent liabilities and spending overruns may threaten fiscal consolidation efforts. Ensuring long-term sustainability of public finances would require strengthening fiscal governance including oversight and compliance with budget targets and fiscal rules at central and local level.
- **The banking system is overall well capitalised and liquid, but the performance of small local banks is uneven and requires close monitoring.** Small domestic banks are predominantly confronted with having to resolve non-performing loans and cope with high overhead costs, resulting in poor profitability. Improving the current situation would require implementing close and decisive supervision by the central bank.
- **Institutional and regulatory framework on the micro level is underperforming.** The authorities should focus in particular on achieving consistent, non-arbitrary law enforcement, on the efficiency and quality of public administration at the state and local level, on the areas of public procurement and public-private partnerships, and on issues related to local taxation and para-fiscal burdens. The law-making process would require more effective and pro-active communication strategies targeting the stakeholders from the outset of the process and inclusive public consultation early enough during legislative procedure. More focus is also needed on the timely adoption and implementation of secondary legislation, with proper public scrutiny.
- **The large informal sector persists as an important structural challenge.** The proportion of the informal economy to total GDP is estimated at around 28% to 33%, while over 20% of work is informal. Weaknesses in the institutional and regulatory environment, including the labour market,

corruption and high tolerance for tax non-compliance are the key issues that need to be tackled. Improving the capacities of local and state bodies and cooperation between them, and a more systematic approach focusing on root causes of the phenomenon rather than on fighting its consequences would lead to reduction in the informality.

- **Very low activity and employment remain a key challenge, particularly affecting young people, women and the low skilled.** Labour costs and labour market rigidities are relatively high and affect labour market mobility. Complexities in social support coupled with undeclared work create additional obstacles for formal employment. Skills mismatches, low educational outcomes and insufficient opportunities for reskilling affect transitions to and from employment. Besides low activity and employment rates, the ageing of the population has an additional negative effect on the labour market, and consequently on the sustainability of the pension system.

**The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2018 has been implemented to a limited extent.** The 2017 fiscal strategy has been implemented to a large extent. However, some of the new excise duties were withdrawn due to poor performance. No additional measures were adopted to achieve fiscal targets, but payments related to unfavourable court cases are now accommodated in the budget. Important government initiatives such as reforms of the public administration and the pension system, were delayed or put on hold. There was limited progress on broadband rollout and coverage, while no broadband cost reduction measures were implemented. Work on legislation regulating public private partnerships and concessions has progressed, but the legislation is due for adoption only in Q2-2019. Independent rail regulatory authorities have yet to be created and will not reach operational capacity before 2020. The development of curricula and apprenticeships with employers has been prioritised and has been implemented continuously. However, more efforts are needed to improve the quality of education at all levels, including pre-school and adult education. Draft labour market legislation is being prepared. While participation in active labour market policies increased, their targeting and coverage continue to be low, and there is still no review of their effectiveness. The outcomes of cooperation between employment offices and social work centres and social protection information system are limited.

**Overall, the ERP partially matches the reform priorities identified by the Commission.** The programme's macroeconomic and fiscal frameworks are sufficiently comprehensive and coherent, providing a good basis for policy discussions. However, the pace of fiscal consolidation is less ambitious and the fiscal policy scenario entails significant risks in controlling public spending. On structural reforms, the previous year's focus on reform measures in the areas of energy, RDI and private sector development through fiscal and non-fiscal incentives was complemented by the series of new and recalibrated reforms targeting the business environment and the informal economy. Measures on education and skills are a continuation of reforms initiated in previous years. They are relevant for improving education outcomes and can contribute to transition from school to work. However, employment and social policy measures are not sufficiently developed and are either too limited in scope or do not address the key structural challenges.

## 2.2. ECONOMIC OUTLOOK AND RISKS

**Economic growth was higher than expected in 2018, driven by public and private investment.** Real GDP is estimated to have increased by 4.1% in 2018, 1.1 pps faster than forecast in last year's ERP. Gross fixed capital formation increased by some 20%, while export growth also surprised on the upside due to a good tourism season. However, higher-than-forecast domestic demand also led to a faster pace of import growth.

**The ERP expects growth to moderate in 2019-2021 along with a gradual rebalancing of growth drivers.** The programme projects a sharp slowdown in investment growth in 2019-2020, followed by a contraction in 2021 after the completion of the Bar-Boljare highway. In the ERP's baseline scenario, private consumption is set to remain subdued due to weak growth in employment and an assumed decline in real wages, mitigated by some additional support for consumer spending from household borrowing, remittances and tourism. In line with medium-term budget planning, government consumption is projected to contract by 0.5% each year until 2021. New capacities in the tourism and energy sector are expected to sustain a moderate expansion of exports. Import growth, by contrast, is seen as declining in parallel with the turn in the investment cycle. Consequently, a growing positive contribution of net exports to GDP growth is expected to start as of 2019. Overall, annual output growth is forecast to decelerate to 2.5% on average in 2019-2021.

On the production side, the ERP projects that key economic sectors (tourism, construction, agriculture, manufacturing and mining) will contribute to growth based on their average historical performances and some investment in new capacities. The ERP sees Montenegro's potential growth rate as reaching 3.3% in 2018-2021, with the main contribution coming from capital accumulation, while total factor productivity is expected to remain negative, reflecting the low technological endowment of Montenegrin companies. The current positive output gap is –according to the ERP– expected to be closed by 2021.

Table II.2.1:

### Montenegro - Comparison of macroeconomic developments and forecasts

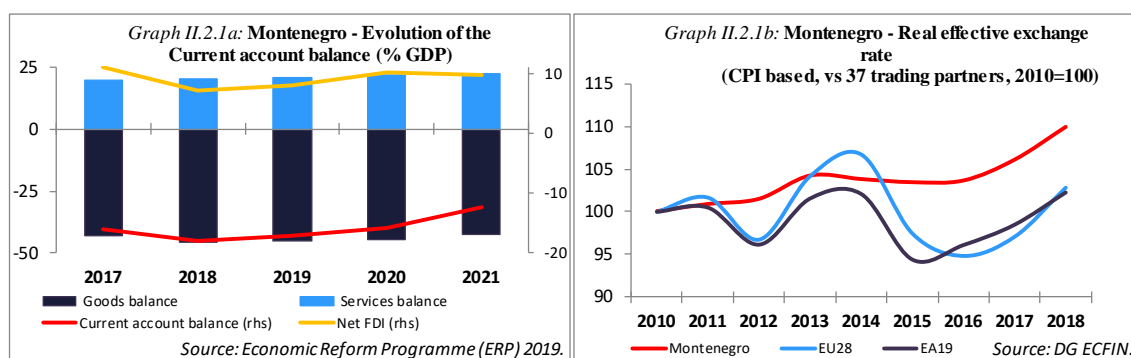
	2017		2018		2019		2020		2021	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
<b>Real GDP (% change)</b>	4.7	<b>4.7</b>	3.9	<b>4.1</b>	2.8	<b>2.8</b>	3.1	<b>2.3</b>	n.a.	<b>2.4</b>
<i>Contributions:</i>										
- <b>Final domestic demand</b>	7.4	<b>7.4</b>	6.7	<b>6.7</b>	4.9	<b>2.0</b>	2.7	<b>1.3</b>	n.a.	<b>-0.9</b>
- <b>Change in inventories</b>	1.9	<b>1.9</b>	-0.2	<b>-0.1</b>	0.0	<b>0.0</b>	0.0	<b>0.0</b>	n.a.	<b>0.0</b>
- <b>External balance of goods and services</b>	-4.6	<b>-4.6</b>	-2.6	<b>-2.7</b>	-2.1	<b>0.8</b>	0.4	<b>1.0</b>	n.a.	<b>3.3</b>
<b>Employment (% change)</b>	3.4	<b>2.1</b>	2.0	<b>2.2</b>	1.6	<b>1.0</b>	1.8	<b>0.9</b>	n.a.	<b>0.5</b>
<b>Unemployment rate (%)</b>	16.1	<b>16.1</b>	15.5	<b>14.8</b>	14.9	<b>14.5</b>	14.6	<b>14.0</b>	n.a.	<b>13.8</b>
<b>GDP deflator (% change)</b>	3.8	<b>3.8</b>	2.7	<b>2.9</b>	3.0	<b>1.2</b>	2.0	<b>1.2</b>	n.a.	<b>1.2</b>
<b>CPI inflation (%)</b>	2.8	<b>2.4</b>	2.9	<b>2.9</b>	2.5	<b>1.8</b>	1.9	<b>1.8</b>	n.a.	<b>1.9</b>
<b>Current account balance (% of GDP)</b>	-16.1	<b>-16.1</b>	-16.5	<b>-18.1</b>	-17.4	<b>-17.0</b>	-14.5	<b>-15.9</b>	n.a.	<b>-12.5</b>
<b>General government balance (% of GDP)</b>	-5.5	<b>-5.3</b>	-2.7	<b>-2.7</b>	-1.6	<b>-2.2</b>	2.4	<b>0.9</b>	n.a.	<b>2.9</b>
<b>Government gross debt (% of GDP)</b>	63.7	<b>63.2</b>	70.0	<b>70.0</b>	67.8	<b>67.0</b>	62.7	<b>64.6</b>	n.a.	<b>60.4</b>

Sources: Economic Reform Programme (ERP) 2019, Commission Autumn 2018 forecast (COM).

**Overall, the baseline growth scenario appears plausible in the current context.** While the projected trajectory appears reasonably cautious, steady output deceleration in 2019-2021 might be prevented by stronger-than-expected investment activity well into 2020, as the completion of the main highway section is delayed by a year. However, the positive effect on GDP growth will be mitigated by the high base

effect and the significant import content of big infrastructure investments. Moreover, consumer spending might grow faster than projected, especially in 2020, in the context of sustained bank lending and declining unemployment. For this reason, the Commission’s most recent forecast projected the same GDP growth (2.8%) as the ERP for 2019, but foresees a 0.8 pps higher expansion for 2020. Consensus and international institutions’ forecasts similarly assume higher growth in 2020. In addition to the baseline projection, the ERP presents an alternative ‘low-growth’ scenario. In this pessimistic scenario, shocks to investment and oil prices cause the baseline projection to shift downwards by 1.4 pps of GDP in 2019, and by additional 0.5 pps in each of the two outer years, due to knock-on effects on imports, employment, wages and tax receipts. The baseline and the low-growth scenarios were developed using the new macroeconomic model of the Ministry of Finance.

**Inflationary pressures are likely to remain subdued.** The annual average of the consumer price index rose by 2.8% in 2018, driven by rising VAT and excise tax rates. Otherwise, in Montenegro’s small euroised economy, headline inflation largely reflects the impact from the external environment, in particular from oil and food prices. Despite the estimated positive output gap, stagnating nominal wages did not generate upward price pressures domestically. The ERP expects inflation to remain practically constant throughout 2019-2021, at around 1.8% on average.



**The projected narrowing of the large current account deficit appears reasonable.** Montenegro has a very narrow production base, resulting in a large structural deficit on the trade balance for goods. This situation has recently been further exacerbated by imports of large volumes of construction material and equipment to keep pace with investment. On the other hand, the current account benefits from strong tourism exports and to a lesser extent from income and remittances by Montenegrins working abroad. The very high current account deficit is expected to have peaked at 17.2% of GDP in 2018, up from 16% a year before. This was mainly due to a fast growing merchandise trade deficit, as the volume of imports largely outpaced the growth of exports. The ERP projects the current account deficit to gradually decline over the programme period to 12.5% of GDP in 2021. The key determinants in reducing the external gap are the expected growth of exports of goods and services (4% annually, in real terms), combined with declining import needs once large infrastructure investments are completed. This scenario seems plausible considering how far advanced the highway works are and given the weakening domestic demand, and the strong import dependence of both of these factors. However, if upside risks to domestic demand materialise, it might result in higher-than-projected import growth and hence a higher current account deficit.

**FDI has a major impact on the external deficit and on its financing given the scarcity of domestic savings.** In 2018, net FDI plunged by 32.4% year-on-year, driven by high outflows from the repayment of inter-company debt and the withdrawal of equity investment following the sale of the electric company shares by its foreign owner. As a result, net FDI financed 41.3% of the current account deficit, the rest being covered by net inflows of portfolio investment and loans. The ERP projects that net FDI will gradually recover and remain strong and broadly stable at between 8% and 10% of GDP in 2019-2021.

Net FDI is expected to finance on average some 63% of Montenegro's current account deficit during that period. The ERP recognises that FDI inflows associated with large projects about to be completed in the energy and tourism sectors, will diminish, but also expects new FDI-financed projects, supported by the new public-private partnership framework, and an economic citizenship programme in return for investment. Gross external debt (according to IMF estimates, as Montenegro does not publish yet external debt statistics) stood at 166% of GDP at the end of 2018, remaining broadly constant since 2013. Around 35% of the long-term debt is owed by the government, while most of the rest consists of inter-company lending between direct investors and subsidiaries. Although the external debt is large, its composition means that it does not give rise to immediate concerns. Official reserves cover about 5.2 months' worth of imports of goods and services, providing a safeguard against adverse shocks.

*Table II.2.2:*

**Montenegro - Financial sector indicators**

	2014	2015	2016	2017	2018
<b>Total assets of the banking system</b> (EUR million)	3 136	3 472	3 791	4 182	4 407
<b>Foreign ownership of banking system</b> (%)	82.7	80.4	79.4	80.4	84.2
<b>Credit growth</b>	-1.9	0.8	1.3	11.8	8.5
<b>Deposit growth</b>	10.0	13.7	9.4	13.8	5.9
<b>Loan-to-deposit ratio</b>	1.0	0.9	0.8	0.8	0.8
<b>Financial soundness indicators</b>					
- non-performing loans	15.9	12.6	10.3	7.3	6.9
- net capital to risk-weighted assets	16.2	15.5	16.0	16.4	15.6
- liquid assets to total assets	22.2	24.8	24.5	25.3	22.6
- return on equity	5.4	-0.9	1.2	7.0	5.4
- forex loans to total loans (%)	1.6	1.6	1.1	0.7	0.6

*Sources: National Central Bank, Macrobond.*

**The stability of the overall financial system has not been affected as overall bank deposits have been growing since the intervention by the central bank, but a swift and efficient resolution remains key to minimising contagion risks.** At the aggregate level, the banking sector is well capitalised, highly liquid and has a reduced stock of non-performing loans, but small banks are confronted with poor profitability and some face capital shortfalls. The ratio of non-performing loans (NPLs) to total gross loans totalled 6.9% at the end of 2018, or 0.4 pps lower than a year earlier, thanks to loan restructuring, write-offs and factoring agreements. The declining NPL ratio is positive for bank lending to the business sector. However, credit to the corporate sector has only gained pace of late (i.e. since December 2017). Financial intermediation is constrained by the high level of informality in the real sector, as well as by weaknesses in contract enforcement and collateral recovery. Overall, the banking system maintains adequate buffers to absorb shocks as capital adequacy and liquidity ratios exceed regulatory requirements. Profitability has also been improving. However, out of 15 banks in 2018, the four largest account for 95% of total profits while some smaller banks have been struggling. In December 2018, Montenegro's central bank put two small non-systemic banks (accounting for 1.1% and 5.8% respectively of total banking-sector assets) under temporary administration due to lower than required capital and liquidity ratios. In the meantime, one of them entered bankruptcy proceedings, while the other is awaiting recapitalisation in order to continue operating. The stability of the overall system has not been affected as overall bank deposits have been growing since the intervention by the central bank, but a swift and efficient resolution remains key to minimising contagion risks and maintaining confidence on the stability of the financial sector.

### 2.3. PUBLIC FINANCE

**In 2018, fiscal outcomes improved compared to a year earlier, but the deficit target was missed.** The general government deficit improved from 5.3% of GDP in 2017 to 3.8% of GDP in 2018. Revenues as a percentage of GDP increased by 1.3 pps while the share of expenditure declined by 0.3 pps. The 10% year-on-year growth in revenues was supported by higher VAT and excise tax rates, improved collection of tax arrears, and an unplanned dividend payment (worth 0.8% of GDP) by the newly re-nationalised power company. However, revenues from excise on tobacco significantly underperformed the initial plans as the rate rise boosted informal trade, which prompted the authorities to reverse the rate increase during the mid-year budget rebalance. Overall, total revenue was 0.6% of GDP higher than planned in last year's ERP. Total expenditure increased by 6.5% year-on-year, but was almost 2.7% of GDP higher than initially planned, as under-execution of capital spending being more than offset by a higher-than-expected wage bill, the repayment of liabilities from previous years, and a surge in transfers to education and health institutions. Overall, the deficit targets of the original budget (1.6% of GDP) and the revised budget (2.2% of GDP) were both missed by a large margin. The ERP estimated that the primary deficit contracted from 3.2% of GDP in 2017 to 0.6% in 2018, an optimistic projection compared to the more negative outcome of 1.8% of GDP recorded in 2018.

**The 2019 budget suggests stability in fiscal policy, but postpones the previous ambition of further consolidation.** The Montenegrin Assembly adopted the 2019 state budget on 28 December 2018. Fiscal plans assume that GDP will grow by 2.8% in 2019, the same rate as projected in the Commission's autumn 2018 forecast. The budget deficit target of 2.2% of GDP is lower than the realised deficit in 2018, but deviates significantly from the marginal (0.1% of GDP) surplus projected in last year's ERP. Compared to the 2018 outcome, the budget projects an increase in total revenue of 4.6%. Discretionary measures are limited to some new fees and the introduction of an excise duty on coal. Revenues from VAT, excise and social security contributions are expected to rise thanks to economic growth and the expected broadening of the tax base, including through a continuing reduction in tax arrears. A substantial increase in grants anticipates the disbursement of EU funds for public administration reform and other projects. Compared to the budget outcome for 2018, total expenditure is projected to increase by 0.9%. The expenditure increase is seen as being largely driven by capital spending, surging by 17.1% y-o-y, reflecting the combined result of under-execution of the capital budget in 2018 and the need to intensify works to complete the first section of the Bar-Boljare highway. The planned current expenditure is, by contrast, expected to decline by 1.9% y-o-y, indicating a very modest annual adjustment in non-discretionary expenditure (i.e. wages, pensions and social benefits).



Table II.2.3:

**Montenegro - Composition of the budgetary adjustment (% of GDP)**

	2017	2018	2019	2020	2021	Change: 2018-21
<b>Revenues</b>	41.5	42.6	43.0	42.6	41.7	-0.9
- Taxes and social security contributions	35.0	35.6	35.4	35.3	34.8	-0.8
- Other (residual)	6.5	7.0	7.6	7.3	6.9	-0.1
<b>Expenditure</b>	46.8	45.3	45.2	41.7	38.8	-6.5
- Primary expenditure	44.4	43.3	43.1	39.8	37.1	-6.2
<i>of which:</i>						
Gross fixed capital formation	6.9	6.8	7.8	5.5	3.5	-3.3
Consumption	16.2	16.0	15.6	15.0	14.6	-1.4
Transfers & subsidies	13.2	12.5	12.3	12.2	12.0	-0.6
Other (residual)	8.0	8.0	7.4	7.1	7.1	-0.9
- Interest payments	2.4	2.0	2.1	1.8	1.7	-0.3
<b>Budget balance</b>	-5.3	-2.7	-2.2	0.9	2.9	5.5
- Cyclically adjusted	-5.8	-3.6	-2.6	0.8	2.9	6.5
<b>Primary balance</b>	-3.2	-0.6	-0.1	2.8	4.6	5.3
- Cyclically adjusted	-3.4	-1.6	-0.5	2.7	4.6	6.2
<b>Gross debt level</b>	64.2	70.0	67.0	64.6	60.4	-9.6

Sources: Economic Reform Programme (ERP) 2019.

After the fiscal adjustment carried out in the last two years, the budget is expected to move to a large surplus in the medium term as spending related to the Bar-Boljare highway is phased out. After frontloading a major fiscal adjustment (with the Budget Deficit and Public Reform Recovery Plan adopted at the end of 2016, the 2017 Fiscal Strategy and the 2018 Public Debt Strategy), fiscal policy now relies on a gradual decrease in the capital expenditure-to-GDP ratio to reach in 2021 an overall budget surplus of 2.9% and a primary surplus of 4.6%. Compared to last year's ERP, the new programme attenuates and postpones fiscal consolidation, as the targeted fiscal balance for 2019 and 2020 is lower by 2.3 and 4.5 pps respectively. The revised fiscal path reflects to a large extent: (i) the one-year delay completing works on the main section of the Bar-Boljare highway (completion is now expected in 2020 instead of mid-2019); (ii) a higher than previously projected wage bill; and (iii) the inclusion above the line (i.e. as current expenditure) of planned arrears repayment related to court cases. The new fiscal targets are expected to be achieved through a combination of slightly declining revenues (by 0.9 pps between 2018 and 2021) and a cutback in expenditure (by 6.6 pps over the same period) relative to GDP. The decline in the revenue ratio is the result of comparatively faster GDP growth. No new tax hikes are planned except for the gradual alignment of excise duties with EU rates. The decline in the expenditure ratio is planned to be achieved primarily by a 4.3 pps of GDP reduction in capital spending between 2019 and 2021. The projected paths for the fiscal deficit and for nominal GDP growth would allow the debt-to-GDP ratio to decline quickly to 60.4% in 2021 from 70% in 2018. Overall, although the government's planned fiscal stance has become less ambitious compared to last year's ERP, it would still bring about a significant reduction in the debt ratio.

After 2019, the main fiscal measures underpinning the programme consist of broadening the tax base, strengthening local public finances and containing current spending. Montenegro plans to roll out electronically monitored cash registers (see also Chapter 4, Structural Reforms) from 2020. These are expected to reinforce budget revenue by some 0.36% of GDP, once fully implemented. The tax administration will continue efforts to reduce tax debt and monitor taxpayers who reschedule tax

liabilities. Another measure aims to strengthen the revenue side of local governments' budgets. The implementation of the Law on Local Self-Government Financing would strengthen municipalities' income by increasing the share of personal income tax allocated to them, generating an additional EUR 12 million per year (or 0.25% GDP). The law also aims to strengthen budget discipline at local level, which remains weak despite improvements. On the expenditure side, implementation of the public administration optimisation plan, which targets staff cuts at central and local level of 5% and 10% respectively by 2020, is expected to produce savings of some 0.9% of GDP in 2021 compared to the 2019 wage bill. Draft amendments to the law on Pension and Disability Insurance have been prepared with a view to making the pension scheme more sustainable, but failed to be accompanied by a detailed analysis of the fiscal impact of such amendments. The reform was put on hold in 2019 due to disagreement between the social partners.

#### Box II.2.1: Debt dynamics

Table:

<b>Montenegro - Composition of changes in the debt ratio</b> (% of GDP)					
	2017	2018	2019	2020	2021
<b>Gross debt ratio [1]</b>	<b>64.2</b>	<b>70.8</b>	<b>67.0</b>	<b>64.6</b>	<b>60.4</b>
Change in the ratio	0.8	6.6	-3.8	-2.4	-4.1
<i>Contributions [2]:</i>					
<b>1. Primary balance</b>	<b>3.2</b>	<b>1.8</b>	<b>0.1</b>	<b>-2.8</b>	<b>-4.6</b>
<b>2. "Snowball" effect</b>	<b>-3.1</b>	<b>-2.5</b>	<b>-0.4</b>	<b>-0.4</b>	<b>-0.6</b>
<i>Of which:</i>					
Interest expenditure	2.1	2.0	2.1	1.8	1.7
Growth effect	-2.9	-3.0	-1.9	-1.5	-1.5
Inflation effect	-2.3	-1.5	-0.6	-0.8	-0.8
<b>3. Stock-flow adjustment</b>	<b>0.7</b>	<b>7.4</b>	<b>-3.4</b>	<b>0.8</b>	<b>1.0</b>
<i>Memorandum item</i>					
Gross financing needs	13.9	20.5	12.0	10.6	6.1
Highway loan [3]	4.1	4.9	4.4	0.5	0.0

[1] End of period.

[2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).

The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other effects.

[3] Includes loan and government own contribution.

Source: *Economic Reform Programme (ERP) 2019, ECFIN calculations.*

The debt ratio is expected to have peaked at 70.8% of GDP in 2018. The large increase in 2018 was driven by additional borrowing to build up 6% of GDP worth of deposits to service upcoming financial obligations. In the medium term, the significant improvement in the primary balance will drive the fast pace of debt reduction. The overall implicit interest rate is expected to decline slightly, from 3.4% in 2018 to 2.8 in 2021. Stock-flow adjustments will be markedly negative in 2019, as maturing debt is paid back using the deposits built up in 2018. Possible cost overruns from the highway are a major risk for the planned debt trajectory in 2020.

#### **The public debt ratio is expected to have peaked in 2018 at a high level, entailing significant risks.**

At the end of 2018, Montenegro's general government debt <sup>(9)</sup> stood at 70.8% of GDP. Partly because of frontloaded public borrowing in 2018 to smooth debt rollover in 2019-2021, the debt ratio was 7.1 pps higher than at the end of 2017 and marked 11 consecutive years of growth. It was also substantially higher (by 4.8 pps) than projected in last year's ERP. Almost all of the public debt is owed by the central government. In 2018, thanks to liability management operations, the authorities have been able to significantly lengthen the average maturity of the public debt stock and reduce the share of variable rate instruments. This shifting in debt composition means that rollover and interest rate risks have been lowered. Around 83% of the debt is denominated in euro and 15% in US dollars. In a benign interest rate environment, the debt generated interest payments were worth 2.0% of GDP in 2018, down from 2.4% in

(9) Excluding public guarantees and including deposits to service financial obligations in 2019-2021.

2017. However, investor sentiment towards emerging economies is volatile, making further debt reduction essential to mitigate debt-related vulnerabilities and rebuild room for policy manoeuvre.

**The ERP's medium-term budgetary projections entail a number of risks, which could be mitigated by implementing further reforms.** The sustainability of public finances relies, on the expenditure side, on controlling the costs of the large non-discretionary items of the budget (i.e. wages, pensions and the health and social care system). However, Montenegro's track record on containing such expenditure points to downside risks. Some of the measures envisaged under the public administration optimisation plan (which covers local governments enterprises but not central government state-owned ones) have an unrealistic timeframe and their costs are not specified, putting at risk the objective of reaching a balanced budget. The failure to adopt the pension reform postpones the aim of reducing the pension scheme's funding gap. Possible cost overruns for the section of highway are an additional risk, while financing the remaining sections, either through public-private partnerships or directly by borrowing, risks creating additional major liabilities for the state budget. On the revenue side, risks stem mainly from failure to meet targets for collecting tax arrears and enlarging the tax base. Finally, there are continuing risks in local authorities' financial management: their planned annual budget surplus of 0.8% of GDP might turn out to be overly optimistic. Upside risks for the budget come from one-off revenues from the concession of airports and unspecified revenues from the recently launched economic citizenship programme.

**There are plans to strengthen several aspects of the budgetary framework.** The current fiscal rules mandates a public debt and deficit ceiling of 60% and 3% of GDP respectively. The rules are relatively soft as they requires the government to adopt a strategy to correct any excess within a five-year deadline. The debt threshold was exceeded in 2015. However, the ERP now envisages reducing the debt ratio to 60.4% by 2021, a year longer than laid down in the fiscal rules. Formal compliance with the fiscal rules is monitored by the State Audit Institution. Authorities are preparing a study on possible options for establishing a Fiscal Council as an independent body to reinforce fiscal oversight. The ongoing public finance management reform includes plans to improve the budget planning IT system and introduce a system of centralised payroll calculation in 2019 to enhance control and management of wages in the public sector. The formal introduction of three-year budgeting has been postponed to 2020. Staff numbers have been reinforced at the Ministry of Finance to take over the implementation of accrual accounting, which is a prerequisite before the introduction of the European System of Accounts (ESA 2010). All these projects heavily rely on technical assistance and financing by international institutions.

#### 2.4. STRUCTURAL CHALLENGES AND REFORM PRIORITIES

**The comparative advantage of Montenegro is built on its geographical location, its climate and landscape.** Its small and open economy is service-oriented and largely focused on tourism as the principal source of income. Services account for nearly 80% of total exports, while foreign tourists alone generate over 20% of the country's GDP. Tourism potential is still far from being fully realised, with the mountainous northern region harbouring some of the last primary forests in Europe and unspoiled nature, as well as good snow coverage in winter. At the same time, given the country's reliance on one sector and its small size, the economy remains vulnerable to external shocks and climate change challenges.

The Commission has conducted an independent analysis of the Montenegrin economy to identify the key structural challenges to competitiveness and inclusive growth, drawing on Montenegro's ERP itself and other sources. This concise analysis shows that despite progress achieved in some areas, the country experiences several structural and cross-cutting weaknesses across many sectors. However, the main challenges in terms of boosting competitiveness and securing long-term, inclusive growth are (i) increasing labour market activity, (ii) strengthening the regulatory environment and (iii) formalisation of the economy. This assessment therefore focuses on these three challenges.

#### 2.4.1. Key challenges

##### ***Key challenge #1: Increasing labour market activity***

Key obstacles to growth and competitiveness remain structural. Recent positive labour market developments are a reflection of favourable economic developments rather than structural reform efforts. Low activity is an overarching challenge and the consequence of several bottlenecks. Weak job creation, skills mismatch, strict labour market regulation and relatively high labour taxation, and undeclared work negatively affect employment, particularly among young people, women and the low skilled. The gender employment gap is significant and has been increasing. Low participation in early childhood education and care affects low female labour market participation and potential long-term education outcomes of children. In addition, the overall education system performance is weak. Low outcomes in primary education affect performance in the later stages of education, while weaknesses in secondary (vocational) and higher education create obstacles to transitions from school to work. Insufficient adult education and employment activation hinder and/or do not assist labour mobility and transitions onto the labour market. Demographic changes and shorter working lives put further pressure on the labour market and the sustainability of pension system. With high poverty rates, the social protection system does not target effectively the needs of the most vulnerable sections of the population, which at the same time can create disincentives to work.

##### ***Key challenge #2: Strengthening the regulatory environment***

**The Montenegrin government's focus on macroeconomic stability and fiscal consolidation in recent years has created a more predictable business environment; however, the institutional and regulatory framework at the micro level can be further improved.** Businesses are adversely affected by inconsistent and arbitrary law enforcement, inefficiencies and weak capacity in public administration, as well as issues related to local taxation and para-fiscal charges.

**The main business complaint for years has been related to the interaction with the authorities.** The perception is that the conduct of business is undermined by the slow pace of administrative responses, lack of deadline compliance and the lack of deadlines for some procedures. There is also a poor and conflicting interpretation of laws between different decision-making authorities, between state and municipal level, as well as between local authorities. Other serious concerns include poor practical inclusiveness, often bordering on disregard for business voices in the public consultation processes, non-enforcement of court decisions and inconsistency or arbitrariness in case-law.

**The deficiencies in the regulatory environment are exacerbated by the weaknesses in the procedures for adopting and implementing laws.** The regulatory framework is perceived as unstable and unpredictable, owing notably to poorly explained and not sufficiently consulted amendments to laws affecting businesses and employees, and to generally slow and often erratic law implementation. Many legislative proposals would require more effective and proactive communication strategies targeting the stakeholders from the outset. Inclusive public consultations should be carried out early enough in a legislative procedure. More focus should be put on the timely adoption and implementation of secondary legislation, which is often delayed - sometimes by several years - compared to the main law and usually adopted without effective public scrutiny, even though it usually contains crucial provisions and practical regulations affecting the businesses.

**The area of public procurement and concessions shows weaknesses in both preliminary selection process and appeals stage.** Public procurement procedures are often affected by rigidity in eligibility criteria, imprecise requirements or a lack of document specifications, unforeseen delays and often changes in technical specifications and criteria. The procurement procedure outcomes can initially be positively reviewed by the State Commission, but are then often successfully contested in the Appeals Court. Suspicions of corruption are often voiced by the business community. There are significant

deficiencies in the transparency and quality of public consultations, and little publicly available information on ongoing concessions procedures. The planned adoption in 2019 of the new public procurement and public-private partnership laws is expected to bring gradual improvements, provided that relevant secondary legislation is adopted in good time and implemented effectively. The same is true for the recently initiated project to roll out e-procurement.

**Taxation is another area where considerable improvement is needed.** Different and often unpredictable taxes, fees and charges on businesses and investors are seen as arbitrary, confusing and often non-transparent for potential investors and businesses. More than 1500 para-fiscal burdens have been identified on a national level by a survey jointly organised by ILO and The Montenegrin Employers Federation (MEF) in 2017. In addition, according to the Montenegrin government, there were 659 different local taxes, fees and charges in Montenegro in 2017. The law on administrative fees, adopted in March 2019, aims to simplify, restructure and reduce some local fees and charges, but the number of taxes and para-fiscal charges after the reform will remain significant. Planning the payment of tax commitments remains difficult due to the frequency of payments and law changes, making this another area for improvement.

### ***Key challenge #3: Formalisation of the economy***

**Reliable monitoring and assessment tools are needed to address the informal economy challenges.** The proportion of the informal economy to total GDP is estimated at 28 to 33%. Over 9000 small businesses declare that they employ only one person, despite most of these being registered in the accommodation and food service activities. However, there are no reliable benchmarking tools to provide for a continuous monitoring and assessment of the country's informal economy. The size of undeclared and informal work is estimated by various sources at a minimum of 22-25% of employment and up to 33-35% of employees when accounting for workers paying only part of their due tax and other social contributions (UNDP National Human Development Report and World Bank data).

**The persistence of the informality is closely related to the identified structural and regulatory challenges.** Corruption, regulatory burden, weak enforcement capacity, difficult access to finance, weaknesses of the labour market and high tolerance for tax non-compliance are among the root causes of informality. Low level of awareness of the societal impacts of the informal economy and the willingness to engage in informal transactions add to the complexity of the picture. In addition, tax non-compliance correlates with the perception that the taxation system remains unfair and the quality of public services is low, as assessed by the EU-OECD joint initiative Support for Improvement in Governance and Management (SIGMA).

**The high level of informality in the economy has far-reaching consequences.** It hinders the efficient allocation of state and business resources, reduces tax revenues, slows down economic development and has negative long-term outcomes for workers. In the Montenegrin context the impact of unfair competition from the informal sector is particularly heavy on local SMEs and microenterprises, which dominate the economy.

**The government has taken some action to address informality, but it has been limited in scope and has not addressed the root causes of the problem.** An action plan to combat the grey economy was finally adopted in 2017, and a government commission was appointed to better coordinate different actions. The ERP includes a measure on electronic fiscal invoices, which, when implemented, should help address one aspect of informality. However, reducing the informal economy is heavily dependent on certain reforms in the regulatory environment, which have been postponed to 2019 or later. Achieving greater formalisation is also dependent on improvements in the capacities of, and the cooperation between, local and state bodies, which are currently lacking, and on a more systematic approach, including better estimations of the size and dynamics of the informal economy.

## 2.4.2. Labour market, education and social policies

### Labour market developments

**Positive trends on the labour market have continued, but significant gaps remain compared with the EU.** The unemployment rate continued to decrease from 16% (2017) to 15.2% (2018), but remains well above the EU average. This is a result of sustained, yet mild improvements in activity and employment rates (64.7% and 59.8% respectively), which nonetheless also remain particularly low and significantly below the EU average. Long-term unemployment also decreased, but still represents over 70% of total unemployment. Regional disparities are considerable, with unemployment disproportionately high in the north of the country. Roma and persons with disabilities also have particular difficulties integrating into the labour market.

**Low activity and employment are a particular challenge for Montenegro, both compared to the EU and to the region.** The activity rate of women is particularly low (57.2% compared to 72.3% for men), with the employment gap at almost 15 pps and increasing. This is partly due to past social disincentives for women to work and the high burden for family care. The rate of young persons not in education, employment, or training (NEETs) is the lowest among the enlargement countries (16.7%), but remains well above the EU average and is coupled with high youth unemployment (29.4%). The low-skilled are another group far from the labour market and represent almost 40% of the inactive population. An estimated 22% of workers engage in undeclared work and 10.4% of formally employed receive envelope wages. However, regular collection of reliable data in this area has not yet been established. The prevalence and risk of this phenomenon is higher among young and older people (UNDP National Human Development Report and World Bank data). While job creation is weak, there is also a shortage of skills, resulting from the skills mismatch and weak reskilling opportunities.

**Provision of employment services and active labour market policies (ALMPs) insufficiently covers jobseekers and their needs.** This is partly due to low funding (0.18% of GDP for ALMPs) and the low capacities of the Public Employment Service (PES). While coverage has been increasing, there is still no comprehensive evaluation of their effectiveness. Direct job creation measures are prevalent, and are particularly aimed at the low skilled, with less attention given to reskilling or education programmes. To improve activation and incentivise employment, PES and social work centres started a new cooperation approach, but its impacts on transition to employment have not materialised clearly so far. New legislation aiming for better provision and targeting of ALMPs is foreseen to be adopted in 2019, but it is not clear yet what its impact will be.

**Interventions to improve labour market outcomes have not yet had substantial effects on increasing employment.** Obstacles to greater labour market participation are structural. Disincentives to work are highest for low-wage earners and wages are condensed towards the minimum wage. Participation in undeclared work has been linked with labour market rigidity, high wage taxation and a low standard of living (Katnic and Williams 2018). The adoption of the new labour law is planned for 2019, and aims to improve labour market flexibility and ease transfer to formal employment. However, no follow-up mechanism on monitoring its effects – once adopted – is envisaged so far.

**Social dialogue remains weak in Montenegro.** The tripartite Social Council is in place, but the practice of meaningful dialogue, addressing conflicts and systematic consultation are not yet well developed. New laws on the Social Council and representativeness of trade unions were adopted recently, but the consultation on the preparation of measures (including the Economic Reform Programmes) is still often limited.

### Box 11.2.2: Monitoring performance in light of the European Pillar of Social Rights

The European Pillar of Social rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights on equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion to benefit citizens in the EU. Since these 20 principles are essential for countries if they are to achieve fair and well-functioning labour markets and welfare systems, they are equally relevant for candidate countries and potential candidates. The new reinforced social dimension for the Western Balkans includes an increased focus on employment and social reforms through greater monitoring of relevant policies (EC, 2018). The Western Balkans Ministers' "Declaration on improving social policy in the Western Balkans" (6 November 2018) confirms that they will use the Pillar to guide the aligning of their labour markets and welfare systems with the EU's.

**Montenegro faces challenges over a number of Social Scoreboard <sup>(1)</sup> indicators measuring compliance with the principles of the European Pillar of Social Rights.** This is notably the case for equal opportunities and access to the labour market. There is also an issue of poor data availability concerning social protection and inclusion. While unemployment has decreased and employment improved, Montenegro still faces low activity rates, including a high share of young people not in employment, education or training (NEETs). The gender employment gap remains significant and has increased in recent years. Activation measures are still insufficient to contribute substantially to formal employment, while labour reform is still pending. Montenegro has a high share of people at-risk-of poverty or social exclusion. Nonetheless, the share of early school leavers is very low and significantly better than the EU average.

MONTENEGRO		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Better than EU average, improving
	Gender employment gap	Around EU average, deteriorating
	Income quintile ratio (S80/S20)	Worse than EU average, no change
	At risk of poverty or social exclusion (in %)	Worse than EU average, improving
	Youth NEET (% of total population aged 15-24)	Worse than EU average, improving
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-64)	Worse than EU average, improving
	Unemployment rate (% of population aged 15-74)	Worse than EU average, improving
	GDHI per capita growth	N/A
Social protection and inclusion	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU average, deteriorating
	Children aged less than 3 years in formal childcare	Worse than EU average, improving
	Self-reported unmet need for medical care	Worse than EU average, trend N/A
	Individuals' level of digital skills	Worse than EU average, trend N/A

**Insufficient job creation, coupled with informal work opportunities and weak employment support, contributes to low activity and employment.** This is accentuated by skills mismatches and is reflected in the very high share of long-term unemployed people. The risk of poverty and social exclusion is particularly high for vulnerable families, the unemployed and children. Employment remains the best way out of poverty. While safety nets exist, the social protection system is not well equipped to target and assist those in need. To improve transitions from school to work, work-based learning and traineeship programmes have been implemented or introduced both in higher education and in VET. However, their effects and impacts need to be systematically monitored and evaluated.

**Demographic structure and trends pressure the labour market and the pension system.** The dependency ratio has

been steadily increasing, while the employment rate for older

(<sup>1</sup>) The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance (<https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators>). The 12 indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-28 average (performing worse/better/around EU-28 average) and a review of the trend for the indicator based on the latest available 3-year period for the country (improving/deteriorating/no change). Data from 2014-2017 are used.

(Continued on the next page)

*Box (continued)*

workers (55-64 years) is 43.7%. This, coupled with general high inactivity and low employment, indicates the clear need for prolonging working lives. There is a pension reform proposal in preparation, but it is unclear whether it will sufficiently address the financial sustainability and adequacy aspects of Montenegro's pension system.

**There is a further need to strengthen the collection of timely and reliable data in Montenegro.** The responsible institutions' financial and administrative capacities are limited due to inadequate resources. Several indicators remain unavailable, particularly those on social protection and inclusion. In addition, several statistics are not harmonised with EU standards or are not systematically sent to Eurostat. However, Montenegro published the results of its first Statistics on Income and Living Conditions (SILC) survey in December 2019.

### Social protection system

**The risk of poverty and social exclusion in Montenegro has been declining, but remains high.** The country's first Statistics on Income and Living Conditions (SILC) survey found that in 2016 the at risk of poverty and social exclusion rate was at 34.6% (2016), still well above the EU average of 23.5%, but the lowest among the enlargement countries. Particularly high are the rates for children (0-17 years) and young people (18-24), which amount to 30.9% and 29.6%, and these have even increased since 2013. The low skilled are the most at risk of poverty and social exclusion, and this affects their children as well. The north of the country and rural areas have double the risk of poverty and social exclusion. Income inequalities have declined somewhat, but remain at the higher end compared to the EU, although lower than in most enlargement countries.

**Income support schemes are in place, but their targeting is insufficient to cover those in need.** The share of low wage earners is high in Montenegro, and wage distribution is highly condensed close to the minimum wage at EUR 193 (which might also be to some extent due to underreporting of salaries). The at-risk-of-poverty line was approximately EUR 175 for a single household and EUR 367 per month for a household with two adults and two children below 14 years of age in 2017. In-work poverty in Montenegro is low, but has increased in recent years. To improve targeting of social support and incentivise work, the social card system and social activation between centres for social work and PES have been established. However, the results are not yet visible.

**Despite improvements, the coverage of early childhood education and care remains low.** Montenegro sustained the increase in participation in child-care services (0-5 years), which has improved by more than 10 pps since 2011. However, at 46% it remains well below the EU average. This is somewhat a result of low capacities, both in terms of funding and provision, as well as traditional low availability linked to the role of women in family care and their low participation on the labour market.

**Low activity rates, short working lives and increasing old-age dependency are putting pressure on Montenegro's pension system.** The employment rate of older workers (55-64 years) was 43.7% in 2017, which is below the EU average (57.1%). The average duration of working lives in Montenegro is also low, at 30.5 years, facilitated by opting for early retirement. While currently the pension system covers most elderly people, it might be affected in the future given the dependency ratio of 1:1.7. The gross replacement rate at the standard retirement age is about 37%. The average pension stands at around EUR 280 per month (55% of the average net wage), while the minimum pension is EUR 125 (44% of the average pension and 25% of the average wage). The at-risk-of-poverty rate for older workers (54-64) is 20.3%, while for the elderly (65+) it is 16.1%. Montenegro has announced further pension system reform for 2019, but this has been put on hold.



## Education and skills

**The performance of Montenegro's education system is of limited quality and relevance for the labour market.** Investment in education has increased somewhat in recent years and accounts to around 4% of GDP. Nonetheless, PISA results from 2015 highlighted underachievement in reading, mathematics and science (the results from the 2018 testing are still pending). Only 20% of the population has completed tertiary education, despite the commitment for reform efforts. On the other hand, the rate of earlier leavers from education has traditionally been low in Montenegro (4.6% in 2018), better than the EU average, and has even been decreasing.

**The skills mismatch is manifested on secondary and higher education levels.** This is a result of high levels of transition from vocational to higher education programmes and enrolment in less labour market-relevant programmes. Occupational mismatch (i.e. over qualification) is higher for those with tertiary education, although it is decreasing. In contrast, for those with secondary education it has been increasing (ETF forthcoming).

**There is a lack of result-oriented indicators and defined monitoring and evaluation tools to adjust and develop reform measures.** Tracer studies have been carried out at higher education level and one has started for VET. However, a labour market information system fit to produce information on medium- to long-term skills needs is not yet fully developed. The development of qualifications has been prioritised: since 2014, Montenegro has referenced its national qualifications framework to the European Qualifications Framework with continuous support from the EU. Sector committees, featuring education and labour market representatives, are in place and an extensive list of qualifications has been reformed. However, there is no review of the rollout to VET schools and other education providers; this means that it is not possible to assess its relevance for the overall reform progress and employability of students.

**Some reforms have advanced, including the focus on work-based learning, particularly in VET.** The revised VET law introduced a practical learning and apprenticeship system, which has seen increased enrolment and engagement by employers. The revised higher education law also introduced 25% practical learning, which complements the ongoing programme for professional training of graduates. Comprehensive analysis and evaluation of the implementation, effectiveness and first results of the introduction of practical learning in VET and higher education is still pending. Given the absence of programme performance, its impact on the school-to-work transition is unclear.

**Less reform consideration is being given to adult learning and the upskilling and reskilling of the working-age population.** Participation in lifelong learning at 3.3% (2018) remains far below the EU average, though it has increased compared to the previous year (2.8%). There is a lack of information on the availability and quality of measures for upskilling and reskilling. In 2018, the government adopted its adult learning strategy. Currently, the priority is to carry out quality assessment of providers and to extend the provision. While adult education and upskilling and reskilling measures are included in ALMPs, they make up a small proportion of such policies and are often insufficiently targeted.

### 2.4.3. Competitiveness and sectoral issues

#### Business environment

**Montenegro continues to improve its business environment at a slow rate, but major qualitative achievements are yet to materialise.** Despite a number of ongoing initiatives to improve the business environment, reduce overall administrative burdens and support businesses, progress as seen by investors and businesses has been rather slow over the last 5 years. Recent examples of progress include electronic access to land registry data and business licensing, the Law on administrative fees and the SME development strategy and action plan. However, the Montenegrin Foreign Investors Council Index for 2018 increased only slightly to 6.49 points (0-10 rating), vs 6.30 in 2013. This indicates that serious

progress is still needed to make the country truly business-friendly and attractive for investors. Similar conclusions can be drawn from the World Bank Doing Business Report 2019, in which Montenegro's overall position was 50 out of 190 countries, Montenegro and the latest World Economic Forum Global Competitiveness Report, in which it ranked 71 out of 140 economies surveyed. Access to finance is an exception to the overall picture, as this is an area where Montenegro has been gradually improving. However, this improvement has been less pronounced for SMEs and microenterprises, which battle with generally weak financial literacy and entrepreneurial skills.

**Effective application of the rule of law is key for improving the business environment.** Effective and independent judicial systems are a prerequisite for creating an environment that is investment- and business-friendly as they instil confidence throughout the entire business cycle. Montenegro's business environment could benefit from effective measures to further strengthen the rule of law, ensure adequate and timely contract enforcement and increase the transparency of legal changes, which in turn could lead to an increase in productivity and competitiveness. If corruption is not forcefully addressed, it will make Montenegro a less attractive place for doing business.

### Research, development and innovation

**Public and private investments in research, development and innovation (RDI) are low.** The RDI sector also suffers from a low number of researchers and weak links between academia, research institutes and business. The number of researchers per capita is only 20% of the EU average, while over 90% of research staff is employed by the government and the higher education sector. With a rate of only 0.32% of GDP invested in R&D (2016), Montenegro needs to make continued efforts to reach its 2020 target of 0.60%, which is already considerably lower than the Europe 2020 target of 3%. There are few innovative enterprises, and research institutions have limited commercial and legal expertise. This is reflected in a very low number of patent applications (10 in 2016, WTO) and an insignificant number of domestic industrial design applications (only 3 out of 228 applications registered in Montenegro in 2016, WTO).

**On the other hand, the main government funding scheme for RDI significantly increased during 2018 and most of the new projects are now based on the principle of business co-financing.** However, there is no data yet to substantiate an increase of private sector funding. A new programme to strengthen human resources and research capacities in scientific research institutions has been launched, with one of its aims being to facilitate the employment of researchers in the private sector. The development of a smart specialisation strategy (S3) for the country is at an advanced stage. Montenegro plans to implement such a strategy and promote an innovation culture through the 'Tehnopolis' innovative-entrepreneurial centre in Nikšić and the planned science and technology park at the University of Montenegro in Podgorica. Furthermore, a programme for supporting innovative start-ups was adopted - cofinanced by the Policy Support Facility of Horizon 2020 – aimed at creating the right conditions for innovative businesses to emerge, develop and grow. At the same time, the lack of robust and up-to-date R&D and innovation statistics impedes access to reliable research data. The quality of R&D statistics needs to be improved by widening the coverage and frequency of surveys. The development of innovation statistics that would meet the requirements for inclusion in the EU Innovation Scoreboard is currently in the pilot stage.

### Digital economy

**Access to broadband networks is seen as key to the further digitalisation of the economy.** Montenegro's information society strategy sets an ambitious goal of 100% household coverage with high-speed broadband (above 30 Mbit/s) by 2020. However, despite intensive efforts, legislative and infrastructure hurdles are likely to significantly delay this process, with 28% of all households and 40% of rural households still without any internet access in 2017. The process of mapping existing telecommunication infrastructure is ongoing and will be completed only by the end of 2019. The

legislative framework for high-speed broadband development is also not yet adopted. Low population density increases costs of private broadband deployment and discourages investment by existing private operators in less populated areas, resulting in the slow connection speeds. The government should consider financial and policy incentives for rural broadband and invest in a digital skills development programme. This would promote digital economy jobs and increase business use of ICT, the absence of which being one of the factors that undermines Montenegro's competitiveness. A more proactive approach on issues such as cross-border data transfers and data protection and cyber security would also be advisable.

### Investment activity

**Public and private investments remain one of the main drivers of GDP growth.** This trend will likely continue in the near future. The government has announced strategic investment plans in four areas (tourism, transport, energy and agriculture), with investment expected to reach around EUR 2.75 billion in 2018-2021. Public investment is already at an all-time high, with several large projects such as the undersea interconnection power cable with Italy and the first section of the Bar-Boljare highway nearing completion in 2019-20. Private investments, in particular in hotel and tourism infrastructure, focus mainly on the coastal area, while the north of the country attracts little funding aside from investment in two ski resorts. New investments in the production of aluminium and renewable energy plants are forecasted to boost export capacities in the future and contribute to reversing negative trends in trade.

**Foreign direct investment (FDI) decreased in 2018, but remains high compared to regional peers.** The FDI per capita indicator for the last 10 years averaged around 19% of GDP. FDI contributes significantly to Montenegro's current account deficit financing. Net inflows of FDI decreased to 8.6% of GDP by September 2018 due to large outflows related to inter-company debt payments and following the sale of stakes in the electricity company EPCG by its Italian owner. The main sources of FDI investment are EU Member States and Russia. Due to the high general government debt-to-GDP ratio further financing of large projects through the state budget is hardly possible. However, increased EU and international funding and the expected adoption of the public-private partnership law in mid-2019 should contribute to maintaining the current level of investment in the mid-term future.

### Trade performance

**The trade deficit remains high, reaching 32.2% of GDP in 2018, despite a significant surplus achieved in the trade of services.** The trade deficit in goods widened by 10.2% year on year in 2018. The export of goods remains modest due to low diversification and a predominance of low value added products and crude materials in its structure. Imports, meanwhile, are dominated by manufactured goods, construction materials, machinery, transport equipment and food. The trade in services balance recorded another big surplus and a year-on-year increase of 9.9% by the end of 2018, driven mostly by tourism activities.

**EU Member States dominate both exports and imports, accounting for 44% and 48% of all trade in 2018.** Serbia and China (with Hong Kong) are the main trade partners outside the EU, accounting respectively for 19.3% and 10% of imports and 23% and 3.5% of exports. Trade openness remains relatively high at 110.6%, while tariffs are low and non-tariff barriers relatively low, due to the EU accession process and WTO membership. There is significant potential for greater intra-regional trade within the Central European Free Trade Agreement (CEFTA) framework and with the EU, as trade preferences allowing for access to the EU market without customs duties apply for 98.6% of Montenegrin products.

**Montenegro is encouraged to implement all the aspects of the Regional Economic Area Multi-Annual Action Plan (REA MAP).** The REA MAP is based on EU standards and will facilitate country's integration in regional and European value chains. It will also help increase the attractiveness of the

economy for FDIs in tradable sectors. Improved connectivity with neighbouring countries in transport and energy will facilitate access to the regional markets. The creation of a regional digital space and of more integrated labour markets with neighbouring economies will open new possibilities for the country's youth, which is also important in light of the high youth unemployment.

## Energy

**The energy market needs to improve its infrastructure and efficiency.** Montenegro covers close to 40% of its electricity consumption through imports. Energy transmission losses amounted to over 17% of electricity consumption in 2017, five times higher than the EU average. The reliability of the electric power supply in rural areas also needs to improve. However, the use of renewable energy sources is high and increasing. In 2017, some 40% of the country's electricity production (significantly above the EU average of 31.8% in 2017) came from renewable sources, mostly hydropower and biomass. The energy legislation is aligned with the third energy package for electricity and gas, but a natural gas market does not exist because there is no access to gas pipelines. The wholesale and retail electricity markets in Montenegro are open for competition, but new providers are yet to come.

**Energy production and cross-border trade in energy should significantly increase in the coming years.** New energy production capacities are being created with the launch of a wind farm and the granting of licences for the construction of several solar power plants, including a large 250 MW solar plant in Briska Gora. The construction of the undersea energy link towards Italy is progressing as planned and will enable energy export from Montenegro and the entire Balkan region to Italy. Integration into the regional electricity market should also improve in the future through new energy interconnectors with Serbia and Bosnia and Herzegovina as part of the Trans-Balkan Corridor of the Energy Community.

## Transport

**Montenegro's long-term sustainable economic development would benefit greatly from further developing and improving transport infrastructure and from ensuring a good connection with European transport corridors.** The country's geographical situation makes better transport links with the wider region and the rest of Europe particularly important. In the World Economic Forum Global Competitiveness Report 2018 Montenegro scores very low on road, airport and shipping connectivity. Transportation services accounted for 4.1% of gross value added (GVA) in 2017 (below the EU average), and provided employment for 5.3% of the workforce. The number of road accident fatalities (per 1 million inhabitants) is almost twice the EU average and is increasing.

**There is slow progress on improving and modernising sections of the road and rail networks, but sufficient funding for the current maintenance of rail and road network remains an issue.** Further steps are also needed to open the rail market up to competition. State funding is largely focused on the construction of the Bar-Boljare highway, but works on the priority section are suffering from delays and cost overruns. Upcoming tender for a concession to maintain and upgrade two main airports aims to address, in the near future, the issue of limited accessibility by air transport. Efficiency of border-crossing procedures (and customs) is a related area where improvements are needed.

## Agriculture

Significant investments are planned to develop the agricultural sector (including forestry and fishery), which currently faces a number of challenges. The government is expecting to invest EUR 122 million in the next 3 years, mainly from EU funds, which will facilitate progressive modernisation. Agricultural land in use accounts for 18% of the country's territory, although 94% of such areas are pastures and meadows. Agriculture contributed 8.4% to the country's GVA in 2017 and 8% of employment. It is also the main or partial source of income for close to 50 000 households. With the exception of a few larger agricultural enterprises, agricultural production is fragmented and characterised by small, often family-run parcels

with high production costs, limited organisation and a lack of adequate equipment. The problem is exacerbated by limited skills and poor access to credit and markets.

**Montenegro is a net importer of food, reaching EUR 500 million annually in imports and only EUR 50 million in exports.** Wine tops the exports list. Neighbouring Western Balkan countries, and in particular Serbia, account for over 80% of the trade in agricultural goods. The Stabilisation and Association Agreement gives Montenegro unrestricted access to the EU market for nearly all agricultural products. However, agricultural exports to the EU remain mostly unexploited due to the limited scale of agricultural production and because of the necessity to fulfil the EU veterinary and phytosanitary requirements.

### Industry

**Montenegro's industrial base remains modest and hampered by low product diversification and low labour productivity.** Industry and construction made up 19.4% of GVA in 2017 and 17.1% of employment. New investments in the energy and aluminium production (which are the country's top exports) are aimed at improving the competitiveness of these sectors, but modernisation efforts in other areas are less pronounced. The production of higher value added products remains limited and local industry is characterised by low participation in European and global supply chains. The government's efforts focus on SME support and SME policy, a natural choice in a small economy. Industrial policy receives support from the Investment and Development Fund of Montenegro (IDF) among others, but access to finance still remains a significant obstacle for SMEs. Effective working structures still need to be created to help Montenegrin applicants prepare their applications for EU funding under Europe's programme for small and medium-sized enterprises (COSME). Montenegro is currently revising its industrial policy.

### Services

**The services sector remains the most important sector of the Montenegrin economy, providing 72.1% of GVA and employing three quarters of the workforce.** Retail and wholesale trade and tourism are the main contributors to GVA and employment in the services area; ICT, financial and professional services remain less developed. Services — in particular tourist services — are the country's main export and accounted for 78% of total exports in 2017. Spa and congress tourism are possible niches that could be exploited, and would also help to offset the high seasonality of the current tourism trends. Further diversification of the services sector beyond the current focus on tourism would reduce the economy's vulnerability to external factors such as geopolitical risks, intense competition for tourism in the Mediterranean region and weather conditions.

## 2.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2018

<b>Overall: Limited implementation (34.1%)<sup>(10)</sup></b>	
<b>2018 policy guidance</b>	<b>Summary assessment</b>
<p><b>PG 1:</b></p> <p>Fully implement the July 2017 fiscal strategy.</p> <p>Take additional fiscal measures if necessary to achieve the debt and deficit targets as outlined in the 2018 ERP.</p> <p>Establish adequate budget allocation to accommodate contingent liabilities related to unfavourable court cases.</p> <p>Prepare an options paper on the establishment of an independent body for fiscal oversight for further consultation with stakeholders, including the EU.</p>	<p>There was <b>partial implementation</b> of PG 1.</p> <p>1) <b>Substantial implementation:</b> The strategy was to a large extent implemented, but the new excise duties on tobacco products and carbonated water with sugar were withdrawn in July 2018, due to low performance and an increase in informal trade.</p> <p>2) <b>No implementation:</b> Additional non-planned expenditure took place during 2018. However, no additional fiscal measure was implemented and the deficit target was missed. The deficit and debt targets for 2019 and 2020 have also been softened compared to the previous year's ERP.</p> <p>3) <b>Full implementation:</b> In the second budget revision in July 2018, the Ministry of Finance increased budget reserves by an additional EUR 17 million, reducing the planned surplus of local government budget by the same amount. To improve budget execution performance, the budget heading for repayment of liabilities from previous period will be part of budget expenditure as from 2019.</p> <p>4) <b>Limited implementation:</b> Montenegro requested in October 2018 the EU's technical assistance for the preparation of an options paper and support for the establishment of a fiscal council and its operations. The grant application for this IPA project was approved in February 2019.</p>
<p><b>PG 2:</b></p> <p>Gradually reduce public spending on wages and pensions as a share of GDP.</p>	<p>There was <b>limited implementation</b> of PG 2.</p> <p>1) <b>Partial implementation:</b> There was some reduction in the relative share of wages and pensions in 2018, although the wage bill turned out higher than expected in nominal terms. The plan is for both items to decline slightly as a percentage of GDP over the programme period. This is expected to be achieved thanks to the economy growing faster than the regular indexation of pensions and any possible public sector salary increases.</p>

<sup>(10)</sup> For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission's Overview and Country Assessments of the 2017 Economic Reform Programmes available at [https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments\\_en](https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en).

<p>implement the new optimisation plan of the public administration reform, including local self-government and public institutions</p> <p>and prepare pension reforms that would change the valorisation and indexation of pensions and tighten eligibility for early retirements.</p>	<p>2) <b>Limited implementation:</b> The public administration reform is being implemented but has been delayed. There was some net reduction of staff, but the target for 2018 was missed. Moreover, the administration hired additional staff before the optimisation plan was adopted in July 2018, undermining the results of the reform.</p> <p>3) <b>No implementation:</b> Draft amendments to the law on Pension and Disability Insurance have been prepared. However, the reform of the pension system was put on hold because the draft amendments were strongly challenged by the trade unions, resulting in changes to the initial draft that would have run counter to the aim of improving the financial sustainability of the pension scheme.</p>
<p><b>PG 3:</b></p> <p>Continue efforts aimed at NPL resolution and corporate debt restructuring, focusing also on loans held outside the banking sector and underlying obstacles outside the remit of the central bank.</p> <p>Establish a framework for the recovery and resolution of credit institutions.</p> <p>Consider conducting asset quality reviews in the banking sector</p>	<p>There was <b>partial implementation</b> of PG 3.</p> <p>1) <b>Partial implementation:</b> The legal framework guiding voluntary debt restructuring has been extended to May 2019. In addition, the CBCG intends to intensify its supervision of banks with the aim to monitor their compliance with the amended decision on minimum standards for the management of credit risks, which also includes the monitoring of the implementation of their strategies to resolve non-performing exposures. Both measure may help to further reduce the stock of non-performing loans on the balance sheets of banks. Apart from that, efforts outside the immediate remit of the CBCG that may facilitate the resolution of non-performing debt appear not to form part of the priority reform measures presented in the ERP by the authorities.</p> <p>2) <b>Limited implementation:</b> The adoption of the Law on Resolution of Credit Institutions, implementing Directive 2014/59/EU on Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms, is planned for 2019, followed by the preparation of all necessary secondary legislation.</p> <p>3) <b>Limited implementation:</b> The ERP assigns a low priority to conducting an asset quality review (AQR), but signals to consider to perform an AQR for vulnerable banks in 2019. The CBCG indicated its intention to implement an AQR from 2019Q2 onwards with its scope, however, yet to be decided.</p>

<p>and options for enhancing the emergency liquidity assistance framework.</p> <p>Enhance the accountability and transparency of macroprudential policy by publishing a document outlining the central bank competences, objectives and instruments in this area.</p>	<p>4) <b>Partial implementation:</b> The CBCG Council passed a decision detailing the conditions under which banks can access the CBCG's (emergency) liquidity facilities, which started the process of improving the framework.</p> <p>5) <b>Full implementation:</b> The CBCG adopted a macroprudential policy framework in June 2018 and published it on its website (<a href="https://www.cbcg.me/slike_i_fajlovi/eng/fajlovi/fajlovi_naslovna/macprudential_policy_framework.pdf">https://www.cbcg.me/slike_i_fajlovi/eng/fajlovi/fajlovi_naslovna/macprudential_policy_framework.pdf</a>). It largely follows the recommendations of the European Systemic Risk Board on intermediate objectives and instruments of macroprudential policy.</p>
<p><b>PG 4:</b></p> <p>Based on a mapping of infrastructure and analysis of market interests, develop a comprehensive action plan on broadband roll out and coverage,</p> <p>and implement the broadband cost reduction measure in line with EU Directive 2014/61.</p> <p>Ensure the collection and delivery of statistical data on research and development, and innovation.</p> <p>Develop a model for the introduction of fiscal incentives for the research and innovation sector in line with EU state aid rules.</p>	<p>There was <b>limited implementation</b> of PG 4:</p> <p>1) <b>Limited implementation:</b> Mapping of the telecommunication infrastructure is ongoing and should be finalised in 2019. Adoption of the national action plan on broadband roll out and coverage is foreseen for 2020.</p> <p>2) <b>Limited implementation:</b> A draft law (Law on Access to and Deployment of a High-Speed Electronic Communication Network) has been prepared and consulted with the Commission, but its adoption is delayed until Q4 2019. The Law will be fully implemented only in 2021.</p> <p>3) <b>Limited implementation:</b> No improvement on R&amp;D statistics. First Innovation survey done in 2018 for the 2014-2016 period. Second Innovation survey planned for 2019 for the period 2016-2018.</p> <p>4) <b>No implementation:</b> The model has not been developed.</p>
<p><b>PG 5:</b></p> <p>Adopt legislation on concessions and public private partnerships in line with EU rules and best practices</p> <p>accompanied by an action plan for institutional capacity building in this area.</p> <p>Ensure effective, efficient and independent rail regulatory and safety authorities to implement the full opening of the rail market.</p>	<p>There was <b>limited implementation</b> of PG 5:</p> <p>1) <b>Limited implementation:</b> The new Law on Public-Private partnership and amendments to the Law on Concession are announced to be adopted during 2019. However, laws are currently still in the drafting phase, thus their adoption is again postponed.</p> <p>2) <b>No implementation:</b> Trainings for line institutions, local governments and the private sector are envisaged for 2020, and only partially in 2019 (with donor support). No comprehensive action plan for institutional capacity building is developed.</p> <p>3) <b>Limited implementation:</b> The new law on railway was announced as the key measure to address this policy guideline. However, the law is still in the drafting phase; its adoption is postponed to 2019. Though the new law would resolve the status of the</p>



	<p>Railway Directorate, to act as authority for regulatory and safety activities, its administrative, financial and technical strengthening will deserve particular attention.</p>
<p><b>PG 6:</b></p> <p>Review active labour market policies in order to improve their coverage and effectiveness, in particular for youth, women and the long-term unemployed.</p> <p>Ensure better coordination between employment activation measures and social benefit schemes.</p> <p>Increase enrolment in vocational and higher education corresponding to labour market needs.</p>	<p>There was <b>limited implementation</b> of PG 6:</p> <p>1) <b>Limited implementation:</b> While participation in active labour market policies has increased, there has still been no assessment and evaluation of their effectiveness. The Law on mediation in employment is planned for adoption in 2019, but its impact on better provision, design and targeting of ALMPs and employment services is unclear. A new integrated database on employment should be made operational to provide for better monitoring of the labour market and its programmes.</p> <p>2) <b>Limited implementation:</b> The Employment Office of Montenegro and centres for social work have put in place a ‘coordinated activation approach’ to developing individual activation plans. However, the approach has yet to be utilised to improve service quality. An integrated database including Ministry of Labour, Education, Employment Office and social centres is not operational yet. There is a proposal to carry out a social protection review in cooperation with Unicef, but the funds have not been secured yet.</p> <p>3) <b>Partial implementation:</b> Tangible progress was made in the area of VET. The dual education programme saw significant increases in student enrolment and employer participation. However, it remains to be seen whether employers’ involvement (and consequently sustainability of the dual system) will continue, particularly with an increased transition to employers’ own co-financing of apprenticeships. The effects on higher education are not available and it is too early to establish impacts on school-to-work transitions.</p>

## 2.6. THE 2019 POLICY GUIDANCE

### **JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TURKEY**

The Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

Brussels, 17 May 2019

[...]

In light of this assessment, Participants hereby invite Montenegro to:

1. Use windfall gains, such as proceeds from privatisation and airport concessions, to accelerate the reduction of the general government debt ratio. Broaden the tax base by introducing an electronic fiscal invoice system. Reduce the public sector wage bill as a share of GDP by fully implementing the public administration optimisation plan at the central and local self-government level, including a system of centralised payroll calculation.
2. Reinforce fiscal governance by introducing medium-term budgetary planning and programme budgeting. Advance the reduction of arrears at local level, including those of municipal companies. Prepare an options paper on the establishment of an independent body for fiscal oversight for further consultation with stakeholders, including the EU.
3. Strengthen efforts to resolve the remaining stock of non-performing loans, including those held outside the banking system, and address obstacles hindering resolution outside the responsibility of the central bank. Conduct a comprehensive asset quality review of the financial sector in line with international best practices and publish the results. Closely monitor risks related to the consumer loan segment, deploying appropriate micro- and macroprudential policy tools if needed, and consider measures to bolster the resources at the disposal of Montenegro's deposit insurance fund.
4. Improve the regulatory environment by developing publicly available guidance on the practical implementation of each law that affects the business environment. Ensure consistent application of the provided guidance.
5. Develop a comprehensive strategy providing reliable benchmarking tools allowing for the continuous assessment and reduction of the informal economy, including undeclared work. Ensure close cooperation between central and local authorities to reduce the informal economy. Adopt and implement the new legislative framework on public procurement, public-private partnerships and concessions.
6. Increase labour market participation, in particular for youth, women and the low skilled, by strengthening employment activation measures, including through better provision of upskilling and reskilling measures. Improve coordination between employment and social services. Establish a solid monitoring and evaluating mechanism on the implementation and results of practical learning at vocational and higher education.

## ANNEX A: ASSESSMENT OF THE STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP

### **Measure 1: Improving the ownership, managerial and organisational structure in electrical power companies with state-dominant ownership**

The measure to improve the ownership, managerial and organisational structure of electrical power companies with state-dominant ownership is new and has the potential to have a longer-term effect on the Montenegrin economy and its competitiveness. However, its immediate and direct effects have not been demonstrated. Activities planned for 2019 appear to be too ambitious in timing, whereas those for 2020 and 2021, focusing on implementation, appear too spread out. The financial allocation for the measure's implementation (EUR 100 000 from the state-owned enterprises and EUR 30 000 from the national budget) might have been underestimated. If implemented properly, in the longer run the measure could lead to improved competitiveness in the energy sector, which is an important pillar of the Montenegrin economy.

### **Measure 2: Improving the legislative/regulatory and institutional framework for integration into the regional electricity market**

The measure to improve the regulatory and institutional framework for Montenegro's integration with the regional electricity market is rolled over from the previous ERP and directly linked to the connectivity reform agenda agreed at the 2015 Vienna Summit. There was limited implementation of the 2018 activities, which focused on aligning national legislation with the relevant EU *acquis*, and most of the 2018 activities have been rolled over into 2019. Although 2020 and 2021 activities have now been included, they have not been well prepared. While the focus of this measure does now include implementation of the relevant legislation under the third energy package, important details are lacking.

### **Measure 3: Creating an efficient and independent rail transport regulatory and safety authority**

The liberalisation of the transport market is deemed to be key in raising the country's competitiveness and long-term growth potential. Limited implementation of activities in the previous year for this measure did not generate the expected results as required amendments to the Law on the railways are still in the drafting phase and have been postponed until 2019. While the planned legislative amendments provide for alignment with the EU *acquis*, the consecutive implementation and re-focusing of the Rail Directorate towards safety and regulation in rail transport is a major undertaking. The measure recognises some of the risks associated with the new regulatory responsibilities. However, the magnitude of required training, mentoring and twinning is underestimated. The adequacy of the resources allocated to this measure (EUR 315 000 annually) is yet to be verified against the planned changes. This measure alone is not sufficient to achieve the complete opening of the railway market. More time and complementary measures are needed to increase transparency, facilitate economic activity and create the confidence needed to attract private sector investments.

### **Measure 4: Supporting investment to develop and modernise the industrial sector**

This measure, which was already part of the ERP in 2016, 2017 and 2018, aims to ensure continuous improvement of industrial development. It is a combination of two measures under industrial sector development laid down in the 2018-2020 ERP. In 2019, support is envisaged under two discrete components, the first focusing on creating new jobs, and the second on investment in manufacturing equipment. While the second component contributes to industrial modernisation and thus to greater competitiveness, the first component is not linked to any increase in productivity or efficiency and its very sustainability is questionable. The expected impact on competitiveness and increase in the industrial production would stem almost exclusively from the second component.

### **Measure 5: Supporting investments in the food production sector in order to reach EU standards**

The measure to invest in the food production sector to help companies achieve EU standards is essential for the agricultural sector to become more competitive. The level of public support in this area is steadily increasing, and Montenegro has prepared measures to provide more farmers with access to credit, which will help the support scheme to be effective. Montenegro is also encouraged to make faster progress in obtaining EU export accreditation for exports of animals, products of animal origin and food products. While it is important to reduce import dependency and increase exports, Montenegro has identified tourism as an important market for its agricultural products. The additional IPARD measure on diversification of agricultural activities, including agro tourism, will contribute to achieving this goal.

#### **Measure 6: Diversifying tourist products**

The priority measure to diversify the tourism sector was rolled over from 2018 and the description of the measure remains (almost) the same. The measure remains formulated as an objective rather than as a reform with clear and targeted activities. The planned activities now make sense following last year's clarification that the measure aims to present a regular grant scheme that would mobilise local-level initiatives to make tourism in the north of the country more attractive. However, some segments (implementation, expected impacts) require further clarification. The introduction of key performance indicators (e.g. increase number of tourists and overnight stays) tries to establish a correlation with the expected impact (which depicts tourism employment trends as a whole), but more work on the indicators is needed. The budgeting of the measure is unclear when compared with the much higher amount allocated (but mostly unspent) from last year.

#### **Measure 7: Strengthening prudential oversight and the bank resolution framework**

Montenegro presented this measure as the response to Policy Guidance 3 specified in the Joint Conclusions of the Economic and Financial Dialogue of May 2018. However, it is *de facto* a rollover of refocused measures from the 2018-2020 ERP. The measure is relevant and important, but it is not clear why the adoption of the Law on credit institutions and the Law on rehabilitation of credit institutions have been delayed and why secondary legislation for these laws is expected to be adopted only in 2020. A clear framework for the implementation check at the credit institutions level would be recommended.

#### **Measure 8: Implementation of the new regulatory framework for PPP policy and amendments to the Law on concessions**

This measure is a follow-up to Policy Guidance 5 specified in the Joint Conclusions of May 2018. The adoption of the two laws is planned for 2019. The implementation of these laws will have a very significant impact on the long-term competitiveness of the economy and growth potential. It would create a basis for further development, making it easier for Montenegro to target projects for which state institutions and bodies would transfer responsibility to the private sector, thus boosting the economy's attractiveness. To make these laws more effective, Montenegro should adopt a comprehensive legislative and strategic framework in this area. In addition, a human resources needs assessment should be developed as expertise in this area is lacking. Sufficient funding and time are needed to train both the public and private sector in this field in a way that goes beyond simple introductory training.

#### **Measure 9: Adoption and implementation of the Law on administrative charges**

This new measure represents one of the most significant developments in the area of business environment in the last several years. For years, all business associations have been stressing that high, numerous and often-changing administrative taxes negatively affect the predictability of the business environment. If adopted in the proposed form, the Law would contribute to creating a better environment for existing and new businesses, eventually making the economy more competitive. The Law also provides the legal basis for the electronic payment of administrative taxes and the electronic submission

of proofs of payment. Out of 659 local taxes, 7% will be abolished, while 11% will be decreased. This is an important step in improving the overall context of doing business in Montenegro.

**Measure 10: Adoption of the Law on electronic fiscalisation in the sale of products and services and the implementation of the electronic fiscal invoice system**

This measure was already part of the ERP in 2016, 2017 and 2018. The draft of the law was prepared in 2018 and a public debate was organised, but no further steps were taken due to potential issues over technical implementation. The measure is relevant for competitiveness and should lead to a reduction in the informal economy, as data from electronic cash registers will be linked with data on taxes and contributions paid. Taking into account the assistance provided to Montenegro through a project funded by the World Bank loan, there is a good chance that this measure will finally start to be implemented in 2019, with the adoption of the Law. Full implementation is planned for 2021.

**Measure 11: Improving support for the micro, small and medium enterprise sector**

This measure was already part of the ERP in 2016, 2017 and 2018. It is relevant and important for increasing the competitiveness of Montenegrin SMEs and the entire economy, as well as for economic growth. In 2019, support to the MSME sector is to include further improvements in the provision of financial assistance to: (i) strengthen innovation and cluster development; (ii) introduce international standards; (iii) strengthen support for business creation; and (iv) reduce the number of failed businesses. In addition, the Investment and Development Fund of Montenegro plans to implement credit guarantees under the LGF COSME programme and to promote and strengthen the investment readiness of innovative start-ups in order to improve the use of the Enterprise Innovation Fund within the Western Balkans Enterprise Development and Innovation Facility. The key performance indicators should focus on expected outcomes rather than output (number of grants, trainings etc.).

**Measure 12: Improving the legislative and regulatory framework with aim to reduce the costs of deploying high-speed electronic communications networks**

The measure has been rolled over from the 2018-2020 ERP and responds to Policy Guidance 4 of the Joint Conclusions of May 2018. Montenegro advanced its preparations for legislative alignment with Directive 2014/61/EU, but adoption of the law has been delayed until the end of 2019, while full implementation is planned only for 2021 and is dependent on the timely implementation of the Law on spatial planning and construction of structures. A discrepancy remains between the planned entry into force of the respective national law in 2021 and Montenegro's 2020 goal of 100% broadband availability, even if partial implementation could be envisaged earlier on the basis of mapping national broadband infrastructure.

**Measure 13: Strengthening the national innovative ecosystem**

The measure to strengthen the national innovation ecosystems includes four components offering financial and non-financial support for research and innovation for businesses and the scientific community. The measure responds to Policy Guidance 4 of the 2018 Joint Conclusions. The grant scheme, which is designed to stimulate cooperation between scientific and business sector, is likely to bring benefits to the Montenegrin economy as it is comparatively well resourced (i.e. the budget complements the contribution by external donors) and such measures have proven relatively successful in the past as they address a genuine need. The Podgorica Science and Technology Park is fundamentally a good idea as long as it is managed competently and supported by the authorities to ensure it attracts users through various incentives. The support to innovative start-ups and regional centres of excellence is much more difficult to assess as the description provides only limited information on what is actually intended and how it will be implemented. The key performance indicators could become more specific and

oriented towards the desired outcomes. Overall, the budget contributions and policy orientations are in line with national and EU-level sector policies.

**Measure 14: Implementing the trade facilitation measures set out in the WTO Trade Facilitation Agreement and in CEFTA Additional Protocol No. 5**

The measure defines more narrowly the trade facilitation measures laid down under CEFTA Additional Protocol 5 and the 2018 national trade facilitation strategy from the more general 2018-2020 ERP measure. In particular, it focuses on reducing customs clearance procedures, relying primarily EU funding, both national and regional. While implementation of the measure in terms of the procurement of the necessary IT equipment looks realistic, the implementation of the Authorised Economic Operator (AEO) programme may face some delays as the new decree is yet to be adopted, and needs to be followed by validation missions for the mutual recognition of the AEO programme. The measure rightly identifies the main bottlenecks in the area, but overly relies on the ongoing and planned EU assistance projects. Apart from that, success of the measure greatly depends on beefing up capacities in the customs administration, but also on private sector flexibility.

**Measure 15: Development of qualifications and education curricula in accordance with the labour market needs**

The measure is relevant for improving education outcomes. However, the measure continues the actions carried out in previous past years (development of new curricula and teachers training), without building-/following-up on its results. No focus is placed on monitoring and evaluation, which is a persistent weakness. Given that the measures are a continuation of previous years, there is no build-up on their implementation in terms of upgrading and proceeding based on outcomes, results and monitoring. The limited application of forecasting tools for future skills and employers' needs, as well as career guidance and counselling continue to be a bottleneck for fast transition between school and work.

#### **Measure 16: Implementation of apprenticeships with employers**

The measure is relevant for improving the school-to-work transition. Under the measure, apprenticeships in vocational education and training (VET) would continue within the newly introduced dual education system. However, there is no planned mitigation of risks, particularly for the possibly lower numbers of students enrolled in the programmes and the potential diminished interest among employers. The number of students expected seems overly optimistic. Career guidance services for learners should also be highlighted and incorporated into the reform, in order to provide independent professional counselling to students.

#### **Measure 17: Support for self-employment and strengthening of local employment initiatives**

The measure is appropriate as an employment support measure and active labour market policy measure but does not constitute a structural reform measure addressing a key structural challenge on the labour market. The measure provides for self-employment grants planned under the IPA 2015-2017 sector operating programme. The description of activities is weak, while the key performance indicators focus on output rather than performance, and the question of effectiveness and contribution to growth is very difficult to assess. While the diagnostic behind the measure focuses on the lack of job creation, it is unclear how the measure will address this (as the lack of financing is only one of many structural obstacles).

#### **Measure 18: Development of day-care services for the elderly**

The measure addressing the needs of the elderly is certainly relevant and commendable from a poverty reduction and social welfare policy perspective. However, it is likely too narrow to have any comprehensive impact on poverty rates among older people or on the deinstitutionalisation of social care provision. There is no link between the diagnostic and the measure proposed; therefore, it is also not clear what structural bottlenecks are meant to be addressed. The rationale behind the measure's contribution to the labour market as a job generator is questionable.

#### **Measure 19: Incentive for including children in sports activities**

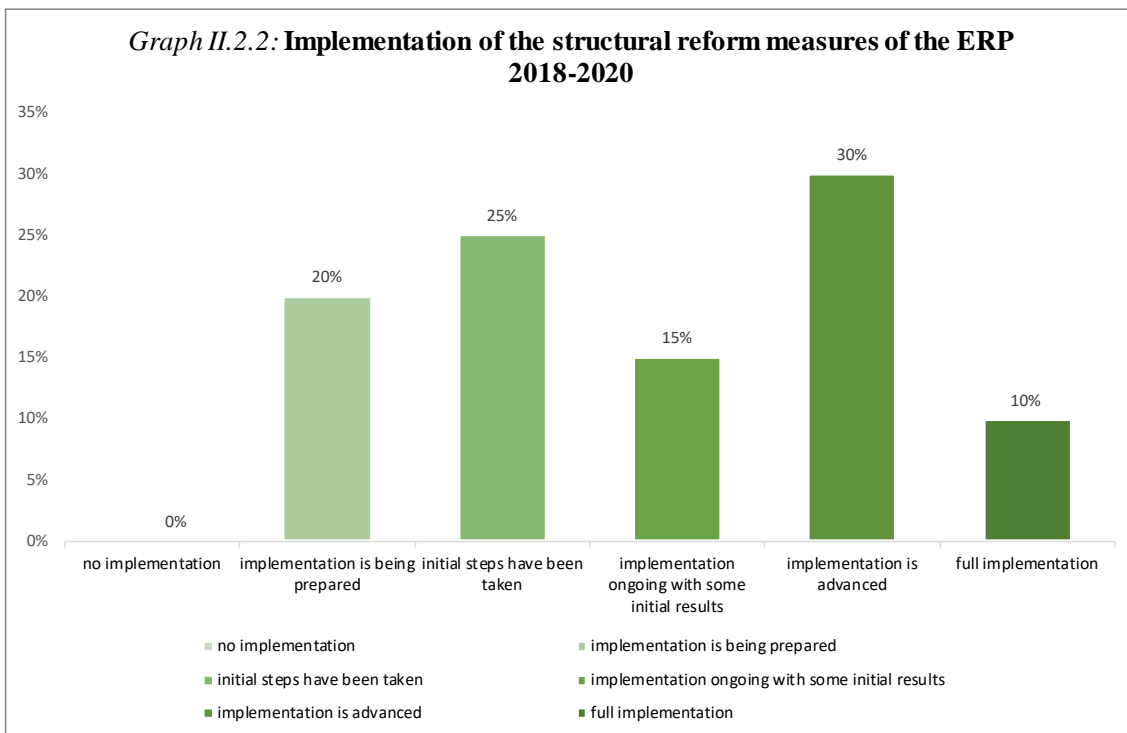
The measure promoting sports activities among young people is commendable for its intended effects on the wellbeing of the young. However, its effective impact on overall competitiveness and social inclusion will most likely be limited. There is no link between the diagnostic and the measure proposed and it is unclear in what way the measure represents a structural reform measure addressing a key structural challenge in social policy.

**ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM ERP 2018-2020**

There was a moderate progress on implementing the measures in 2018, with an average score of 3.1 out of 5. The reporting on the activities is mostly of a good quality. As partial or complete scores were missing for three priority reforms, these have been calculated by the Commission. To provide a fair picture of the level of implementation, some adjustments to the scoring of activities were made for five other reforms, based on the description of the implementation and explanations covered by the table, as well as the Commission’s own research.

Implementation has been stronger for some measures, such as measure 6 on supporting the development and modernisation of the industrial sector, and measure 13 on improving non-financial support to SMEs.

Implementation has been weaker for other measures, such as measure 2 on improving regulatory and institutional framework for integration into the regional electricity market, and measure 7 on supporting investments in the food production sector. Implementation was particularly weak for measures 3 and 15 — adopting secondary legislation on a single window for formalities in maritime transport and establishing a Science and Technology Park in Podgorica.





## ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Montenegrin Government adopted the 2019-2021 Economic Reform Programme on 24 January 2019 and submitted it to the Commission on 31 January 2019.

### *Inter-ministerial coordination*

The preparation of the 2019 ERP was centrally coordinated by the Office of the Prime Minister and the Ministry of Finance. An inter-ministerial working group involved all relevant ministries. The high-level Competitiveness Council, chaired by the Prime Minister, continued to monitor the implementation of the ERP structural reform measures and the joint policy guidance.

### *Stakeholder consultation*

A draft ERP was made available online from 12-31 December 2018 for a public consultation. The authorities organised a roundtable discussion on 24 December. No business associations or civil society organisations participated in this event. Annex 3 includes the comments provided by one stakeholder, the Union of Free Trade Unions of Montenegro. The ERP was not discussed separately in the Social Council. There was also no prior consultation on the design and selection of measures. The draft ERP was discussed in the Parliamentary Committee for Economy, Finance and Budget on 27 December.

### *Macro framework*

The programme presents a reasonably comprehensive picture of past developments. The information provided is concise and well structured. The quality of translation has improved too. Statistical tables are more complete than in the past with almost all the relevant data covered, but weaknesses remain, for instance on the balance of payments' capital and financial account table. The macroeconomic framework is coherent, consistent and sufficiently comprehensive, and provides a good basis for policy evaluation and discussions. Overall, the quality of this part of the ERP has improved compared to previous years' programmes.

### *Fiscal framework*

The fiscal framework is detailed, in line with stated policy objectives, and consistent with the macroeconomic framework. The factors behind projected revenues are presented clearly, but the expected effect on the budget of economic growth, discretionary measures and tax administration reform are not sufficiently quantified. There is scope for better description of expenditure measures and their anticipated budgetary impact. Fiscal reporting standards remain weak and do not meet ESA2010 requirements.

### *Structural reforms*

The structural reform Sections (4, 5 and 6) follow the guidance note. The overall reporting on the implementation of the Policy Guidance for 2018 is vague and some of the recommendations are not addressed at all. Reporting on the structural reform measures from the 2018-2020 period is generally both sufficient and up-to-date, albeit with some errors and important details missing. The number of reform measures in 2019-2021 ERP is limited to 19 and the page limit for Section 4 is respected. The structure of the reform measures is good in terms of scope and timeline and, to some extent, in terms of budget for activities planned. Some of the proposed key performance indicators focus on measuring administrative output rather than the results of the proposed measures. Tables 9-11 of the annex have been submitted and are filled in appropriately.

## 3. NORTH MACEDONIA

### 3.1. EXECUTIVE SUMMARY

**Economic growth resumed in North Macedonia in 2018 and the outlook is now positive.** Driven by strong exports and robust consumer spending, real gross domestic product (GDP) increased by 2.7% in 2018. However, investment continued to decrease. Thanks to an improved domestic environment, as the political crisis has receded and the positive outlook for negotiations to join the EU becomes firmer, the Economic Reform Programme (ERP) expects growth to increase sharply from 3.2% in 2019 to 5.0% in 2021, driven mainly by domestic demand. However, this optimistic scenario carries significant risks. In particular, as the external environment might deteriorate more than expected, and import growth might increase more than expected due to rising domestic demand, the growth contribution from the external balance could be lower. The projected strong pick-up in investment might be compromised by a low implementation of planned public infrastructure works, and by a low impact of the increased financial support for private investments.

**A number of policy reforms support fiscal consolidation, but this may not be enough to stabilise debt in the long-term.** The ERP expects the general government primary deficit to decrease from 1.7% of GDP in 2019 to 0.7% in 2021. However, the intended consolidation measures have many implementation risks. Strengthening fiscal sustainability would require further efforts to mobilise revenue and make policy changes that generate savings, including to the pension system. Capital expenditure was heavily cut in 2018, but has been increased significantly in the fiscal outlook. However, it remains subject to serious risks of under-implementation. While there has been further progress on fiscal transparency, the increasing debt burden of public sector companies that operate outside the general government fiscal regime requires closer scrutiny.

The main related challenges include:

- **Stabilising public debt by lowering primary deficits while safeguarding growth-enhancing capital expenditure.** Fiscal consolidation requires stringently implementing adopted and planned measures on pensions, income taxes and streamlining social assistance. Additional measures that could speed up debt reduction include (i) improving revenue collection; (ii) reducing tax exemptions; (iii) putting in place a more transparent state aid framework; and (iv) further reforms to the pension system. However, fiscal adjustment must not come at the expense of investment in public infrastructure and education. Debt stabilisation needs to be anchored in a strengthened fiscal governance framework. This involves adopting the new organic budget law, which would provide for fiscal rules and a proper medium-term budget framework.
- **Improving the transparency of off-budget bodies tasked with major public sector infrastructure projects.** Public companies that would, according to international statistics standards belong to the general government sector are currently not included in the general government fiscal data. Since they implement substantial infrastructure projects financed by government-guaranteed loans, including them in the government's fiscal accounts would provide a more accurate picture of public finances.
- **Domestic companies are not sufficiently integrated into global value chains. This denies them lucrative opportunities and hampers their and the economy's productivity and competitiveness growth.** Further awareness should be raised on the underlying causes of inefficient inclusion of domestic companies in global value chains. Notably, the need to: (i) improve the overall business climate, making rules more transparent and user-friendly; (ii) improve entrepreneurial skills and financial literacy in SMEs; and (iii) develop a more competitive services sector.

- **The size of the informal sector continues to be a challenge for the business environment as it creates unfair competition from unregistered companies.** It limits the opportunities of formal businesses to expand and invest in further development, innovation and productivity. Undeclared revenues and work also harm public revenue collection and reduce the opportunities associated with formal employment, including job security and safety at work. Due to its complex character, reducing this sector will require a fine balance of formal enforcement and other carefully designed measures to remove the underlying incentives for informality.
- **A reform of all levels of the education system is crucial to boost the labour market.** This should include primary school to higher education, vocational educational training (VET), lifelong learning and validation of non-formal and informal learning (VNFIL). This should particularly benefit young people, women and less represented ethnic groups who experience high unemployment and inactivity rates especially in underdeveloped regions. Long-term unemployment affects low qualified people in particular. A large proportion of workers with low qualifications are affected by informal and precarious employment and they are more likely to move countries to find work. Reforms are underway to address the difficult transition from school to work and skills mismatches.

**The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2018 has been partially implemented.** The government adopted a number of reforms which are expected to underpin fiscal consolidation, in particular regarding pensions, social assistance, and the introduction of progressive taxation. The government also cleared a substantial amount of unpaid liabilities. It continued to improve fiscal transparency by further enhancing fiscal reporting, such as on budget users' arrears. However, essential measures to improve budget planning and fiscal discipline, such as a proper medium-term budget framework and fiscal rules, are still outstanding, and debt has not been sustainably stabilised.

The government adopted the strategy and the action plan for the formalisation of the informal economy. Steps were taken to clarify the inspectorates mandates by expanding the role of Inspection Council. However, further efforts should be made to strengthen the civil courts' institutional capacity. In response to the difficult context of the labour market, the government decided a reform of the education system. The adoption of the 2018-2025 Education strategy and action plan is based on clear identification of the main challenges and the definition of the priority areas to be addressed within the period. It covers the six pillars of the education system and will require considerable resources and efforts with strong coordination to be effective.

**The ERP sets out reform plans that are broadly in line with the priorities identified by the Commission.** The macro-fiscal framework targets a significant reduction in the primary balance based on durable revenue and expenditure measures. This would support the stabilisation of general government debt. Not all of the planned structural reform measures adequately address more fundamental policy reforms that would alter market conditions and address the underlying causes of obstacles to productivity and growth. Instead, some of the ERP's measures focus on disbursing subsidies to the private sector. Furthermore, the suggested measures lack quantifiable goals and an impact assessment, which could ensure their proper follow up. The introduction of the Youth Guarantee will now cover the whole country with a particular emphasis on underdeveloped regions, with some 40,000 young people covered during the next three years. The reform of the Social Protection system shall be adopted soon.

### 3.2. ECONOMIC OUTLOOK AND RISKS

**The economy recovered in 2018 on the back of strong exports.** After nearly stagnating in 2017, GDP growth is estimated to have risen to 2.7% in 2018, driven mainly by the external balance and supported by robust household spending. Investment contracted, however. Net exports' positive contribution to growth was due to both, stronger exports and lower imports – the latter partly because of the stalled implementation of import-intensive government infrastructure works.

**The ERP expects growth to accelerate significantly between 2019 and 2021 averaging 4.1%.** GDP growth is projected to increase to 3.2% in 2019 (which is 0.3 percentage points (pps) than projected in last year's ERP), to 4% in 2020, and to 5% in 2021. The ERP expects the negative output gap to close in 2020 and to turn strongly positive in 2021, as the rate of GDP growth would exceed the potential growth estimate of around 3%. The main growth driver would be an investment rebound, which would average 5.5% between 2019 and 2021, due to public works being stepped-up. In addition, private investment would benefit from increased government financial support and from an improved business climate as the country progresses on its Euro-Atlantic path. Growth drivers would shift markedly in 2019 from the external balance to domestic demand, although net exports would retain their positive contribution to growth thanks to a continued strong increase in exports.

**The programme presents two alternative macroeconomic scenarios based on what it views as the main risks to growth.** The first scenario presumes lower-than-expected growth in the main trade partner economies. This would lead to lower exports, but also weaker investment. In this scenario, output growth is projected to be lower by an average of 0.8 pps in each of the three programme years. The second scenario assumes delays in investment in infrastructure and equipment. This would also translate into weaker import growth. As a result, annual output growth would be some 0.6 percentage points lower than in the baseline scenario. The ERP does not estimate the impact of the realisation of both external and domestic risks.

**The ERP's baseline assumptions for an investment- and exports-driven rebound of GDP growth seem overly optimistic.** Given last year's steep decline in investment, promising early indicators of investment activity, and the political stabilisation, the government's expectation of an increase in gross capital formation in 2019 of 4.2% seems realistic. However, the subsequent acceleration of investment growth may prove unrealisable. The Resuming public capital spending carries many implementation risks. State aid to private companies, made available under the government's Plan for Economic Growth, had a slow take-up in 2018, and it is uncertain to what extent the financial support measures will attain their goals. External demand might be weaker than expected, and there might be a stronger than projected investment-related pick up in imports, translating into a smaller contribution from the external balance. On the supply side, there are also a number of caveats on the role of foreign direct investment (FDI) as a key pillar of export-driven growth. Some foreign-owned companies seem to have reached the limits of their production capacity, and mention that the shortage of qualified workers limits further extension. Domestic firms could benefit from the presence of FDI to enhance their export potential and slowly increase their integration into global value chains, but there are few linkages between foreign and local companies in the country.

**Consumer prices are expected to remain stable.** Inflation is expected to increase from 1.5% in 2018 to 2% in 2019 and to remain at that level for the remainder of the forecast horizon. These projections seem plausible. Being a small open economy, international price developments determine the country's price level. The programme assumes that oil prices will stabilise after 2019, and that the main increase in consumer prices will be from commodities and food prices. The programme also expects rising pressures from increasing domestic demand, which is plausible considering the expectations that output growth in 2020 and 2021 will be above potential.

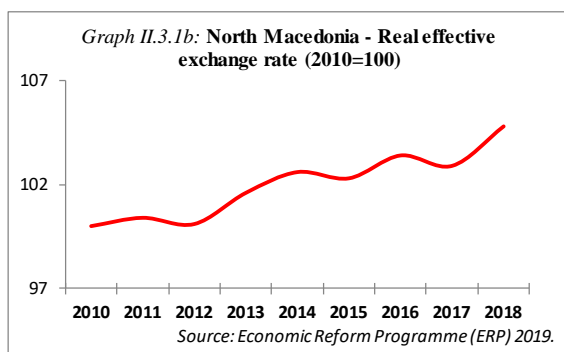
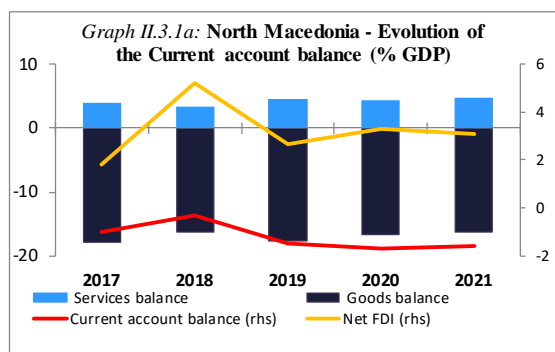
Table II.3.1:

**North Macedonia - Comparison of macroeconomic developments and forecasts**

	2017		2018		2019		2020		2021	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
<b>Real GDP (% change)</b>	0.0	<b>0.2</b>	2.1	<b>2.8</b>	2.8	<b>3.2</b>	3.1	<b>4.0</b>	n.a.	<b>5.0</b>
<i>Contributions:</i>										
- Final domestic demand	0.6	<b>0.3</b>	1.3	<b>0.6</b>	3.3	<b>3.0</b>	4.0	<b>3.6</b>	n.a.	<b>4.1</b>
- Change in inventories	-0.4	n.a.	0.1	n.a.	0.0	n.a.	0.0	n.a.	n.a.	n.a.
- External balance of goods and services	-0.2	<b>-0.1</b>	0.7	<b>2.2</b>	-0.5	<b>0.2</b>	-0.9	<b>0.4</b>	n.a.	<b>0.9</b>
<b>Employment (% change)</b>	2.4	<b>2.4</b>	2.2	<b>2.0</b>	2.2	<b>2.1</b>	2.1	<b>2.2</b>	n.a.	<b>2.6</b>
<b>Unemployment rate (%)</b>	22.4	<b>22.4</b>	21.3	<b>21.2</b>	20.6	<b>20.1</b>	20.1	<b>19.1</b>	n.a.	<b>18.1</b>
<b>GDP deflator (% change)</b>	3.5	<b>3.4</b>	1.5	<b>3.7</b>	2.4	<b>2.4</b>	2.1	<b>2.4</b>	n.a.	<b>2.4</b>
<b>CPI inflation (%)</b>	1.3	<b>1.4</b>	1.6	<b>1.5</b>	2.0	<b>2.0</b>	2.1	<b>2.0</b>	n.a.	<b>2.0</b>
<b>Current account balance (% of GDP)</b>	-1.3	<b>-1.0</b>	-0.7	<b>-0.5</b>	-0.9	<b>-1.5</b>	-1.5	<b>-1.7</b>	n.a.	<b>-1.6</b>
<b>General government balance (% of GDP)</b>	-2.8	<b>-2.8</b>	-2.8	<b>-2.2</b>	-2.6	<b>-3.0</b>	-2.3	<b>-2.3</b>	n.a.	<b>-2.0</b>
<b>Government gross debt (% of GDP)</b>	39.3	<b>39.5</b>	42.2	<b>41.0</b>	44.5	<b>43.3</b>	45.7	<b>43.2</b>	n.a.	<b>41.4</b>

Sources: Economic Reform Programme (ERP) 2019, Commission Autumn 2018 forecast (COM).

**The country's external position has improved and appears to be sustainable.** The current account deficit narrowed in 2018 to 0.3% of projected GDP, which is lower than the previous year's projection, thanks to the improved trade balance. According to the programme, the current account deficit will widen again in 2019 to 1.5% of GDP, and will remain at about that level for another two years. The projected deterioration is less severe than previously anticipated. It is expected to be driven by a slightly widening deficit in the primary income, reflecting an expected increase in foreign investors' capital income, and lower secondary income from remittances. Still, the expected extent of current account deterioration seems large, and not in line with the projections for its components. The merchandise trade deficit is expected to remain largely stable at 16-17% of GDP. Risks to this projection arise from potentially overestimated export and underestimated import growth, the latter also resulting from the ERP's expectation of a decline in the oil price and thus the energy trade deficit, which makes up about one third of the current account shortfall. In all three years, the current account deficit is projected to be more than covered by FDI inflows. However, recent and projected further raises in minimum wages, which are now at about half the average wage, pose a risk to external competitiveness against the background of stagnant labour productivity, in spite of government support to labour-intensive industries. Following a sizeable increase in 2018, gross external debt is expected to rise further in 2019 and to decline thereafter, to 77.1% of GDP in 2021. The decline would result from lower public sector external debt, even though borrowings by public enterprises are expected to rise further also in 2020 and 2021. Compared to 2017, external debt would still be higher by 3.8 pp in 2021.



**The banking sector improved its resilience and lending picked up further.** The financial sector is dominated by banks, even though their share in total financial sector assets has dropped somewhat in

recent years. The banking sector concentration remains high and unchanged compared to previous years, with some 58% of assets held by the three biggest banks. Liquidity is abundant, in spite of accelerated growth in lending to the non-financial sector in 2018 (7.6%, up from 5.9% in 2017). Liquid assets account for about one third of total assets and cover more than half of short-term liabilities. The capital adequacy ratio rose further in the first half of 2018, to well over twice the regulatory minimum of 8%. Banks' profitability jumped markedly, compared to the previous year. The quality of banks' assets improved in 2018: the share of non-performing loans (NPL) in total loans to the non-financial sector (including the impact of mandatory write-offs) decreased by 1.1 pp year-on-year, to 5.2% at the end of the year. The decrease is mainly due to the collection of non-performing claims in the corporate sector. Risks to banks' solvency are contained by the high provisions covering NPLs. Lending growth is still largely driven by household loans, but credit to non-financial enterprises picked up significantly in 2018. The share of deposits in euros is still high, which complicates the central bank's efforts to incentivise lending in national currency.

*Table II.3.2:*

**North Macedonia - Financial sector indicators**

	2014	2015	2016	2017	2018
<b>Total assets of the banking system (EUR million)</b>	6511	6878	7233	7513	8187
<b>Foreign ownership of banking system (%)</b>	76.2	74.8	75.0	74.4	72.9
<b>Credit growth</b>	10.0	9.6	6.5	5.4	7.3
<b>Deposit growth</b>	10.5	6.4	6.1	5.0	12.1
<b>Loan-to-deposit ratio</b>	88.1	90.6	87.0	87.7	86.2
<b>Financial soundness indicators</b>					
- non-performing loans	10.8	10.3	6.3*	6.1*	5.0
- net capital to risk-weighted assets	15.7	15.5	15.2	15.7	16.5
- liquid assets to total assets	29.8	28.2	28.9	27.1	26.7
- return on equity	7.4	10.4	13.6	13.5	16.0
- forex loans to total loans (%)	49.4	46.5	44.9	42.5	41.4

\* including the impact of write-offs.

Sources: National Central Bank, Macrobond.

### 3.3. PUBLIC FINANCE

**The budget deficit narrowed in 2018 on the back of a severe decline in capital spending.** The general government deficit improved, decreasing from 2.8% of GDP in 2017 to 1.8% in 2018. This was mainly the result of the government's re-evaluation of ongoing construction projects and of implementation delays, which lowered capital spending by 1.4% of GDP compared to 2017. Fiscal performance was supported by higher tax revenue (+9.3%) and social contributions (+6.9%). Overall revenue collection improved by 4.9% year-on-year, but remained below budget. Current spending increased by 6.4%, as the government stepped up social transfers and subsidies. A supplementary budget, adopted in November, was used to reallocate funds budgeted for capital expenditure to municipalities to allow them to pay off a sizable part of their arrears, amounting to 0.5% of GDP.

**The 2019 budget assumes a larger deficit with increasing revenues and much higher capital expenditure.** The 2019 deficit target (3% of projected GDP) is 0.5 pps higher than projected a year earlier, mainly on account of the expected clearance of arrears by municipalities, amounting to some 0.4% of GDP. It assumes an increase in total government revenue by 11.8% over the 2018 outcome. A number of reforms enacted in 2018 are expected to increase revenues. Firstly, the introduction of

progressive income taxation is projected to add some MKD 1.4 billion, or 0.2% of GDP. Secondly, an 0.4 pps increase in the pensions contribution rate, and an 0.1 pps increase in the health insurance contribution rate are expected to raise some MKD 2 billion (equivalent to 0.3% of GDP, including savings from the introduction of CPI-only pensions indexation). On the expenditure side, on-budget capital investment is set to increase significantly, by 1.7 pps as a share of GDP. The programme's projections also incorporate a 5% rise in public sector wages as of September 2019; the fiscal impact from the social assistance reform (some 0.3% of GDP in 2019), including the introduction of a means-tested guaranteed minimum income and the phasing out of some non-targeted allowances; and stepped up financial support to private investments under the "Plan for Economic Growth".

Table II.3.3:

**North Macedonia - Composition of the budgetary adjustment (% of GDP)**

	2017	2018	2019	2020	2021	Change: 2018-21
<b>Revenues</b>	31.0	31.2	32.2	31.4	30.4	-0.8
- Taxes and social security contributions	26.8	27.2	27.7	27.3	26.6	-0.6
- Other (residual)	4.2	4.0	4.5	4.2	3.8	-0.2
<b>Expenditure</b>	33.9	33.4	35.2	33.7	32.4	-1.0
- Primary expenditure	32.5	32.3	33.8	32.4	31.2	-1.1
<i>of which:</i>						
Gross fixed capital formation	4.2	3.2	4.9	4.6	4.6	1.4
Consumption	10.3	10.3	10.5	10.1	9.5	-0.8
Transfers & subsidies	18.1	18.7	18.4	17.8	17.1	-1.6
Other (residual)	0.0	0.0	0.0	0.0	0.0	0.0
- Interest payments	1.4	1.2	1.3	1.3	1.3	0.1
<b>Budget balance</b>	-2.8	-2.2	-3.0	-2.3	-2.0	0.2
- Cyclically adjusted	-2.0	-2.1	-2.2	-2.6	-3.3	-1.2
<b>Primary balance</b>	-1.5	-1.0	-1.7	-1.0	-0.7	0.3
- Cyclically adjusted	-0.6	-0.9	-0.9	-1.3	-2.0	-1.1
<b>Gross debt level</b>	39.5	41.0	43.3	43.2	41.4	0.4

Sources: Economic Reform Programme (ERP) 2019.

**Public stimulus remains an important growth driver.** The government's medium-term priorities are focused on reducing income inequality and the informal economy, and supporting investments. The programme's revenue and expenditure are consistent with the revised Fiscal Strategy. Between 2018 and 2021, the ERP expects the general government revenue as share of GDP to drop by 0.8 pps, due to a lower tax revenue ratio. The revenue ratio is, however, already very low by comparison. In the same period, the programme expects transfers and subsidies to drop by 1.7 pps as a share of GDP. The social assistance reform is projected to lead to budget savings as of 2020, through the streamlining and targeting of transfers, and through the elimination of child allowance for the third child. The government estimates the combined expected benefit from the pensions reform (higher contributions and CPI-only indexation) to be around 0.35% of GDP per year. The primary balance would drop from 1.4% of GDP in 2017 to 0.7% in 2021. As the ERP expects the output gap to close in 2020, the cyclically adjusted primary balance would become strongly expansionary in the programme's last two years.

*Box II.3.1: The 2019 budget*

The 2019 general government budget was enacted by the parliament on 21 December 2018. It targets a general government deficit of 3% of projected GDP, which is 0.8 pps higher than the projected 2018 deficit. The revenue ratio would increase by 1pp, and the expenditure ratio by 1 pps. The main policy measures with a fiscal impact derive from the introduction of progressive income taxation, and from pensions and social assistance reform.

## Main measures in the 2019 budget\*

Revenue measures		Expenditure measures	
<ul style="list-style-type: none"> <li>• Introduction of progressive Income taxation (+0.2% of GDP)</li> <li>• Rise in pensions and health insurance contributions (+0.3% of GDP) (including impact of change in pensions indexation)</li> </ul>		<ul style="list-style-type: none"> <li>• Reform of social assistance, including introduction of minimum guaranteed income (+0.3% of GDP)</li> </ul>	
<b>Total revenue effect</b>	<b>(+0.5% of GDP)</b>	<b>Total expenditure effect</b>	<b>(+0.3% of GDP)</b>

\* Estimated impact on general government revenue and expenditure.

Source: ERP 2019

**Borrowing by public enterprises and upcoming debt repayments challenge the projected debt trajectory.** The programme expects general government debt to increase in 2019 to 43.4%, remain largely stable in 2020, and then decrease to 41.4% in 2021. Due to a rise in the guaranteed debt of public enterprises, in particular the Public Enterprise for State Roads (PESR) which is tasked with the implementation of major road infrastructure projects, from 8.3% in 2017 to 11.8% in 2021, total public debt would climb to 54.5% in 2020, and drop only slightly thereafter. The government's annual gross financing needs are estimated at around 14% of GDP on average between 2018 and 2021, rising to about 17% in 2021 as the third Eurobond (500 million) matures. However, when public companies - in particular the PESR - are included, overall refinancing needs of the public sector are likely to be substantially higher. The government plans to meet these needs in 2020 and 2021 from domestic and foreign sources, complemented by a new World Bank loan in 2019, as well as by drawing down its central bank deposits. Given the recently lengthened maturities of domestic issues, the government has enhanced its potential for domestic refinancing of the maturing external debt. Still, the composition of debt exposes the government to marked interest rate risk, given the high share of short term domestic currency debt. In addition, the continually high share of foreign currency-denominated public debt (over three quarters of the total) creates vulnerabilities in case of exchange rate depreciation.



Box II.3.2: Debt dynamics

The general government debt ratio is expected to rise further in 2019, stay at about that level in 2020, and decline in 2021 to below its 2019 level. The primary balance would contribute the bulk of the debt rise in 2019, but would drive debt levels to a declining degree from then onwards. The share of interest expenditure in the debt dynamics would remain stable for the programme's duration. The contribution of stock-flow adjustments would vary each year, reflecting in large part the expected build-up and drawdown of government deposits at the central bank, in relation with anticipated borrowing and debt repayments.

Table: North Macedonia

Composition of changes in the debt ratio (% of GDP)

	2017	2018	2019	2020	2021
<b>Gross debt ratio [1]</b>	<b>39.5</b>	<b>41.0</b>	<b>43.3</b>	<b>43.2</b>	<b>41.4</b>
Change in the ratio	-0.3	1.5	2.3	-0.1	-1.8
<i>Contributions [2]:</i>					
<b>1. Primary balance</b>	<b>1.5</b>	<b>1.0</b>	<b>1.7</b>	<b>1.0</b>	<b>0.7</b>
<b>2. "Snowball" effect</b>	<b>0.0</b>	<b>-1.3</b>	<b>-0.9</b>	<b>-1.4</b>	<b>-1.8</b>
<i>Of which:</i>					
Interest expenditure	1.4	1.2	1.3	1.3	1.3
Growth effect	-0.1	-1.1	-1.3	-1.7	-2.1
Inflation effect	-1.3	-1.4	-1.0	-1.0	-1.0
<b>3. Stock-flow adjustment</b>	<b>-1.8</b>	<b>1.8</b>	<b>1.6</b>	<b>0.3</b>	<b>-0.8</b>

[1] End of period.

[2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).

The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other effects.

Source: Economic Reform Programme (ERP) 2019, ECFIN calculations.

**Budget projections face sizeable risks calling for more ambitious fiscal consolidation.** There are numerous uncertainties about the programme's expected budget execution and fiscal targets, mainly on the downside. Revenue may remain below budget if GDP growth forecasts prove too optimistic. Assuming the planned scale-up in investment spending happens, attaining the targeted reduction in the primary balance until 2021 would require the government to strictly adhere to the new pensions indexation formula and refrain from ad hoc pension increases. The expected budget savings from the social assistance reform in 2020 and 2021 depend on the swift adoption and entry into force of the new law, which will generate savings, including by reforming the rules on parental allowance. The expected budgetary developments may also be affected by the untransparent administration of the new state aid regime, which may lead to higher than budgeted expenditure for subsidies. However, the momentum of the expected robust economic growth could be used for more ambitious fiscal consolidation to stabilise public debt levels. This would entail targeting a primary balance, particularly through additional revenue-increasing measures, such as more efficient tax collection involving an improvement in the Public Revenue Office's capacity, and more inspections. To this end, the swift adoption of relevant measures (Tax System Strategy; Inspections Law) is necessary.

*Box II.3.3: Sensitivity analysis*

**The programme includes a sensitivity analysis of the fiscal deficit with regard to three parameters.** In case economic growth is lower than expected in the baseline scenario, by 1pp annually on average, the budget deficit would increase by an average of 0.5 pps per year. Lower capital expenditure (75% realisation) would imply a reduction in GDP growth by 0.6 pps per year, and an increase in the deficit by 0.3 pps; reduced tax collection by 5% per year would increase the deficit by 0.9 pps. The programme also assesses the potential impact on public debt developments from higher interest rates and depreciation of the local currency against the baseline scenario.

**The government has further increased the transparency of public finances, but it needs to improve information on public enterprises and on state aid.** After publishing the amount of budget users' unpaid liabilities, the government has made significant progress in clearing its arrears, and has speeded up outstanding VAT reimbursements. The amount of publicly available fiscal documentation has increased further, and a law that will enable the government to further increase the available public data is due to be passed by parliament. However, the expected sizeable increase in public enterprises' guaranteed debt, which could result in potential liabilities for the government, calls for increased transparency on the financing of these operations, in particular including extra-budgetary units in fiscal documentation where required by international statistical standards. The transparency of the new state aid regime also needs to be improved, in particular by creating a central state aid registry. Furthermore, improvements to the fiscal framework are still pending. This concerns in particular the adoption of the new organic budget law, which sets out fiscal rules. In order for these to fully deliver the intended benefits, a proper medium-term budget framework, more realistic macroeconomic forecasts, and better control of expenditure commitments need to be put in place.

### 3.4. STRUCTURAL CHALLENGES AND REFORM PRIORITIES

This chapter provides the Commission's independent analysis of North Macedonia's economy and identifies the main structural challenges. Each of these challenges influences the overall competitiveness in its own way. However, as the challenges are very often mutually reinforcing, it will be essential to address them in the medium-term to boost competitiveness and inclusive growth. The three most important challenges identified are: (i) addressing youth unemployment, (ii) integration of domestic companies in global value chains and (iii) formalisation of the economy. The informal economy distorts competition, decreases the quality of the business environment, decreases public revenue and leaves some workers without social protection or with limited rights. By failing to integrate with global value chains, domestic firms are missing lucrative opportunities and the ability to increase their productivity, learn from best practices and in such a way positively influence the country's trade balance, growth and competitiveness.

#### 3.4.1. Key challenges

***Key challenge #1: Addressing youth unemployment***

**Labour market remains characterised by overall low activity and employment and high unemployment.** Both youth unemployment and long-term unemployment are a prominent issue in underdeveloped regions, especially affecting low qualified and less represented ethnic groups. Young

people are exposed to poor and lengthy transitions from school to work largely due to a weak education system starting from early childcare and primary school. Ensuring a high quality education for all and improving the educational infrastructure and curricula as well as the competences of the teaching staff is essential. Low awareness of the population of the need to acquire qualifications by participating in the lifelong learning process remains an issue. The contribution of employers in training programmes is critical in addressing employment gaps and high level of unemployment.

***Key Challenge #2: Integration of domestic companies in global value chains***

Strong integration in global value chains (GVC) would provide North Macedonia with the opportunity to raise economic growth, employment and wages, in particular for skilled workers. These networks trade parts and tasks produced in multiple locations that often cross borders multiple times before they are assembled as final products. GVCs operate in a predictable sequence, with each stage of production depending on the previous one creating a stable relationship. Integrating into GVCs can therefore benefit the domestic economy more than standard trade transactions because they are more likely to persist. This in turn provides an opportunity for domestic companies and the economy as a whole to absorb technology, skills (including managerial and entrepreneurial competences) and production standards.

Attracting foreign direct investment (FDI) has been central to the government's economic policy for many years, partly as a way to integrate in GVCs. North Macedonia is among the most open economies to FDI and scores better than the OECD average on regulatory restrictiveness to investments <sup>(11)</sup> (OECD, 2016). However, the policy of attracting FDI has mainly involved establishing special economic zones (SEZ) offering incentive packages for foreign companies. As of 2016, the government had granted EUR 225 million in the form of investment incentives to 25 foreign investors employing a total of 20 000 workers (World Bank, 2018). In spite of the financial cost, the policies of attracting FDI have not been effective in creating backward linkages between domestic firms and these foreign investors. North Macedonia's FDI has failed to produce spill-over effects for the rest of the economy. Domestic purchases by international investors accounted for just 1% of total exports in 2017 arguing that some foreign investment related policies have resulted in enclave industries having only a few ties with domestic firms.

**Productivity and competitiveness of domestic firms would benefit from enhancing linkages with foreign firms.** In addition to forgoing positive effects on competitiveness, missing the exposure to GVCs through foreign companies deprives the domestic firms of opportunities to strengthen their management capabilities and adopt international quality standards. This would help create a positive feedback loop and lead to further integration in the global economy and result in better access to finance.

The underlying causes of the weak links of domestic companies with foreign producers are complex and there is generally insufficient awareness by policy makers of the obstacles and the motivation of foreign firms to invest in the country. Part of the problem is that the current incentive schemes do not attract the types of foreign producers that could easily integrate with domestic firms. However, more importantly, managers and staff of exporting companies think the issue lies with local suppliers often unable to match the sophistication, technical and safety requirement of imported intermediary products or services. Therefore, this inability of domestic firms to integrate in GVCs is closely linked to overall weaknesses in the business environment.

Businesses cite the lack of entrepreneurial skills and financial literacy in SMEs as their number one concern as it prevents them from innovating, accessing finance, expanding and ultimately making themselves more attractive partners to foreign firms. Even though there is high liquidity in the banking system, banks require high collateral for lending, partly due to the unpredictability and uneven application of the insolvency regime and enforcement of collateral. In financing their working capital and fixed

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<sup>(11)</sup> According to the OECD FDI Regulatory Restrictiveness Index (2016), North Macedonia scores 0.022 compared to an OECD average of 0.067 (0=open, 1=closed).

assets, companies rely heavily on internal funds and retained earnings. Exporting firms highlight that even in cases when support was offered to domestic firms to adjust processes to comply with EU standards, local firms showed little interest (World Bank, 2018). This could indicate different business cultures between the domestic companies and those leading the global value chains, insufficiently skilled labour force as well as weak capacity or motivation to attract and retain talent including adequate management.

Further increasing the efficiency and transparency of inspections and reducing the time and costs of commercial disputes would address the challenges that restrict the competitiveness of domestic companies. Increasing transparency of para-fiscal charges on central and local level would facilitate doing business. Inefficient inspections in North Macedonia reduce companies' productivity. For example, an additional tax inspection reduces productivity by 5.5% for the median firm (World Bank, 2018). The central government has 28 inspectorates with overlapping mandates, subject to as many as 200 laws and employing over 900 inspectors. The Inspection Council, which reports to the central government, supervises inspectorates, but has no power to correct problems. The new Law on inspection supervision has been enacted by the government and aims to address the weaknesses in inspection processes. It is a step in the right direction in streamlining the inspections procedures and improving the business environment and it therefore has a potential to help boost the competitiveness of domestic businesses. The law enables the Inspection Council to resolve issues with inspectorates in a way that is consistent with international practices. The law also envisages warnings for minor infractions and grace periods for corrective actions.

**Developing the services sector is also vital to address the weak integration of domestic companies in global value chains.** Services, such as logistics, transportation and information and communication technologies (ICT) are currently fairly unsophisticated, which forces foreign companies to use alternatives outside the country. Furthermore, the restrictions on regulated professions seem to hinder competition in the services sector. Diversifying into service tasks within GVCs could give the country the necessary to upgrade to more sophisticated products and services while diversifying production and thereby increase export diversification and further increase productivity (learning by exporting).

Rather than tackling these underlying business environment issues, the government's flagship policy to improve domestic firms' competitiveness is to provide various forms of state aid to businesses. Based on the Law on financial support of investments, adopted in January 2018, the support is provided to companies that have procured and installed products from suppliers registered in the country where the final product is intended for export, among other beneficiaries. However, the effectiveness of this policy remains under-investigated and unclear. Further effort should be made to monitor the cost effectiveness of these schemes and ensure coordination of different programmes.

**North Macedonia is encouraged to implement all the aspects of the Regional Economic Area Multi-Annual Action Plan (REA MAP).** The REA MAP is based on EU standards and will facilitate country's integration in regional and European value chains and will also help increase the attractiveness of the economy for FDIs in tradable sectors. Further connectivity with neighbouring countries in transport and energy will further strengthen the access to, and integration in, the regional market. The creation of a regional digital space and of more integrated labour markets with neighbouring economies will offer new possibilities for the country's youth, which is also important in light of the high youth unemployment.

### ***Key challenge #3: Formalisation of the economy***

**The considerable size of the informal economy in output and employment distorts private sector competition.** The informal sector remains extensive both in its share of GDP and in the number of people employed. Different indicators point to between 20% and 40% of GDP, while informal employment represents 18.1% of total employment or around 130 000 individuals (Labour Force Survey, 2016). The country's informal sector takes various forms of which the most prominent are unregistered labour,

undeclared wages and other irregularities in the enforcement of the Labour Relations Act. Hidden salaries are the most acute problem with income being partially or completely undeclared by almost 44% of employees. Other form of informal economy is the practice of not issuing tax receipts or invoices or reporting lower turnover.

**The persistently high informal sector has several underlying causes.** The high unemployment rate (19.6% in Q4 2018) with an extremely high long-term unemployment rate (77.9% of unemployed in 2017) reduces the ability of potential workers to enforce their rights and forces them to accept informal jobs or partly-declared salaries. These undeclared workers are most likely to engage in industries and services where cash transactions are common. The high share of cash in the money supply, due to the factors such as insufficient financial literacy and a historical propensity towards cash transactions, complicates the tracking of transactions and is a cause of informality. In addition, the high tax wedge for low-income groups transitioning from social assistance to formal employment could contribute to the size of the informal sector. Informality is also caused by underlying socio-cultural factors and shortcomings of the welfare system. Ensuring adequate and timely contract enforcement and increasing the transparency of legal changes will increase public and businesses' trust in state institutions. This will then lead to an increased perception of the link between taxes paid and benefits received which will reduce the acceptance of the informal economy and reduce its proliferation. Further increasing the consistency in law enforcement, clarifying the mandates of various inspections, notably on labour law and occupational safety, will also help reduce informality. Further increasing educational attainment and quality could also help decrease informality since individuals with a lower level of education are more prone to undeclared work (80% of employees with university degrees have a written contract versus 56.8% of those with primary education).

**The complex character of informality renders its formalisation challenging.** Enhancing the skills, expertise and powers of tax officials, improving judicial efficiency and ensuring greater independence of inspectors are some key objectives in the fight against the informal economy. However, using negative incentives such as punitive measures and better enforcement could further reduce disposable income and increase labour costs, which could reduce consumer spending, exports and consequently GDP. This could lead to even lower employment and create a vicious circle, so it should be approached carefully and combined with other measures. An additional problem in formalisation is the high level of tolerance for informality among the general population with 21.1% willing to participate in undeclared work in order to get a higher wage (CRPM, 2016). In general, perceived fairness of official rules and norms have significant effect on encouraging voluntary compliance and thus improve tax morale. Therefore, reducing the informal economy in North Macedonia will require finely balancing formal enforcement with other measures designed to remove underlying incentives for informality, such as adjusting the legislation to simplify the establishment and activities of 'self-employed', crafts people, sole proprietors and micro enterprises.

**The informal sector has many negative consequences for the overall competitiveness of the economy and growth.** It creates unfair competition for formal businesses that limits their opportunities for expansion and further investments in their development, innovation and productivity. It also reduces the opportunities associated with formal employment, including job security and safety at work. According to the latest Business Environment and Enterprise Performance (BEEPS) survey (2016), the practices of competitors in the informal sector are seen as the main obstacle for businesses in the country. 56% of companies cite competing against companies in the informal sector as a main challenge, exceeding the average for Southeast Europe by 7 pp.

**The first medium-term strategy for the formalisation of the informal economy (2018–2022) and its related action plan were adopted in 2018.** The action plan includes measures relating to the regulatory and business environment, and on raising the public and businesses' awareness of the importance of formalising informal activities combined with deterrent measures. The strategy was developed using a participatory approach and reflects the latest OECD recommendations. It recognises that deterrent

measures alone are not enough to effectively reduce the informal economy and that there is a need to remove the underlying causes of informality such as weaknesses in the labour market and business environment. However, in order to address these underlying causes and ensure that the wide set of measures and actions is undertaken, the strategy's measures need to be further integrated in other sectors' policies and action plans.

### 3.4.2. Labour market, education and social policies

#### Labour market development

**The labour market is improving slightly, however, considerable gaps remain compared to the EU average.** In 2018, the highest employment rate (51.7%) and the lowest unemployment rate (21%) for people aged 15-64 was recorded since 2007. However, the activity rate has remained nearly unchanged over the past decade, hovering around 65.4% (15-64). Nevertheless, this continued positive trend has large gaps. Youth unemployment, long-term unemployment, female unemployment and regional disparities are among the challenges facing North Macedonia. Long-term unemployment (LTU) in 2017 stood at 17.4% and more than half of long-term unemployed have been seeking employment for four or more consecutive years.

**Young women, the low skilled, young people living in rural areas and less represented ethnic groups are particularly exposed to unemployment or informal employment.** The youth unemployment rate remains a serious problem. It peaked at close to 60% in 2007 but decreased over the years to reach 45.4 in 2018. The employment gap between best performing region (Southeast) and the weakest one (Northeast) remains significant at 25%. The high inactivity rate among women is closely related to educational attainment, which may signal some barriers to employment for women with lower levels of education. 30% of women in the labour force have a university level education compared to 17% of men, however, 12% of men are unemployed compared to 31% of women. Despite some increase in women's employment in the past years, the gender employment gap for people aged 20-64 is 21.9 pps (2017), almost double the EU-28 average. Considering low education levels, men have more than 2 times higher employment rate than women, even if employed women are on average better educated than employed men. The unemployment rate of Roma stagnates around 50% despite labour market improvements and several – largely ineffective – support schemes and policies.

**Low quality employment affects the labour market dynamic and youth employment in particular.** Approximately half of young workers aged 15-24 are in low quality employment. Particularly worrying is the high share of young people (estimated at 35%) in informal employment. A quarter of young people in 2017 (24.6% in Q3 2018) are not in employment, education or training (NEETs). Young people under 30 represent more than one third of all unemployed (37.9% in 2017). Knowledge-based service sectors have grown fast, but their share in employment remains rather low (around 10% in 2017). The issue of young people's emigration from the country is well known but its significance is not yet sufficiently considered by policy makers. Due to their inability to find a regular job elsewhere, in 2017, 13% of all workers were self-employed (EU-28 average: 10%). The share of unregistered employment in total employment is estimated 18.1%, but decreased over the years (by 10 pps since 2008).

**Tackling high youth unemployment is a national priority.** A one-year pilot phase of the Youth Guarantee scheme targeting people aged 15-29 was successfully introduced in 2018 in three municipalities. In 2019, the Youth Guarantee will be extended to the whole country with a particular emphasis on the most underdeveloped regions (Northeast, Polog, Southwest and Prespa) where urgent measures are needed. The Youth Guarantee includes activities to reach out to non-registered NEETs in their direct environment and to connect them to individual services such as counseling, mediation and training. Some 10,000 young people (aged 15-29) are expected to benefit from the Youth Guarantee in the underdeveloped regions which represents one quarter of all beneficiaries in the country. However, the efficient implementation will require a significant effort by the Ministry of Labour and Social Policy, the Employment Service Agency as well the National Youth Council, responsible for the fieldwork activities.

**There is encouraging progress in social dialogue.** Regular meetings of the Economic and Social Council (ESC) contributed to a significant increase in the number of recommendations and opinions to the government. Social partners are involved in the drafting of the new law on labour relations which will include provisions on freedom of association, collective bargaining and strike. The law will further regulate branch collective agreements and facilitate setting up a trade union. The development of Local Economic and Social Councils is expected to be reinforced in 2019. There are plans to increase the number of compulsory consultations of the ESC, but a clear timeframe and the use of output indicators to measure the policy impact is recommended.

*Box II.3.4: Monitoring performance in light of the European Pillar of Social Rights*

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights on equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion to benefit citizens in the EU. Since the 20 principles are essential for countries if they are to achieve fair and well-functioning labour markets and welfare systems, they are equally relevant for candidate countries and potential candidates. The new reinforced social dimension for the Western Balkans includes an increased focus on employment and social reforms through greater monitoring of relevant policies (EC, 2018). The Western Balkans Ministers' Declaration on improving social policy in the Western Balkans (6 November 2018) confirms that they will use the Pillar to guide the aligning of their labour markets and welfare systems with the EU's.

**North Macedonia faces challenges for a number of indicators of the Social Scoreboard <sup>(1)</sup> supporting the European Pillar of Social Rights.** This is particularly the case for equal opportunities and access to the labour market. The employment rate, despite increasing in recent years, is well behind the EU-28 average. The main reasons for such a low performance in activity and employment are the gender gap and youth unemployment.

NORTH MACEDONIA		
<b>Equal opportunities and access to the labour market</b>	Early leavers from education and training (% of population aged 18-24)	Better than EU average, improving
	Gender employment gap	Worse than EU average, deteriorating
	Income quintile ratio (S80/S20)	Worse than EU average, improving
	At risk of poverty or social exclusion (in %)	Worse than EU average, improving
	Youth NEET (% of total population aged 15-24)	Worse than EU average, no change
<b>Dynamic labour markets and fair working conditions</b>	Employment rate (% of population aged 20-64)	Worse than EU average, improving
	Unemployment rate (% of population aged 15-74)	Worse than EU average, improving
	GDHI per capita growth	N/A
<b>Social protection and inclusion</b>	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU average, improving
	Children aged less than 3 years in formal childcare	Worse than EU average, improving
	Self-reported unmet need for medical care	Worse than EU average, no change
	Individuals' level of digital skills	Worse than EU average, deteriorating

The problem is even more pronounced for less represented ethnic groups. The labour force faces strong regional disparities. Informal and precarious work affects a large proportion of workers and one in three young people has only a temporary work contract.

**The Youth Guarantee has been successfully introduced to tackle youth unemployment, which mainly affects the country's poorest region.** It is the main tool for facilitating the school-to-work transition and access to work, particularly for NEETs. It involves strengthening of the Employment Service Agency so that it offers career counselling, orientation and motivation trainings, job search assistance and employment mediation.

**The reform of the social protection system aims to increase coverage.** However, this crucial reform is still under consultation. It aims to cover more of the population in its effort to tackle poverty, which include introducing a guaranteed minimum assistance (GMA) and integrating other associated rights that were previously not accessible. It provides for a set of new laws such as the law for social security of older people or the child

protection law. The success of the social protection reforms strongly depends on modernising the institutions that implement them.

<sup>(1)</sup> The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance (<https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators>). The 12 indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-28 average (performing worse/better/around EU-28 average) and a review of the trend for the indicator based on the latest available 3-year period for the country (improving/deteriorating/no change). Data from 2014-2017 are used.

*(Continued on the next page)*



*Box (continued)*

**North Macedonia has a well-developed statistical system.** The State Statistical Office is the primary producer and coordinator of the statistical system of the country. Since 2004, the Labour Force Survey (LFS) has been carried out as a continuous quarterly survey throughout the year, providing quarterly and annual statistics. The Survey on Income and Living Conditions (SILC) is conducted as a regular annual survey and has been implemented since 2010.

### Social protection system

**The current social protection system excludes those at risk of poverty or social exclusion.** In 2017, 22.2% of the population was at risk of poverty compared to 21.5% in 2015. This increase in poverty is evident among those aged over 65. In addition, almost 40.63% of the country's population living in a household with dependent children was at risk of poverty or social exclusion. This risk affects 71% of households with one single adult with dependent children, significantly higher than the average of 48% for EU-28. Social transfers have almost no impact on alleviating poverty. Social financial assistance is currently only granted under certain conditions, which keeps the most vulnerable people outside the protection system. The coverage is therefore relatively limited and not always adequate.

**The social protection system reform aims to tackle the poverty by covering a larger proportion of the population.** A set of new laws regulating social protection (notably, the law on social protection, law on social security of elderly and amendments to the law on child protection) have been recently put forward for a public debate and will be ready for adoption in the coming months. However, their implementation will require an additional budget. Therefore, a new personal income tax law will introduce progressive taxation. The draft legislation foresees the introduction of a guaranteed minimum assistance (GMA) and integrates other associated rights that were previously not accessible. In particular, the new legislations aims to strengthen the link between financial rights and social services and intends to place more emphasis on activation offers to push people out of the informal economy. The requirement for applicants to be registered as unemployed will be abolished, so that the new system is also accessible to other vulnerable groups such as seasonal and temporary workers. The draft law for social security of older people aims to provide a minimum income to people above 65 that do not receive a pension or other assistance due to insufficient contribution (15 years minimum required) and is expected to cover around 4,000 people. The new child protection law will redefine the child allowance, introduce an education allowance and transform the existing parental allowance for the third child into a one-off benefit for the first, second and third child.

**Cooperation between institutions should be strengthened and increasing their capacity is key for effective implementation.** The success of the social protection reforms depends strongly on modernising the institutions that implement them. This particularly involves adapting the management and information system and ensuring its interconnectedness and improving coordination between social work centres, employment agencies and adult education centres. Increases in staff, training and professionalisation are pre-requisites for providing tailored services for the most vulnerable.

### Education and skills

**The education system does not address inequalities in employment.** For those with a university-level education, the activity rate is above 85% while the rate falls to 34.1% for those with primary and lower secondary education. Regarding gender, the activity rate for women with university-level education is slightly above that for men (86.4% vs 83.9%) but the rate falls to 54.2% for women with 4 years of secondary education compared to 76.4% for men. Moreover, the activity rate of women with incomplete primary and lower secondary education is three times lower than that of men (13.5% vs 40.2%). The 2015 PISA test results were far below the OECD average. They show that a large proportion of young people do not have the basic skills to enter the labour market, in addition to other reasons such as low mobility,

and unattractive wages and working conditions. The latest tracer study on VET and higher education graduates shows that young people are rarely well matched to the jobs they hold early in their career.

**The new 2018-2025 education strategy should be the main tool to overcome the problems that have accumulated in all areas of education. However, it lacks coordination and there are insufficient resources to implement it efficiently.** The new education strategy and action plan (adopted early 2018) cover all fields and levels of education and aims to develop an inclusive and integrated education system by focusing on outcomes instead of on knowledge acquisition in order to make the learning more relevant to global labour market needs. The strategy and action plan seek to address a number of challenges, but they lack specific goals and do not suggest a clear system to monitor implementation, which is divided between different agencies that all lack financial resources. To achieve the strategy's objectives and cover the costs of the action plan, additional contributions from the State budget and from other sources will be necessary. In 2017, education spending amounted to 12.4% of the state budget, compared to 12.1% in 2016.

**The enrolment of children in pre-school education remains very low overall and especially among marginalised communities.** Moreover, the governance and management of pre-school is under the responsibility of different bodies. For primary level, learning accomplishment is critically low as demonstrated by results of the 2015 PISA Survey. For general secondary education, the curricula still contain some outdated lessons. Vocational Education and Training remains insufficiently attractive. The number of vocational subjects in the curricula is the lowest in Europe (about 52% compared to 70% in the EU-28). In addition, the hours spent in practical training are exceptionally low. The programmes are not flexible enough to adapt to swift technological development. The Law on the National Qualification Framework (NQF) was adopted in 2013 but it was only applied as of the end of 2015. The reform of the NQF and the validation of non-formal and informal learning and learning outcomes-based education are ongoing. In 2018, the National Board for Qualification Framework adopted 36 qualifications together with a decision for their allocation at different education levels and the first training sessions for the Sectoral Qualification Councils took place. The country is a full member of the European Qualifications Framework (EQF) and successfully presented the NQF to the EQF in 2016. Since 2014, the country participates in Erasmus+ as a "Programme Country", on the same footing as Member States. The country has access to actions in the field of higher education, youth, sport, vocational education and training (VET) as well as school and adult education projects for cooperation and mobility. North Macedonia can also cooperate with partners outside Europe under international projects. Participation in the lifelong learning system is very low (2.2%) compared to the average for the EU-28 (10.9%).

### 3.4.3. Competitiveness and sectoral issues

#### Business environment

**Weaknesses in the business environment and the large informal sector continue to be main structural bottlenecks to competitiveness and growth.** They affect the productivity and innovation potential of domestic firms preventing them from focussing on integration in global value chains, which is a key challenge for the economy. Since 2004, North Macedonia improved its World Bank 'Doing Business' (2019) ranking by an impressive 70 places and ranked 10th out of 190 countries in 2019. However, while specific indicators making up the overall ranking improved, businesses remain concerned about particular elements of the business environment. Frequent policy changes and red tape are among the top five concerns reported by businesses (BEEPS V, 2016). There is a need to make the regulatory environment more predictable and user-friendly, tackle widespread informality, streamline para-fiscal charges and improve the efficiency of the inspection system.

**The effective application of the rule of law is key for improving the business environment.** Effective and independent judicial systems are a prerequisite for creating an environment that is investment- and business-friendly as they instil confidence throughout the entire business cycle. Effective measures to

further strengthen the rule of law, ensure adequate and timely contract enforcement and increase the transparency of legal changes could positively affect the business environment in North Macedonia and consequently lead to an increase in productivity and competitiveness. Moreover, further decreasing corruption would make the country a more attractive place for doing business.

### Research, development and innovation

**The country is evaluated to be a ‘modest innovator’ and spends less than half a percent of GDP on research and development (R&D).** The European Innovation Scoreboard 2018 assesses the country as a 'modest innovator'. The country's average innovation performance remains below 50% of the EU average, despite slow improvements. This is linked to a very low total rate of R&D expenditure, which amounted to 0.44% of GDP in 2016 (compared to the EU-28 average of 2.1% of GDP in 2018) consisting mainly of public expenditure with minimal private sector input. Public funding for research, development and innovation has accelerated in 2018 through the use of a wider range of support instruments by the Fund for Innovation and Technology Development. However, the impact remains unquantified and unclear and it should be urgently monitored. The country's annual participation in the Horizon 2020 framework programme is increasing, but the overall success rate in 2018 (10.3%) is below the program's overall success rate of 14.9%.

**There is a lack of innovation infrastructure and cooperation and coordination among academia, the private sector and the government.** An integrated research and innovation strategy covering the whole innovation value chain from basic research to business innovation was adopted in 2012, but needs to be updated. There is no detailed assessment of the innovation system or what needs to be done in order to improve the overall governance of innovation at policy and institutional level. Other policy documents in the area, such as strategies on research, higher education and smart specialisation, are also not yet in place.

### Digital economy

The digitalisation of the economy is progressing, but is hampered by the low level of digital skills and high costs of digital services. The proportion of households with internet access increased by 21 pp between 2012 and Q1 of 2018, rising to 79.3% in 2018. Mobile broadband penetration is also expanding and reached 73% in 2018. However, fixed broadband penetration remains limited and negatively impacts competitiveness. According to the OECD Competitiveness Outlook (2018) with regards to digitisation the country scores 2.3 out of 5. In 2018, the government finished mapping the national broadband of existing electronic communication networks, which will enable it to develop its broadband strategy. In 2018 the country adopted the 2018-2022 cybersecurity strategy which provides a coherent and strategic approach to cybersecurity with five main goals: (i) cyber-resilience; (ii) cybersecurity culture; (iii) cybercrime; (iv) cyber-defence and (v) exchange of information and cooperation. It is complemented by a detailed action plan. Both documents demonstrate national authorities' commitment to comprehensively tackling this issue.

**The population's insufficient digital literacy is a significant obstacle to further digitalisation of the economy.** Digital literacy is one of the education strategy's priorities. However, a specific strategy addressing digital skills is still missing. The use of electronic signatures is limited to a few institutions that provide services to businesses. The interoperable system is only used by a few institutions, despite the equipment and software having been installed. E-government is at an early stage of preparation. E-commerce, on the other hand, increased by 62% in 2018. However, some key barriers to e-commerce still have to be removed, including customs duties and VAT on imports for small value items.

### Investment activity

The low investment level and capital stock significantly slow down efforts to increase productivity and the overall competitiveness of the economy. In 2009-2017 investment contributed 1.8 pp to GDP growth and in the same period the investment-to-GDP ratio averaged 29%. In 2018, investment in the country will contribute only 0.4 pp to GDP growth, which is significantly lower than for regional peers <sup>(12)</sup>. In the first three quarters of 2018, gross fixed capital formation was estimated at 27.4%. In 2017, the country experienced a slump in investment spending impacted by a decline in confidence, following the prolonged political crisis. Investment spending did not fully recover in 2018 and remains insufficient in view of the shortcomings in the country's infrastructure and production potential.

**Traditionally, most investments in the country have been private.** The share of public investment in total investment increased in 2009-2017 compared to 2001-2008 (from an average of 22%, to an average of 26%), but this was mainly due to the increase in investment in roads and civilian construction projects. Such projects financed on- and off-budget increased from 28% of total public investment in 2002-2008 to 43% in 2009-2017. Since these areas traditionally have a lower rate of return and a lower multiplication effect on the economy, the overall rate of return on investment in the economy fell to 9.7% in the period 2008-2017 compared to 13% in 2000-2008. The large informal economy and challenges in the labour market, including insufficient managerial skills, negatively affect private investment behaviour. While the political crisis caused a slump in investment in 2017, the investment spending in the economy remains insufficient overall due to the persistent challenges in the business environment, which is often causing projects to be delayed due to cumbersome procurement procedures and poor performance of contractors.

### Trade performance

**Exporting companies, notably SMEs, still face key constraints to trade.** These impediments are linked to non-tariff barriers, including technical standards and administrative obstacles. Barriers also include relatively high logistical and customs costs and a lack of managerial, financial and technical skills. The economy posts a high and growing degree of trade openness. The total value of trade in goods and services amounted to 124% of GDP in 2017. In 2018, both exports and imports grew by 17% and 12.4% respectively. Import coverage by export stood at 76.4% in 2018 with trade deficit amounting to EUR 1.8 billion or 16.9% of GDP. A decline in trade deficit was observed over the last years leading to decline in the current account deficit and easing the pressure on the exchange rate.

**The EU is the country's main trading partner (70.6% in 2017) followed by the CEFTA parties (10.5% in 2017).** Germany, Greece, the United Kingdom, Serbia and Bulgaria are the biggest trading partners. 95.6% of products of North Macedonia can access the EU market without customs duties. The export product mix has been improving in recent years. The share of iron, steel, and clothing in total exports has fallen further (to 17.4% in 2018 compared to 33.3% in 2013), to the benefit of chemicals and machinery and transport equipment (55% compared to 32.8%). The key import products are platinum and platinum alloys, petroleum oils, other metals and alloys and flat-rolled iron products. Given the different exporting product specialisation among Western Balkan countries, there are significant potential opportunities for increasing trade integration in the form of regional value chains that could link up with global value chains, especially in sectors such as food and car manufacturing (World Bank, 2018). A serious impediment to further increases in exports is the quality of logistics. In 2018 the World Bank's logistics performance indicator ranked North Macedonia 81st out of 160 countries (World Bank, 2018). The country scored especially low on customs and quality of logistics. It also had the highest average customs clearance days in Western Balkans, for 83% of firms it took over five days to complete the process (BEEPS V, 2016).

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<sup>(12)</sup> Investments' contribution to GDP growth in 2018: Montenegro 2.7 pps, Kosovo 2.1 pps, Albania 1.5 pps, Serbia 1.7 pps and Bosnia and Herzegovina 0.8 pps.

## Energy

**The economy is characterised by high energy intensity, inefficiencies in the ageing energy production system, persistent high dependency on coal, and an inefficient energy consumption.** The regional connectivity in energy is still inadequate and the implementation of the Energy Community commitments, notably on the Sustainability Charter, remains poor. The new law on energy that came into force in January 2019 liberalised the electricity market for micro and small companies and households. However, corresponding by-laws are missing and insufficient effort was made to educate relevant partners about their obligation on the liberalised electricity market. The country is also finalising the process of adoption of new balancing rules.

**Energy consumption is dependent on imports and domestic production is dominated by fossil fuels.** 41% of the final energy consumption in 2017 was covered by domestic production, while 59% was imported. For energy consumption, oil was the highest at 50.4%, followed by electricity (27.5%), biomass (11%) and coal (6.1%). In terms of final electricity consumption, 74% was covered by domestic production while 26% was imported. Domestic electricity production relied heavily on lignite (62%) followed by hydro production (19.8%) and gas (14.8%). Electricity supply reliability is uneven in the country and the IMF's analysis points to North Macedonia having one of the highest proportions of revenue loss due to the power cuts (7.5%) in the region, second only to Kosovo<sup>(13)</sup> (BEEPS V, 2016). The country is making some progress in regional connectivity, notably in developing an electricity transmissions inter-connector with Albania and starting the preparatory work for gas interconnections with Greece. Those projects, once realised, will accelerate the integration of North Macedonia into pan European networks, contribute to increased diversity and security of supply and will help increase the competitiveness of the energy market over time. Regarding investment in infrastructure, the country is continuing to construct several internal gas pipeline sections. Related to energy efficiency, the amended national renewable energy action plan is now in line with the binding target of a 23.9% share of renewables in the energy mix by 2020 (currently at around 20%) and energy efficiency savings of 9% by 2018 relative to 2009 in both public and private buildings.

## Transport

**The transport market is heavily concentrated on road transport, which contributes to very high transport-related green-house gas emissions amounting to 15% of country's total emissions.** In 2017, the transport sector's contribution to gross value added was 3.5%, which is lower than the EU average level of around 5%. The optimisation of the country's transport system and network therefore has great potential to increase productivity and growth. On the quality of transport infrastructure, the World Economic Forum's 2018 Global Competitiveness Report ranks the country 89th out of 138 economies for transport infrastructure<sup>(14)</sup>. The transport infrastructure's relatively low quality combined with weak trade and transport logistics present barriers for foreign firms wanting to invest in the country and for including domestic firms in global value chains. Rather than focusing on further expanding its road networks, the government should focus on implementing the connectivity reforms related to rail transport and would also benefit from opening of the rail transport market at least for domestic and regional undertakings. Improving the connectivity of transport infrastructures will accelerate the integration of North Macedonia into pan-European networks and will help further develop economic corridors over the region.

**The road maintenance budget is insufficient and road maintenance is handled by insufficiently efficient state companies operating with old equipment.** Ageing infrastructure and improper maintenance lead to more road traffic accidents and consequently to substantial financial costs. In addition, the fatality rate in traffic accidents is 78 people in million inhabitants, which is significantly

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<sup>(13)</sup> Compared to Serbia, Bulgaria, Albania, Bosnia and Herzegovina, Montenegro and Romania.

<sup>(14)</sup> Serbia is ranked 42nd, Montenegro 100th, Albania 109th, Bosnia and Herzegovina 104th.

higher than the EU average of 52. To address this issue the government is considering forming a lead road safety agency to ensure a coordinated and comprehensive approach to road safety.

## Agriculture

**The relatively large agricultural sector consists of highly fragmented private and state-owned land parcels with low productivity and poor irrigation infrastructure.** Overall, the agricultural sector accounted for 10.9% of GDP in 2017 and 15.8% of employment in 2018, but these shares are considerably higher in some regions. Despite access to fertile land, water resources and a favourable climate and despite the country's proximity to export markets, the average farmer produces less than a third of that of the average farmer in the EU-28. In 2018, more than 80% of agricultural land was privately owned with only around 20% state-owned. Extensive private ownership contributes to the small farm size and land fragmentation. This significantly curbs productivity as it prevents farmers from benefiting from economies of scale and hampers investments in modernisation. According to the latest farm structure survey (2016), individual farmers cultivated on average 1.5 ha of land, which is 10 times less than the average farm in EU-28 (16.1 ha).

**Agriculture's potential to boost income and diversify exports is undermined by several structural challenges.** These include low access to credit, low R&D spending, deficient infrastructure and extension services, lack of a market orientation, outdated labour-intensive farming technologies, and the low quality of human capital. There is a need to further support and recognise the importance of economic cooperation between farmers. Smallholder farmers need to better engage with value chains in order to improve their incomes, while reducing market risks. A focus on sustainable agri-business will also be essential to improve standards and productivity, to build and reinforce competitive value chains, and to increase access to markets and regional integration. Agricultural education and training, agricultural extension, and participatory research need to be improved as they are key factors in increasing the number of skilled agricultural workers and increasing competitiveness through innovation and applied technologies. Agricultural subsidies per hectare (estimated at between EUR 340 and EUR 380) are above the EU average (estimated at below EUR 300 for EU-27). Although subsidies are linked to production, they involve a very complex administration scheme and there are indications that they may slow down the structural transformation of the sector.

## Industry

**The main obstacles to competitiveness in industry include low investment and innovation, limited export diversification, underdeveloped enterprise clusters and a significant skills gap.** The industry sector contributed 25% of gross value added of the economy in 2018 and 31% of jobs. Manufacturing generates 19% of country's employment (EU average 20%) with the textile and apparel industry being the largest employer. The country has shifted towards medium value added production and exports in recent years, supported by sizable state aid. Between 2011 and 2016 producing spare parts for the motor vehicle industry created more than 11 000 jobs; more than any other sector. Nevertheless, traditional products such as iron, steel and textiles still make up a large share of exports.

**There are significant variations between different industries in terms of technology adoption, management capabilities, product quality and mark-ups, which also result in diverse levels of productivity across industries.** Human capital inadequacies also hinder productivity: the average manufacturing and services worker is on average four times less productive than their counterpart in Europe and Central Asia (World Bank, 2018). Linkages between domestic industry and international production chains remain weak. The new 2018-2027 industrial strategy, adopted by the government in November 2018, integrates the measures for creating industry based on green, innovative, circular and smart growth. The 38 planned measures cover five strategic measures that reflect companies' needs. They aim to reinforce the manufacturing foundation, raise productivity, facilitate innovation and technology transfer, catalyse green industry and green manufacturing and stimulate manufacturing exports. However,

the suggested measures need to be implemented quickly and the underlying causes of low innovativeness and weak global value chain integration need to be addressed.

### Services

**The services sector accounts for over half of employment and over 60% of GDP.** The sector grew by 1.7% in 2017, but it faces several structural problems. The further development and growth of services sector companies is hampered by weak entrepreneurial skills and a significant skills gap in employees, particularly soft skills, which are especially important in services. Export of the country's services continues to grow and it increased by 1.5% in 2018. However, services still represent only 25% of the value of the country's export basket, which is partially explained by the low share of high growth firms in the sector. In the last 3 years only 5.5% of medium sized service firms experienced average annual growth in employment of more than 10% <sup>(15)</sup>. Tourism and transport continue to constitute the largest chunk of the county's export in services (40%) followed by services provided to manufacturing companies (25%). The latter have significant growth potential because their development is closely related to the inflow of export-oriented FDI. Telecommunications and computer and other information services, along with other business services, represent close to 25% of service exports and could also be expanded. There is potential for regional cooperation with Western Balkan neighbours when it comes to the export of services, especially for tourism packages, which in many cases are complementary rather than competing.

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<sup>(15)</sup> The number is lower than in aspirational peers such as Croatia (9.2%), Poland (10%) and Estonia (9.7%).

### 3.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2018

Overall: Partial implementation (44.0%) <sup>(16)</sup>	
2018 policy guidance	Summary assessment
<p><b>PG 1:</b></p> <p>Develop a proper medium-term fiscal consolidation strategy.</p> <p>Stabilise the public debt ratio by pursuing a sufficiently tight fiscal stance while protecting capital spending.</p>	<p>There was <b>limited implementation</b> of PG1:</p> <p>1) <b>Partial implementation.</b> The government implemented reforms (pensions reforms, rise in health contribution rates, income tax reform, social assistance reform), the net fiscal impact of which is calculated by the IMF to amount to 0.2% of GDP in 2019. However, while sustainable, these measures – in spite of the over-optimistic GDP growth assumptions of the government – may not be sufficient to bring about the envisaged reduction in the general government primary balance in 2020 and 2021. The government expects the social assistance reforms alone to raise the primary balance by some 0.3 pps in 2019, before offsetting effects would set in by 2020 or 2021. Yet, the relevant social assistance law enabling the implementation of these reforms has not been adopted.</p> <p>2) <b>No implementation.</b> The lower than projected budget deficit in 2018 (1.8% of GDP compared to the target of 2.8%) and the expected contained rise in general government debt came about as capital spending was very low (51% execution rate).</p>
<p><b>PG 2:</b></p> <p>Streamline and better target social spending and agricultural subsidies.</p>	<p>There was <b>partial implementation</b> of PG 2:</p> <p>1) <b>Partial implementation.</b> The government has adopted the new Law on Social Protection and Parliament is expected to pass it in the first quarter of 2019. It is reflected in the 2019 budget and aims to improve the targeting of social assistance benefits, e.g. by consolidating the partially overlapping child and social protection benefits with means-tested minimum guaranteed income, and a social pension for the elderly. Third-child parental allowance would be abolished in turn. Measures to reform the system of agricultural subsidies were very limited and consisted mainly of an evaluation of direct payments with recommendations for alignment with the CAP.</p>

<sup>(16)</sup> For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission's Overview and Country Assessments of the 2017 Economic Reform Programmes available at [https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments\\_en](https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en).



<p>Reduce public sector payment arrears and develop an arrears prevention strategy.</p> <p>Take the necessary organisational steps in view of improving tax collection.</p> <p>Adopt the organic budget law with a set of fiscal rules and establish an independent fiscal council to assist in their enforcement.</p>	<p>2) <b>Substantial implementation.</b> The share of VAT refunds within the legal deadline of 30 days has increased, and government and other public sector units have cleared substantial amounts of unpaid liabilities. The municipalities have been transferred funds through the 2018 supplementary budget to clear about half of their arrears in the first half of 2019. All public entities are now required to publish their overdue obligations on a quarterly basis. The government imposed a fiscal rule on municipalities to restrict the scope for over-optimistic revenue planning, which, although it is rather generous, might contain the future accumulation of arrears at local level.</p> <p>3) <b>Partial implementation.</b> Preparatory steps have been taken but the adoption of essential reforms to strengthen revenue administration and enhance monitoring to improve efficiency of VAT and corporate tax collection are still pending. The government adopted a law on the prevention of money laundering and financing of terrorism, which limits allowed cash payment. The law on profit tax has been amended with the aim of better regulating transfer pricing and enhancing corporate tax collection.</p> <p>4) <b>No implementation.</b> The ERP expects that the new organic budget law will be adopted in 2019.</p>
<p><b>PG 3:</b></p> <p>Conduct monetary policy consistent with the exchange rate peg, using available scope within this framework in line with safeguarding price stability.</p> <p>Adopt and implement a comprehensive NPL resolution strategy, addressing all underlying obstacles also outside the remit of the central bank, with the involvement of all relevant stakeholders.</p> <p>Adopt and implement a comprehensive strategy for fostering the use of the local currency, with the participation of all relevant stakeholders.</p>	<p>There was <b>substantial implementation</b> of PG3:</p> <p>1) <b>Full implementation:</b> The NBRNM has appropriately used its scope to pursue a more accommodative monetary policy in 2018 in an environment characterised by low inflation and considerable inflows of foreign capital</p> <p>2) <b>Partial implementation:</b> The authorities developed a comprehensive strategy for the improved management of non-performing loans in the Republic of North Macedonia in cooperation with relevant stakeholders. It was adopted in December 2018. Implementation started.</p> <p>3) <b>Partial implementation:</b> The authorities developed a comprehensive strategy on de-euroisation in the Republic of North Macedonia in cooperation with relevant stakeholders. It was adopted in December 2018. Implementation started.</p>

<p><b>PG 4:</b> Prepare risk assessments focusing on sectors and branches most vulnerable to informalities</p> <p>and identify and apply appropriate corrective measures.</p>	<p>There was <b>limited implementation</b> of PG4:</p> <p>1) <b>No implementation:</b> building on the strategy, the 2018-2020 action plan for formalisation of the informal economy, which sets 29 measures, was adopted in August 2018. The strategy does not include a risk assessment of particular sectors and branches of the economy, although it does include an analysis of the most common types of informality and their causes.</p> <p>2) <b>Partial implementation:</b> In June 2018, new regulation was passed to incrementally limit the size of cash transactions. The authorities are also strengthening customs border control to combat ‘suitcase trade’ by informal businesses. In September 2018, a coordinating body was set up to monitor the action plan implementation. The first implementation report is due in April 2019. The Law on trade of green markets, that would eliminate informality in this sector entered into force in January 2019, but was suspended shortly after.</p>
<p><b>PG 5:</b> Clarify the mandate of each inspectorate to avoid overlap</p> <p>and put in place and apply transparent and consistent procedures. Create a register of para-fiscal charges on central and local levels that clearly states the purpose of each charge and make it publically available.</p> <p>Strengthen the institutional capacity of civil courts to uphold contracts and handle commercial disputes within a reasonable time and at reasonable costs.</p>	<p>There was <b>partial implementation</b> of PG5:</p> <p>1) <b>Partial implementation:</b> The draft new Law on inspection supervision was published on ENER in November 2018. It will specify the mandate of each inspectorate to avoid overlap and to establish and apply transparent and consistent policies. It has not yet been approved.</p> <p>2) <b>Limited implementation:</b> Procedures will be put in place once the law is adopted.</p> <p>3) <b>Partial implementation:</b> The catalogue should be finalised by early 2019. In the meantime, the process of preparing a parafiscal charges registry began with the development of a ‘catalogue of services’. At first, the catalogue will cover about 340 services resulting from 52 laws (charges and administrative fees will be included for each service). The registry will feed into the catalogue.</p> <p>4) <b>Partial implementation:</b> The first draft of the Judicial Network Analysis was prepared in 2018 and submitted to the international experts for comments. It will help strengthen the civil courts’ institutional capacity. Amendments to the laws on public notary and enforcement agents were adopted in December 2018. The amendments to the law on enforcement agents aimed at, among others, to redefine procedures for the extrajudicial settlement of debts and introduce a simpler and more cost-effective process of initiating enforcement procedures. Discussions are under way on how to reduce the costs of tariffs for both public notaries and enforcement agents. However, regardless of the judiciary reforms, no specific measures have been taken to improve capacity and efficiency in handling commercial disputes.</p>

<p><b>PG 6</b> Modernise the education system at all levels by further improving the infrastructure, curricula and teacher qualification</p> <p>Pursue the reform of the VET system to facilitate school- to-work transition.</p> <p>Facilitate women's access to the labour market</p> <p>and ensure sufficient capacity of the Employment Service Agency for implementing the Youth Guarantee.</p> <p>Adopt the law on social protection to better target those at risk of social exclusion</p> <p>Increase enrolment in pre-school education.</p>	<p>There was <b>partial implementation</b> of PG 6:</p> <p>1) <b>Partial implementation:</b> The education strategy and 2018-2025 action plan was adopted in January 2018. The ERP includes a list of activities that have been implemented at preschool, primary and secondary education levels. However, there is no information about tertiary education. Improving education activities in preschools, teacher training in particular, has not yet started. In primary schools, the new curricula and teacher training are still not developed. The road-map for building new infrastructure is still being prepared.</p> <p>2) <b>Substantial implementation:</b> There were some structural improvements following the completion of the institutional structure for implementing the national qualifications framework, which is aligned with the European Qualifications Framework. In October 2018, guidelines were adopted for VET qualifications standards and syllabi. Furthermore, by the end of 2018, 153 occupational and 52 qualification standards had been developed; 5 of them on the business community's request. 100 module-based and competence-focused curricula were introduced for general and vocational education. In addition, 1250 new module-based curricula are being prepared (70 for general education and 1180 for VET). A learning management system was introduced to support teachers' training. By the end of 2018, 28 trainers had trained 2300 teachers, directors and professional associates across the country's secondary vocational schools.</p> <p>3) <b>Limited implementation:</b> According to the latest data available (Q3 2018), the labour market activity rate of women is still very low and has barely increased in one year. The available preschool services, childcare centres, and some recently adopted administrative measures should help women enter the labour market.</p> <p>4) <b>Partial implementation:</b> The Rulebook on internal organisation of the Agency EARM and on the systematisation of staff were amended to recruit and train new employees to extend the implementation of the Youth Guarantee to the whole country.</p> <p>5) <b>Substantial implementation.</b> A set of new laws regulating social protection (notably, the law on social protection, law on social security of elderly and amendments to the law on child protection) have been recently put forward for a public debate and will be ready for adoption in the coming months. However, their implementation will require an additional budget. Therefore, a new personal income tax law will introduce progressive taxation.</p> <p>6) <b>No implementation.</b> Figures are not provided, though the government states that a report was prepared.</p>
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### 3.6. THE 2019 POLICY GUIDANCE

#### **JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TURKEY**

The Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

Brussels, 17 May 2019

[...]

In light of this assessment, Participants hereby invite North Macedonia to:

1. Stabilise the debt ratio by moving towards a balanced primary budget while implementing the budgeted capital expenditure. Adhere to agreed consolidation measures, in particular the new pensions indexation formula. Implement legal and organisational measures to improve revenue collection.
2. Further increase the transparency of public finances by including public enterprises in the general government fiscal reporting framework where mandated by international statistical standards. Adopt the new organic budget law including fiscal rules and arrangements for an independent fiscal council.
3. Operationalise the adopted denarisation and non-performing loan resolution strategies, also by prioritising key areas of reform. Continue to closely monitor the emergence of potential financial stability risks related to the consumer loan segment, deploying appropriate micro- and macroprudential policy tools if needed. Legally clarify the national bank's mandate to set macroprudential policy and establish a framework for an effective co-operation among all agencies involved in macroprudential supervision.
4. Put in place and apply transparent and consistent procedures for business inspections implemented by inspectorates with clear mandates. Create a register of para-fiscal charges on central and local level. Reduce the time and costs of commercial disputes by strengthening the institutional capacity of civil courts.
5. Ensure the implementation of the Action Plan for Formalisation of the Informal Economy 2018-2020 in accordance with the timeline.
6. Implement the Youth Guarantee in the whole territory with an emphasis on underdeveloped regions by ensuring sufficient and qualified human resources of the Employment Agency, and the participation of relevant stakeholders. Strengthen the governance in the education sector in order to accelerate the modernisation of the education system at all levels through improving infrastructure, curricula and teachers' qualifications. Adopt and implement the new social protection legislation for improving the impact of social transfers on poverty reduction.

## ANNEX A: ASSESSMENT OF THE STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP

### **Measure 1: Increasing the competitiveness of the electricity market**

This measure is rolled over from the previous year. It aims to set up a more liquid and organised electricity market to allow more competition in energy supply for the benefit of customers. It will also stimulate cross-border regional market integration and connectivity. The measure will have a significant impact on the economy, though a potential initial increase of the energy price might reduce its competitiveness in the short term. However, as highlighted in last year's assessment, the potential impact on prices in particular, and therefore on vulnerable households, and on other economic sectors, is not quantified. The June 2018 adoption of the energy law marks a turning point in the transposition of the third Energy Package. However, adopting the implementing legislation is a challenge due to the short deadlines and the number and scope of the regulations that have to be developed.

### **Measure 2: Promotion of renewable energy sources and improvement of energy efficiency**

This measure is also rolled over from last year. It will help diversify energy generation and contribute to energy supply security, with expected positive effects for the economy. The measure includes both regulatory aspects (including adopting the energy efficiency law) and power generation capacity building. It sets out alternative methods to promote energy efficiency and renewable energy such as pollution taxes, selling products with energy-saving characteristics and a campaign to encourage the buying-off of inefficient products. However, the exact way that this will be put into practice and the expected impact have not been sufficiently developed. Furthermore, energy efficiency activities should focus more on the residential sector. As pointed out in last year's assessment, energy efficiency and renewable energy use can only be fully achieved by fully complying with the relevant EU *acquis*.

### **Measure 3: Facilitating Macedonia-Serbia cross-border crossing**

This measure, which is rolled over from last year, addresses the bottleneck in the railway border crossing between North Macedonia and Serbia (Tabanovce). It aims to decrease the waiting time at the railway border crossing by establishing a 'one-stop-shop' for border service procedures. The measure focuses on the construction component while neglecting to tackle the procedural issues necessary to smooth the railway border crossing. Additional procedural and regulatory reforms would generate a wider impact as they could be applied to border crossing procedures at other borders. The measure could increase competitiveness, particularly by facilitating cross-border freight traffic, but the competitiveness analysis is poorly carried out. The measure relies on external funding for construction and does not properly budget for the necessary maintenance investments.

### **Measure 4: Implementation of an Intelligent Transport System (ITS) along Corridor X**

This is a new measure. It plans for the ITS to be put in place along road Corridor X, which is a strategic objective of the 2018-2030 national transport strategy. The measure will contribute to road transport safety and the traffic flow along Corridor X. However, its impact cannot be fully determined given the insufficient analysis of the expected impact on competitiveness that does not include any estimate of savings (cost or time). However, the realistic cost estimate and planned timeline makes the measure credible.

### **Measure 5: Improving the irrigation system**

This measure helps tackle one of the agricultural sector's main constraints, complementing Measures 6 and 7. Also rolled over from last year, it aims to revitalise the existing irrigation infrastructure and expand its coverage. Last year's recommendation to address weaknesses in the regulatory framework for irrigation management, to review pricing methodologies and to consider involving water users in irrigation management was not heeded. The human factor in agriculture, particularly the need to extend the services to farmers so they may adapt and benefit from proposed reforms was also not considered. In addition, the proposed investments still focus on big dams and very little attention is given to irrigation networks (only in the scope of IPA funding for small-scale irrigation systems). Investments by the national water management company are not explained in the ERP or presented in the budget. The same goes for the national and IPA funding available for on-farm investments in irrigation, which should be considered as part of this measure and budgeted accordingly. In spite of the size of the construction works and the many impacts they might have, there is no description of synergies with other sectoral policies. The impact assessment is generic and does not include sufficient quantitative information.

### **Measure 6: Consolidation and defragmentation of agricultural land**

This measure, rolled over from last year, is still relevant as it aims to reduce the excessive agricultural land fragmentation by consolidating parcels in targeted consolidation areas. The measure complements Measures 5 and 7 in tackling the agricultural sector's main constraints. However, this reform is slow and has only been partially implemented. The Commission's suggestion in last year's assessment to incorporate abandoned and state-owned land into an amended Law on land consolidation was not followed. The measure's proposed activities lack details on the selected consolidation sites and quantitative objectives or estimates. Moreover, no actions are planned to incentivise voluntary land consolidation initiatives by groups of farmers. Estimates of capital investments involved in the process are not budgeted. Impact assessments are very generic and do not include sufficient quantitative information.

### **Measure 7: Agricultural cooperatives**

The measure to support associations of farmers in agricultural cooperatives remains relevant as it addresses a key challenge of the agricultural sector. It is rolled over from previous years due to limited progress in its implementation. The Commission's recommendation to link the measure to the EU *acquis* alignment process on producer groups and common market organisations was not considered. Even though the reform is consistent with other related measures in the ERP (consolidation of agricultural land and financial support of investment), no information is given on synergies with other cross-cutting reform measures (e.g. introduction of progressive income taxation, social policy, etc.). As is the case with the other measures in the agricultural sector, the expected impact on competitiveness, employment and gender is not sufficiently considered, and the impact of the measure is not quantified enough.

### **Measure 8: Financial support of investments**

The measure on financial support for investments is also rolled over from last year. Together with measure 9 it is part of the government's plan for economic growth. The measure includes ex-post direct state aid for companies to reward them for their successful past performance. All companies that meet the required criteria are eligible to apply on a 'first come, first served' basis. The measure raises concerns on objectivity, transparency and equitability in the disbursement of the funds. As highlighted in last year's Commission assessment, the measure does not address the underlying structural constraints to the low investment levels in the economy. The measure does not consider whether the companies would be willing to use their own funds to employ, innovate and grow regardless of the subsidies. The potential

impact of the grants on individual companies or even on the country's competitiveness therefore remains unclear. There has been insufficient effort to set up SMART indicators and the key performance indicators are only input-based. The expected impact on employment and gender is not sufficiently developed.

#### **Measure 9: Financial support for micro, small and medium enterprises**

Like measure 8, measure 9 is rolled over and is part of the government's plan for economic growth. The measure includes direct state aid to SMEs and micro enterprises for various projects, including raising quality standards, making medium-term business plans and introducing new products or production processes. Similar to measure 8, this measure is not a structural reform tackling underlying causes for why companies do not themselves invest in such processes. In addition, the assessment of the impact on the country's competitiveness is still missing. Furthermore, it raises similar concerns as measure 8 in terms of objectivity, transparency and equitability in the disbursement of the funds. The key performance indicators presented are input-based and SMART indicators are not developed. The expected impact on the employment and gender measures is insufficiently addressed. There is a need to effectively monitor the outcome of the scheme and ensure coordination between different schemes of a similar type to avoid overlaps. There is also a need for a credible exit strategy.

#### **Measure 10: Increasing competitiveness in the tourism and hospitality sector**

The measure is rolled over from the previous year. The Commission's recommendation to embed the measure in a more strategic approach and to add further detail in the measure description, was not considered. The measure could have a significant impact on the sector. However, the scale of the impact is unclear as outputs are unquantified. This measure is also subject to multiple risks. At the same time, the measure seems to have been significantly scaled up compared to the previous year with funding from an EU project, even though this is not specified in the measure. Although it could potentially have a considerable impact on both employment and gender equality, this is not specified. Suggested indicators are input-based and a proper assessment of the impact on the competitiveness of the country is lacking.

#### **Measure 11: Harmonisation of the public procurement legal framework with the *acquis***

The measure is also rolled over from last year. It aims to harmonise the public procurement legal framework. It is expected to increase transparency and predictability on the market following the request to publish public procurement plans electronically and in advance. The number of bidders per tender is expected to rise, in particular bids by SMEs. However, there is no quantification of the impact in terms of numbers of SMEs affected nor are budgetary savings quantified. The risks accompanying the measure are significant. A new software application should ensure increased transparency and fairness in the small-valued procurements, however a number of implementing acts need to be adopted in 2019 to make the law applicable. In addition, the software for small value procurements is to be developed in mid-2020. The full potential of the reform will depend on the human and technical resources at the disposal of the State Appeals Commission and Public Procurement Bureau.

**Measure 12: Development of a National E-Services Portal**

The measure is rolled over from the previous year. As highlighted in last year's assessment, the measure is relevant to reduce the cost and time for businesses to deal with the administration and is therefore important for improving the overall business environment and the ease of doing business. However, this measure has now been under implementation for several years and it is difficult to establish what progress has been achieved. Several risks to the effectiveness of this measure are highlighted, including inefficient coordination and communication between state institutions, lack of human resources and lack of commitment at operational level. Those risks could significantly challenge the measure's implementation and should be clearly monitored and counteracted by mitigating actions. Furthermore, the budgeted costs seem insufficient and only partial. The measure does not quantify the expected impact on competitiveness, which is only described in general terms rather than with a clear focus on quantitative targets.

**Measure 13: Reducing the informal economy**

The measure on reducing the informal economy is new and is prioritised based on the Commission's assessment of last year. As indicated in this year's analysis of key structural challenges, this measure is very relevant to increasing the competitiveness of the economy. The measure aims to implement the 2018-2022 strategy for the formalisation of the informal economy that was adopted in early 2018. The strategy identifies three salient motives for engaging in informal business activities, but these are not properly addressed by the measure's activities. Most of the included activities are based on more repressive stringent monitoring and inspection. In addition, the voucher mechanism for transforming informal workers into formal ones has already been in place for over 10 years and has not proven efficient in addressing informalities. The measure focuses on employment policies while ignoring other important aspects contributing to the informal economy, such as the overall business environment or taxation. The measure's expected impact on competitiveness is not sufficiently quantified and the impact on employment and gender not sufficiently considered. Finally, the gap between the adoption of the strategy (early 2018) and the first activities (planned to start as of April 2019) could signal a lack of commitment for reforms or insufficient institutional capacity.

**Measure 14: Improving infrastructure and access to Finance for research, development and innovation**

This measure, rolled over from last year, aims to provide funding for several stages of the innovation cycle to address some of the key RDI challenges. Although this measure is still highly relevant, it only partially addresses key constraints to RDI. Some of the measure's activities such as the Fund for Equity and Mezzanine Financing and Science and Technology Park are long-planned initiatives whose credibility is at stake given the long delays in implementation. In 2018, an improved record in disbursing grants was noted. More activities and funds will be added in 2019. However, the measure does not require the expected impact of the fund's investments to be quantified. Nor does it envisage adequate ex-post monitoring and evaluation. Overall, the expected impact of the competitiveness measure is unquantified and the impact on employment and gender is insufficiently considered.

**Measure 15: Trade facilitation**

The measure on trade facilitation, also from last year, aims to simplify inspections and clearance procedures. It has the potential to improve competitiveness by speeding up all trade that requires veterinary and phytosanitary certificates issued through the EU Trade Control and Expert System (TRACES). The measure is related to the Additional Protocol 5 of the CEFTA Agreement. The ERP provides a good quantitative assessment of the expected impact on competitiveness. However, the



budgeted costs should be clarified as they are quite small and it is unclear whether they cover all of the measure's required activities.

#### **Measure 16: Further developing of the qualification system**

The measure is rolled over from last year and relevant for improving educational outcomes. The adoption of the 2018-2025 education strategy and the related action plan clearly signals that education is a priority for the Government. However, strong leadership and coordination is necessary to carry out the action plan. Monitoring implementation and quickly addressing delays will be crucial.

#### **Measure 17: Youth Guarantee**

This measure is rolled over from the previous years and it aims to tackle youth unemployment. However, its implementation will pose a challenge for the involved institutions, namely the Ministry of Labour and Social Policy (coordinating institution), the Employment Agency (in charge of registration and counselling) and the National Youth Council (in charge of the fieldwork). Additional well-trained staff will be needed to implement the Youth Guarantee in the country's 30 employment centres for some 10 000 young people per year. The measure does identify the lack of physical and human capacities of the Employment Agency as a significant risk and suggests some mitigating actions. The impact of the measure on competitiveness could have been further elaborated. It is important to ensure that the focus of the measure is on the most vulnerable, particularly women and less represented ethnic groups living in underdeveloped regions, and on collecting of data. Networking and exchanges with European Public Employment Services will improve the way of working.

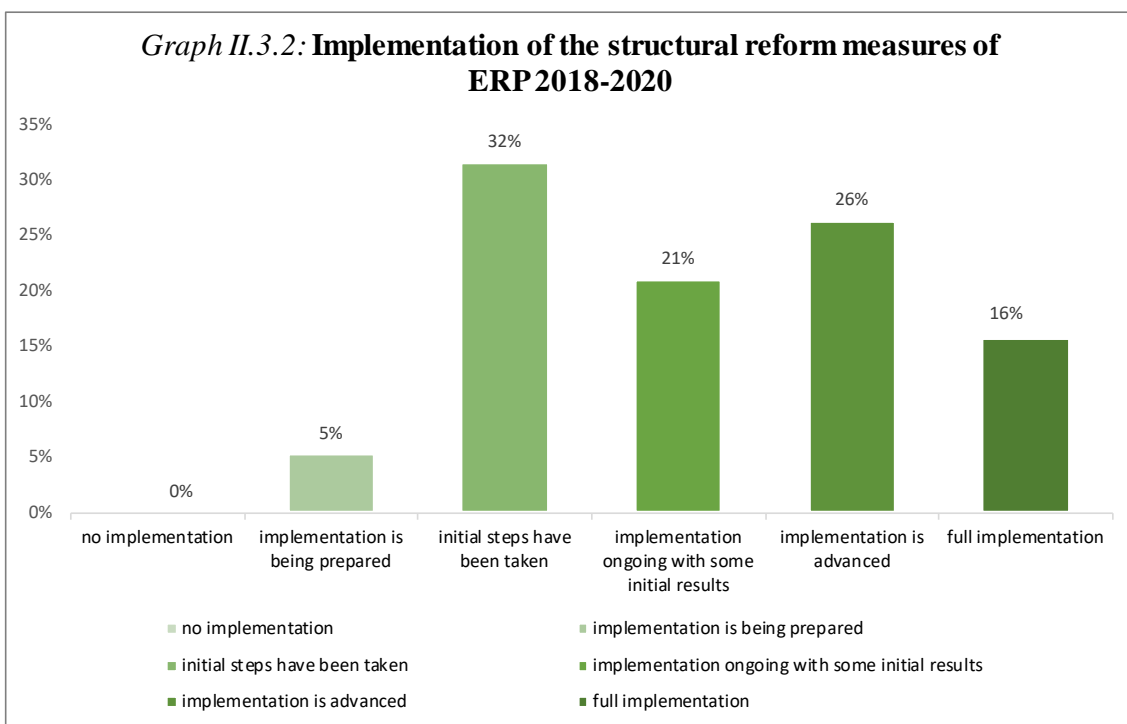
#### **Measure 18: Enhancement of financial benefits in the field of social protection**

This measure is considered crucial for tackling poverty in the country and is rolled over from the previous year. The law regulating the social protection, which is suggested by the measure, is urgent and should be adopted without further delay. Furthermore, additional attention should be put on adopting the bylaws and implementing regulation. The information campaign, including fieldwork targeting potential beneficiaries, particularly the most vulnerable (Roma, women with children), is relevant. However, the measure does not offer a sufficiently detailed outline on its implementation.

**ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM ERP 2018-2020**

Relatively good progress was made in implementing the measures in 2018 (average score: 3.4 out of 5). Activity reports provide a fairly accurate description of the level of implementation, though the scoring is overly optimistic for some activities. The scoring is imprecise for the measures related to agricultural and industrial development. For measures 9 and 10, the described implementation is not fully linked to the ERP 2018-2020 activities, which makes assessing the progress more challenging.

Implementation is stronger for some measures, such as measure 17 on active employment, measure 18 on the Youth Guarantee, measure 1 on harmonising the legal framework for public procurement with the *acquis* and measure 2 on improving internal financial control. In contrast, implementation is weaker for other measures, such as measure 8 on agricultural cooperatives, measure 6 on improving the irrigation systems and measure 11 on improving the competitiveness of domestic companies.



## ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The 2019-2021 ERP was submitted by the government of North Macedonia on 30 January 2019. It is in line with the revised medium-term fiscal strategy of December 2019 and the 2018 Budget Law. None of its components are missing.

### *Inter-ministerial coordination*

The Ministry of Finance of North Macedonia coordinated the preparation of the ERP and an inter-ministerial working group comprised of seven ministries, several agencies and other offices were involved in this work. Upon completion, the government formally endorsed the ERP.

### *Stakeholder consultation*

The draft ERP was posted on the Ministry of Finance's website between 23 November and 7 December 2018 to give stakeholders, including social partners, the opportunity to make comments and recommendations. Interested parties were also invited to send written contributions. The government held an additional public consultation in Skopje on 30 November 2018. The draft ERP was sent to the Economic and Social Council on 20 December 2018. The contributions to the consultation are included as an annex to the ERP.

### *Macroeconomic framework*

The macroeconomic framework is coherent and consistent, but overly optimistic. The ERP presents two alternative scenarios compared to the baseline: (i) assuming lower growth in trade partner countries; and (ii) assuming lower investment, but it does not include a low-growth scenario combining both domestic and external risks. The external sector outlook is described in detail in the ERP and an analysis of external debt sustainability is provided in annex. The external debt analysis refers to stress tests for shocks to the primary current account and to economic growth. These stress tests would have benefited from more detail on the impact of individual debt-creating flows and from alternative scenarios given potential current account or growth shocks.

### *Fiscal framework*

The ERP is based on the latest budget projections following its revision and on the fiscal data available at the end of Q3 2018. Despite the revised economic growth assumptions, the ERP sticks to the fiscal targets of previous years. It includes: (i) information on the expected budgetary impact of new policy measures; (ii) an analysis of the budget balance's sensitivity to lower GDP, lower revenue, and higher expenditure growth; (iii) an analysis of public debt's sensitivity to changes in interest rates and exchange rates; and (iv) a short assessment of the long-term sustainability of public finances based on a number of assumptions, including population aging.

### *Structural reforms*

The structural reforms sections (4, 5 and 6) broadly follow the guidance note. Each measure has a description, which usually includes the annual timeline, a budget estimate, the expected impact on competitiveness and the expected impact on employment. However, the analyses of impacts on competitiveness, employment and gender are not sufficient as these factors are usually not quantified. Quantification is the most relevant criteria for properly prioritising the measures. The implementation risks - and how to mitigate them - are also briefly mentioned in the measure descriptions. The ERP includes 19 measures and largely respects the set page limit. Tables 9-11 in the annex are properly completed. Implementation reports of the 2018-2020 ERP's policy guidance and the structural reform measures (Table 11 in annex) is sufficient but sometimes lacks important details. The score of the reform implementation stage is also sometimes overestimated.

## 4. SERBIA

### 4.1. EXECUTIVE SUMMARY

**The economic reform programme's baseline projection of continued robust economic growth seems plausible, but faces increased downside risks.** The 2018 outcome was better than expected: strong domestic demand and base effects lifted growth above 4% for the first time in a decade. The economic reform programme (ERP) expects the economy to expand steadily at 3.5-4.0% in 2019-2021 due to solid growth in export, private consumption and investment. However, short-term economic prospects have worsened due to the slowdown of external demand from main trading partners, Kosovo's imposition of prohibitively high import tariffs and EU's introduction of steel import quotas. The ERP's projection of gradually narrowing current account deficits rests crucially on the assumption of large foreign direct investment inflows in tradable sectors underpinning further improvements in competitiveness. The financial sector has been sound and actively supported economic growth, but reforms and privatisations of state-owned financial institutions are incomplete.

**The fiscal strategy envisages a reduction of government debt below 50% of GDP through broadly balanced budgets, but it lacks a strong pro-growth orientation.** Due mainly to a continually strong revenue performance, the general government budget was in surplus for a second year in a row. However, the growth-enhancing policy measures in the 2019 budget are too modest. The budget used most of the available fiscal space to increase collective consumption and pensions. Productive capital expenditure remained at a rather low level, compared to high investment needs in some sectors like education, health and environment. Government debt and debt servicing costs, which have declined significantly over recent years, are expected to fall further but economic risks remain elevated and government debt is not yet in safe waters. There are still gaps in fiscal governance.

The main challenges in these respects include the following.

- **Despite the good macro-fiscal results of the previous year, the reform process has lost momentum.** Although the baseline scenario is realistic, it faces major uncertainties and risks. Finalising some long-standing public sector reform initiatives such as the wage system reform and progressing faster on public administration reform in general could provide an important signal to investors and further lower the country risk premium.
- **Good fiscal results are not yet sufficiently anchored and there is further scope to increase capital spending.** Previous experience has shown the vulnerability and sensitivity of fiscal performance to the economic and political cycle. The strengthening of existing fiscal rules would guide public finance and help institutionalise sound fiscal policies. Keeping a lid on wage and pension expenditure and further strengthening the process of capital expenditure execution is required in order to free and better use existing resources in areas such as education, health and the environment. The system for prioritising and monitoring government investments does not cover all projects, regardless of their source of financing.
- **The business environment is affected by unfair competition coming from public companies, non-transparent state aid schemes, the informal economy and an unpredictable regulatory environment.** Public support to companies should seek a better balance between the current limited support to domestic small and medium sized enterprises (SMEs) and generous state aid to incoming foreign direct investment. Although access to finance improved, own resources remain the principle source funding for SMEs. A new industrial strategy is needed to bring about more clarity as to how the government intends to support industrial development. New regulation on economic issues is often adopted without business being properly consulted.

- **The restructuring of state-owned enterprises in the energy sector continued to face delays.** The unstructured sector and prices of energy below cost recovery level prevent further investment, in particular into energy efficiency. In addition, incomplete restructuring and privatisation of state owned enterprises still poses a risk to public finance.
- **Weak labour market integration of women and young people and a large number of unemployed people continue to be a key labour market challenge.** At the same time, the emigration of workers, primarily to the EU, poses longer-term risks to labour market expansion. Apart from the lack of job opportunities, higher wages abroad are a key factor for brain drain. Structural reforms need to give more consideration to containing these developments. The level of informality remains high and needs to be addressed in a more comprehensive manner. Social challenges are multi-fold, with continuous high levels of poverty despite positive economic trends over the past years. Reform plans in this area are further delayed and lack a strategic vision.

**The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2018 has been partially implemented.** Most of the revenue over performance was saved and the 2018 budget was in surplus. The medium-term fiscal strategy targets a broadly balanced budget. There were no measures taken to advance work on strengthening fiscal rules. There has been some improvement in the composition of government spending in 2018. Only very limited steps to develop a single mechanism for prioritising and monitoring all government investment have been taken. While the monetary policy stance was in line with achieving the inflation target, limited steps were taken to restructure and privatise state-owned banks. The management of public projects has improved, but public investment remains relatively low and below the needs of both public and private operators. Governance and restructuring in the energy sector remained largely unaddressed. The process of drafting an industrial strategy has not yet started and there is no proper control mechanism to ensure that all support given to companies is in line with state aid rules. Efforts have been made to regulate para-fiscal charges, but effects of the new regulation remain to be seen. No progress has been made in reducing the high non-wage labour cost of jobs at the lower sections of the wage distribution. Increases in the provision of active labour market measures have been modest. Further steps have been taken to establish the National Qualifications Framework, including the involvement of stakeholders.

**The ERP partially aligns with the reform priorities identified by the Commission.** The macroeconomic and fiscal frameworks are sufficiently comprehensive and integrated with the overall policy objectives, providing a good basis for policy discussions. The structural reform part of the ERP remains largely unchanged from last year, reflecting delays in implementation of main reforms. It appropriately continues with measures to improve the performance and the restructuring of publicly-owned operators in the energy and transport markets. The programme is strongly focused on the business environment, especially on the reduction of red tape and introduction of some new services, including e-government. The diagnostic presented in the ERP for education, employment and social policies is relevant and lists some key challenges, while the proposed measures are rather limited and lack a strategic vision for these three sectors. Objectives and targets are not clearly defined, hindering both ex-ante and later implementation assessments.

#### 4.2. ECONOMIC OUTLOOK AND RISKS

**The ERP's baseline projection of robust economic growth remains unchanged from the previous programme and is broadly in line with the Commission's autumn forecast.** The 2018 outcome was better than expected: strong domestic demand and base effects lifted real GDP growth above 4% for the first time since 2008. The baseline scenario sees the economy expanding steadily at 3.5-4.0% in 2019-2021, due to continuing solid growth in exports, private consumption and investment. Export growth is seen outpacing imports, resulting in a positive net export contribution to growth in each of the years. On the supply side, services, industry and construction would be the engines of growth. After the closure of the negative output gap in 2018, it is projected to stay positive over the ERP period. The envisaged economic expansion should also further increase employment and reduce the unemployment rate to a single digit level by 2021.

**However, some elements of the macro scenario are less incontrovertible and it faces increased downside risks.** This pertains mainly to the slightly over-optimistic export projections and the forecasted reduction of external imbalances. The positive output gap, rising investment, and expansionary fiscal policy should all work against the envisaged narrowing of external imbalances. Since the autumn, when the forecast was prepared, short-term economic prospects have also worsened due to Kosovo's imposition of prohibitively high tariffs on imports from Serbia and EU's introduction of steel import quotas. A further decline in car production by the country's biggest exporter could also hurt short-term growth prospects.

Table II.4.1:

##### Serbia - Comparison of macroeconomic developments and forecasts

	2017		2018		2019		2020		2021	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
<b>Real GDP (% change)</b>	2.0	<b>2.0</b>	4.1	<b>4.2</b>	3.8	<b>3.5</b>	3.8	<b>4.0</b>	n.a.	<b>4.0</b>
<i>Contributions:</i>										
- Final domestic demand	2.7	<b>3.1</b>	5.1	<b>4.4</b>	4.6	<b>3.5</b>	4.6	<b>3.7</b>	n.a.	<b>3.9</b>
- Change in inventories	0.5	<b>0.9</b>	0.8	<b>0.7</b>	0.2	<b>0.0</b>	0.2	<b>0.0</b>	n.a.	<b>0.0</b>
- External balance of goods and services	-1.2	<b>-2.0</b>	-1.8	<b>-1.0</b>	-1.0	<b>0.1</b>	-1.0	<b>0.3</b>	n.a.	<b>0.2</b>
<b>Employment (% change)</b>	2.8	<b>2.7</b>	1.5	<b>1.8</b>	1.3	<b>1.4</b>	1.2	<b>1.6</b>	n.a.	<b>1.6</b>
<b>Unemployment rate (%)</b>	13.6	<b>14.1</b>	13.1	<b>12.7</b>	12.0	<b>11.8</b>	10.9	<b>10.6</b>	n.a.	<b>9.0</b>
<b>GDP deflator (% change)</b>	2.8	<b>3.0</b>	2.3	<b>2.4</b>	2.9	<b>3.3</b>	3.0	<b>3.4</b>	n.a.	<b>3.4</b>
<b>CPI inflation (%)</b>	3.2	<b>3.1</b>	2.1	<b>2.1</b>	2.9	<b>2.3</b>	3.0	<b>3.0</b>	n.a.	<b>3.0</b>
<b>Current account balance (% of GDP)</b>	-6.2	<b>-5.2</b>	-5.9	<b>-5.2</b>	-7.4	<b>-5.0</b>	-7.9	<b>-4.5</b>	n.a.	<b>-4.2</b>
<b>General government balance (% of GDP)</b>	1.2	<b>1.1</b>	0.4	<b>0.6</b>	-0.3	<b>-0.5</b>	-0.5	<b>-0.5</b>	n.a.	<b>-0.5</b>
<b>Government gross debt (% of GDP)</b>	61.6	<b>58.7</b>	56.4	<b>54.4</b>	54.1	<b>51.7</b>	52.1	<b>49.3</b>	n.a.	<b>46.9</b>

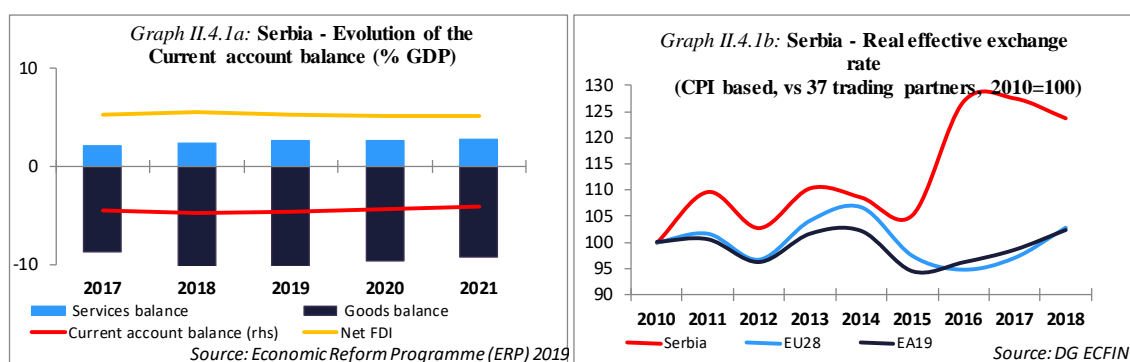
Sources: Economic Reform Programme (ERP) 2019, Commission Autumn 2018 forecast (COM); COM forecast does not take into account the latest national account revision.

**The ERP presents a clear view of economic risks and uncertainties but is rather sanguine about their possible implications.** The programme acknowledges major international risks related to fluctuations of commodity prices, divergent monetary policies of main central banks, and trade tensions; domestically, it outlines risks stemming mainly from a slower-paced implementation of economic reform, in particular of state-owned enterprises, public administration and investment management. Continuing and accelerating economic reforms would provide important signals to potential investors about the authorities' commitment to modernising the economy, a process that depends heavily on attracting productive capital in tradable sectors. Although its underlying assumptions are not evident, the

programme presents an alternative macroeconomic and fiscal scenario, envisaging lower economic growth and worse fiscal performance. However, in view of the magnitude of the risks and historical experience, the alternative scenario seems too benign, is not sufficiently elaborated and lacks details about its demand and supply composition.

**Inflationary pressures are low and price stability seems well anchored despite the cyclical upswing.**

Consumer inflation has been low and stable for several years. It averaged 2.0% in 2018, staying below the mid-point of the central bank target tolerance band of  $3\% \pm 1.5$  pps throughout the year. The central bank maintained its cautious stance, lowering its key policy rate in two steps in 2018 by 25 points each to 3%. In view of exchange rate's importance for the price-setting behaviour of economic agents and financial stability, the central bank continued its frequent and sizeable interventions on both sides of the foreign exchange market, buying a net EUR 1.6 billion in 2018. The ERP envisages, realistically, a slight increase in inflation towards the mid-point of the target band by 2020. Food and oil price fluctuations would continue influencing short-term price dynamics, while growing aggregate demand will be the main factor pushing inflation up during the programme period. The projected stability of the dinar exchange rate, which is also one of the key factors determining inflation, would help contain inflation within the target range.



**External imbalances have widened but there are still divergent opinions on their direction.** Contrary to expectations in last year's ERP, strong import growth and worse terms of trade drove the trade deficit to expand to 12.3% in 2018, while the current account deficit remained unchanged at 5.2% of GDP. The authorities' view is that external imbalances have peaked and will already start shrinking in 2019, with the current account deficit gradually narrowing to 4.5% of GDP by 2021. This expectation is based on the projection of a continued robust export performance, supported by foreign direct investments (FDI) in tradable sectors. However, recent experience shows that the net contribution of new export capacities to lower external imbalances is likely to be constrained due to a major import component. Even though the recent sizeable foreign direct investments enlarged the production and export base, the slowdown of external demand from main trading partners, international trade tensions, and the already high export base are strong arguments for more prudent export projections. In addition, the baseline scenario of growing domestic demand should also trigger further strong import growth, while primary income outflows will likely increase along with the rising stock of foreign investment. The envisaged deterioration of the public savings-investment gap is another factor that may keep external imbalances elevated in the near term.

**Large foreign direct investment inflows fully cover the current account deficit and remain crucial for external sustainability and improving competitiveness.** Net FDI inflows have ensured solid financing of the external deficit: over the last 4 years, they amounted to more than 5% of GDP per year, covering on average one and a half times the current account deficit. FDI inflows have also been key for the ongoing structural transformation of the economy towards tradable sectors. The FDI stock increased by nearly 50% since 2013 and, attesting to the attractiveness of the country as an investment destination, reinvested earnings have more than tripled their share in total FDI. Foreign investors benefit also from generous incentives (direct cash subsidies, tax breaks and various forms of in-kind governmental support, primarily land and infrastructure). Thus, the programme's assumption of continuing strong FDI inflows

over the next few years is plausible, if supported by continued macroeconomic stability, persistent implementation of economic reforms and further improvements in the business environment. Over the last 5 years, the stock of net FDI also increased its share in Serbia's net international investment position from two-thirds to more than 80%. Since FDI can be considered a more stable source of funding, this trend has reduced vulnerabilities to external shocks, despite a persistently high and negative net international investment position of close to 90% of GDP. Another factor that could possibly cushion external shocks is the relatively high level of foreign exchange reserves, which have consistently been covering around six months' worth of imports and are expected to remain at an adequate level during the programme period.

**The financial sector has been supportive of growth and its performance is sound, but reforms and privatisation of state-owned financial institutions are incomplete.** The capital adequacy, liquidity and profitability indicators of commercial banks remained high. Favourable financing conditions and labour market developments have boosted credit growth in 2018. Lending to households and corporates increased at double-digit rates, excluding effects from exchange rate fluctuations and non-performing loan (NPL) sales and write-offs. Although the central bank does not consider the overall credit level excessive, in order to curb the build-up of risk, it took steps to limit credit growth in some market segments like household cash loans with long maturities. The 2015 NPL resolution strategy provided good results and NPLs declined from a high of close to 22% to 5.7% in 2018. The authorities have also recently updated their memorandum on the dinarisation strategy and taken steps to address the legacy NPLs in the portfolio of the Deposit Insurance Agency. The government adopted a new programme for NPL resolution 2018-2020, focusing on limiting the rise of new NPLs. While these and other steps to strengthen the financial sector are welcome, reforms to wind down the still sizable state presence in the sector and improve the governance of state-owned banks have advanced slowly.

*Table II.4.2:*

**Serbia - Financial sector indicators**

	2014	2015	2016	2017	2018
<b>Total assets of the banking system (EUR million)</b>	34 618	35 655	36 992	37 676	41 514
<b>Foreign ownership of banking system (%)</b>	74.5	76.1	76.7	76.9	76.3**
<b>Credit growth</b>	3.1	2.9	2.5	1.9	9.4
<b>Deposit growth</b>	7.6	6.5	11.4	3.3	15.2
<b>Loan-to-deposit ratio</b>	1.1	1.1	1.0	1.0	1.0
<b>Financial soundness indicators</b>					
- non-performing loans	21.5	21.6	17.0	9.8	5.7
- net capital to risk-weighted assets	20.0	20.9	21.8	22.6	22.8**
- liquid assets to total assets	35.6	34.3	36.9	36.7	37.3
- return on equity	0.6	1.6	3.4	10.6	11.3***
- forex loans to total loans* (%)	70.0	71.9	69.3	67.5	68.8

\* Includes both denominated and indexed positions.

Note: Data for December 2018 are preliminary.

\*\* September 2018

\*\*\* As of 30th November 2018

Sources: ERP 2019, National Central Bank.



## 4.3. PUBLIC FINANCE

**The good fiscal performance continued in 2018.** The general government budget was in surplus for a second year in a row. Thanks mainly to a continued strong revenue performance, the budget surplus of 0.6% of GDP for 2018 significantly outperformed the initial target of a deficit of 0.7% of GDP. Better labour market developments and increased corporate profits have led to higher income tax revenue, while one-offs, mostly from collected claims by the Deposit Insurance Agency, boosted non-tax receipts. On the expenditure side, savings on interest payments have largely offset higher than planned spending on goods and services and government investment. The better fiscal results also provided sufficient space for abolishing the crisis-related pension cuts and increasing pensions for those at the lower end of the pension scale.

Table II.4.3:

**Serbia - Composition of the budgetary adjustment (% of GDP)**

	2017	2018	2019	2020	2021	Change: 2018-21
<b>Revenues</b>	41.5	41.1	39.9	39.2	38.7	-2.4
- Taxes and social security contributions	36.1	35.8	35.3	35.1	34.9	-0.9
- Other (residual)	5.4	5.3	4.5	4.1	3.8	-1.5
<b>Expenditure</b>	40.4	40.6	40.4	39.7	39.2	-1.3
- Primary expenditure	37.9	38.5	38.4	37.9	37.6	-0.9
<i>of which:</i>						
Gross fixed capital formation	2.8	3.6	4.0	4.0	4.1	0.5
Consumption	15.3	15.9	16.0	15.9	15.8	-0.2
Transfers & subsidies	17.5	16.9	16.7	16.6	16.3	-0.6
Other (residual)	2.2	2.0	1.7	1.5	1.4	-0.6
- Interest payments	2.5	2.1	2.0	1.8	1.6	-0.5
<b>Budget balance</b>	1.1	0.6	-0.5	-0.5	-0.5	-1.1
- Cyclically adjusted	1.3	0.6	-0.6	-0.7	-0.7	-1.3
<b>Primary balance</b>	3.6	2.7	1.4	1.3	1.1	-1.5
- Cyclically adjusted	3.8	2.7	1.3	1.1	0.9	-1.7
<b>Gross debt level</b>	58.7	54.4	51.7	49.3	46.9	-7.5

Sources: *Economic Reform Programme (ERP) 2019.*

**The 2019 budget is set to provide a stimulus but measures promoting long-term growth are too modest.** The parliament adopted the budget on 7 December 2018. The planned fiscal policy stance is procyclical, targeting a consolidated deficit of 0.5% of GDP, which would result in a deterioration of the cyclically-adjusted primary balance by 1.3% of GDP. Revenue projections can be considered as conservative and do not take into account any possible gains from improved tax collection. Planned expenditure reflects policy changes. The authorities expect a marginal decline in total expenditure as a ratio to GDP and a fall in total revenue by 1.2 percentage points to 39.9% of GDP. The success of fiscal consolidation over the last several years and lower indebtedness should bring additional reduction in interest payments in 2019. Expenditure on social benefits are planned to decline thanks to the growing economy and employment. These savings, along with the envisaged change from a surplus in 2018 to a deficit in 2019 opened up significant fiscal space. The budget used most of it to increase collective consumption (selective public sector wage hikes and higher expenditure on goods and services) and pensions. A small portion of the fiscal space has also been channelled to eliminate the unemployment

insurance contribution (0.75%) paid by employers and to abolish certain parafiscal charges in order to reduce the burden on businesses. Although there has been some increase in capital spending, to 4% of GDP, it is mostly because of higher spending on military and police equipment, while productive capital expenditure remains at rather low levels. The budget also phases out, in two steps over 2019 and 2020, the crisis-era obligation on state-owned enterprises (except the electricity company EPS) to make payments to the budget resulting from wage cuts.

*Box II.4.1: The 2019 budget*

Parliament adopted the 2019 republican budget on 7 December 2018.

The general government deficit target is RSD 25.1 billion (0.5% of GDP), which implies a moderate fiscal policy easing. Most of the new measures are on the expenditure side: selective wage increases, pension increases, higher capital spending. On the revenue side, the main policies are the abolishment of certain fees (with negligible budgetary effect), the increase of the hourly minimum wage, the elimination of the unemployment insurance contribution paid by employers, and the first phase of lifting of the obligation on state-owned enterprises to pay their savings from wage cuts to the budget.

Main measures in the 2019 budget\*

Revenue measures		Expenditure measures	
• Elimination of the 0.75% unemployment insurance contribution paid by employers <b>(-0.2 % of GDP)</b>		• Selective wage increase <b>(0.7% of GDP)</b>	
• Lifting of half of the wage cuts in state-owned enterprises <b>(-0.2% of GDP)</b>		• Revocation of pension cuts and 5% pension hike of low pensions <b>(0.8% of GDP)</b>	
• Increase in minimum wage from RSD 143 to RSD 155 per hour <b>(0.1% of GDP)</b>		• Increase in capital expenditure <b>(0.4% of GDP)</b>	
<b>Total revenue effect</b>	<b>(-0.3% of GDP)</b>	<b>Total expenditure effect</b>	<b>(1.9% of GDP)</b>

\* Estimated impact on general government revenue and expenditure.  
Source: ERP 2019

**The generally prudent medium-term fiscal strategy lacks a strong pro-growth orientation and leaves some key measures not sufficiently elaborated upon.** The programme sets out the medium-term budgetary objective at the same level as last year, a deficit of 0.5% of GDP. This deficit is sufficient to guarantee fiscal sustainability and ensure government debt is reduced further to below 50% of GDP within the programme period, not counting possible restitution-related obligations. The fiscal objectives are also broadly in line with last year's policy guidance to target a balanced budget over the medium term. Both revenue and expenditure ratios are set to decline further at the same pace in 2020-2021. The programme does not present any estimates of the cost of the planned reform of the public wage system nor the reintroduction of pension indexation as of 2020. After some improvement in 2018, the composition of government spending is expected to remain more or less at its 2019 level. This implies keeping overall spending on wages and pensions as a ratio to GDP unchanged. The planned reduction of current non-interest spending is slower than envisaged last year. Capital expenditure is set to level off at

around 4.0% of GDP, which is at too low a level in view of the large investment needs and underinvestment, in particular in some sectors like education, health and environment.

**Government debt and debt servicing costs, which have declined significantly over recent years, are expected to fall further.** The ERP forecasts government debt to continue falling, albeit at a slower pace than in recent years, reaching 46.9% of GDP in 2021. Yields on government bonds and the country risk premium have declined markedly over recent years and are likely to fall further under the baseline macroeconomic scenario. The prudent fiscal policy should also ensure debt-servicing costs are further reduced. The programme envisages interest expenditure falling to 1.6% of GDP in 2021, nearly half from its peak in 2015. In 2018, the primary surplus was the main factor behind the drop in government debt. However, due to the pro-cyclical fiscal expansion, as of 2019 the snowball effect, capturing the difference between interest payments and nominal GDP growth, will become a key debt-reducing factor. Under the assumption of a broadly stable dinar exchange rate and no major privatisation receipts, the stock-flow adjustment is expected to contribute only marginally to debt dynamics.

**Government debt is not yet in safe waters.** Under the baseline scenario, debt indicators would still be significantly above their levels before the 2008 global financial and economic crisis. In the years following the crisis, budget performance was easily derailed and fiscal sustainability deteriorated quickly. Gross financing needs remain large at close to 10% of GDP and the high share of foreign currency denominated debt still exposes government debt to non-negligible fluctuations from exchange rate movements. A rules-based framework does not yet sufficiently anchor policymaking. In view of that, guaranteeing debt sustainability will remain a major policy challenge in the short term. Strengthening existing fiscal rules as envisaged by the authorities, to make them more binding and relevant for policymaking, could play a major role in achieving this goal.

**Fiscal risks and uncertainties are not insignificant.** Despite good fiscal results, reform implementation has been uneven and slow in general and the reform agenda remains largely unfinished. This has resulted in known systemic weaknesses being prolonged, like the public employment freeze and an opaque public wage system, as well as inadequate and inefficient capital spending. There remain major challenges with fiscal implications related to the performance of state-owned enterprises and financial institutions, public sector employment and wage policy, and the overall fiscal governance framework. Some of the newly adopted fiscal measures, such as (i) the selective wage hikes, (ii) the targeted increase of some pensions, (iii) the abolishment of the pension indexation formula, and (iv) the recent acquisition spree by the majority state-owned telecom, are also difficult to justify and eat up space for more productive expenditure. As in previous years, the programme fails to mention possible restitution-related obligations of up to EUR 2 billion or some 4% of GDP. The authorities have once again postponed the deadline for issuing government debt to cover these obligations from 2018 to December 2021.

**The authorities could further strengthen the institutional underpinnings of the budgetary process and fiscal sustainability.** The capacity of the Ministry of Finance to analyse fiscal risks and assess public-private partnerships has increased recently. The authorities also took major steps to improve the capital budgeting process and work progressed on strengthening the tax administration. The coverage of the Budget Execution Information System continued expanding, along with ongoing efforts on developing general government sector statistical information in line with ESA 2010. However, the overall institutional environment related to the budget process is still challenging. The budget calendar is not fully complied with and the Fiscal Strategy has repeatedly been adopted in autumn instead of spring. There was no meaningful parliamentary debate on the 2019 budget and the authorities did not submit final annual budget execution reports to the parliament. Work on revising fiscal rules has largely stalled. The existing fiscal rules remain weak, detached from the policy process and do not offer adequate sanctions in cases of non-compliance nor effective enforcement mechanisms. The improvement in the quality and timeliness of budgetary statistical information was slow. The budget execution reports did not provide information about large one-offs.

#### Box II.4.2: Debt dynamics

Table:

**Serbia - Composition of changes in the debt ratio (% of GDP)**

	2017	2018	2019	2020	2021
<b>Gross debt ratio [1]</b>	<b>58.7</b>	<b>54.4</b>	<b>51.7</b>	<b>49.3</b>	<b>46.9</b>
Change in the ratio	-10.1	-4.3	-2.7	-2.4	-2.3
<i>Contributions [2]:</i>					
<b>1. Primary balance</b>	<b>-3.6</b>	<b>-2.7</b>	<b>-1.4</b>	<b>-1.3</b>	<b>-1.1</b>
<b>2. "Snowball" effect</b>	<b>-0.9</b>	<b>-1.7</b>	<b>-1.6</b>	<b>-1.9</b>	<b>-1.9</b>
<i>Of which:</i>					
Interest expenditure	2.5	2.1	2.0	1.8	1.6
Growth effect	-1.4	-2.4	-1.9	-2.0	-1.9
Inflation effect	-2.0	-1.4	-1.7	-1.7	-1.6
<b>3. Stock-flow adjustment</b>	<b>-5.6</b>	<b>0.0</b>	<b>0.3</b>	<b>0.7</b>	<b>0.6</b>

[1] End of period. In accordance with the Budget System Law. This includes all government-guaranteed debt and non-guaranteed local government debt. It differs from government debt according to the national methodology (Public Debt Law), which does not include non-guaranteed local government debt.

[2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).

The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other effects.

Source: Economic Reform Programme (ERP) 2019, ECFIN calculations.

The government debt to GDP ratio fell by 4.3% of GDP in 2018. Most of the decline was due to the still sizeable primary surplus. Economic growth, which picked-up notably, also contributed to the fall in the debt ratio. Contrary to previous years, the stock-flow adjustment had a negligible effect, reflecting a stable dinar exchange rate and the booking of the large concession fee for the Belgrade airport in 2019. Looking ahead, the programme forecasts that the stock-flow adjustment and interest payments will remain the only debt-increasing factors. However, government debt is expected to decline further thanks to sound

fiscal policy and stable economic growth. Restitution-related debt and fluctuations in government financial assets, not included in the baseline scenario, could also significantly affect debt dynamics.

#### 4.4. STRUCTURAL CHALLENGES AND REFORM PRIORITIES

**Serbia has been progressively restructuring its economy, principally by investing into the tradable sector.** Exports have been a major driver of growth. Manufacturing has modernised and diversified over recent years, but traditional industry, in particular the energy sector has not been restructured. Its underperformance negatively affects economic growth by up to 1% per year. Moreover, to reach higher growth rates, opportunities of the internal market and services will need to be better exploited, through ensuring a level playing field for all companies. Economic growth and improvement of living standards towards EU levels will thus depend on continuous implementation of structural reforms across many sectors. The Commission has conducted an independent analysis of Serbia's economy and identified the main structural challenges to competitiveness and inclusive growth, drawing on Serbia's own ERP and other sources. The analysis highlights a number of structural challenges across many sectors. The three most important ones are: (i) increasing the contribution of labour to growth, (ii) improving transparency and predictability in the regulatory environment and facilitating competition and (iii) tapping energy saving potentials and fully opening the energy market.

##### 4.4.1. Key challenges

###### **Key challenge #1: Increasing the contribution of labour to growth**

**Considerable gaps in labour market participation, education and school-to-work transition have not yet been addressed in a strategic manner.** The labour market potential of the population at working age is not fully used. Women, young people and recent graduates are not well integrated into the labour market and their employment levels are still below the country's potential. The large number of

unemployed people does not benefit from appropriate support for reintegration into employment. The continuing brain drain, including of people with particular skills, risks aggravating labour shortages in the future, given demographic developments. Limited consideration is given to improving the attractiveness of the labour market, in particular in the medium and lower range of wages. Fiscal space has been used predominantly to increase public wages and pensions. However, a broader and more equitable approach to improving socioeconomic conditions is required in the longer term. The continuing high level of undeclared work calls for a more comprehensive approach to encourage formal work, thus strengthening the position of labour in the country's overall economic framework.

***Key challenge #2: Improving transparency and predictability in the regulatory environment and facilitating competition***

**In the private sector there is a strong sense of unfair competition.** The sentiment on unfair competition is primarily fuelled by the omnipresence of public companies, which contribute 20% of GDP but possess 70% of assets, but also by the large informal sector (27% of GDP) and state aid schemes favouring foreign investors over domestic SMEs. Businesses are also concerned by the unpredictable and non-transparent fiscal and para-fiscal revenue collection system.

**State-owned enterprises crowd out private sector development.** Many public companies consume excessive national resources, provide poor services to the rest of the economy and negatively affect fiscal results. Furthermore, both public and private large firms have established a special relationship with the state, which results in tailor-made policies and financial advantages.

**Unfair competition is also fuelled by the large informal sector.** Many SMEs and sole traders operate partially in the grey economy, so as to avoid the relatively high tax wedge on wages or to avoid red tape. While in view of the fiscal policy needs the government has been careful in reducing the tax burden, it has stepped up the fight against the informal sector by increasing tax and labour inspections. For example, the labour inspectorate filed 15% more irregularities concerning employment in 2017 than in 2016. The aim is to bring down the level of the informal sector from the current 27% to 25% of GDP. A new action plan on informality, which is planned for adoption in 2019, focuses on similar measures as in the past - monitoring of financial flows, improvement of tax administration, stimulation measures for fair competition, legalisation of small entrepreneurship and raising awareness. Once adopted, the action plan should be implemented as a matter of priority. In order to achieve more significant results, improvements are also needed in the overall business environment, especially on tackling corruption, rule of law, contract enforcement and better regulation.

**Serbia's FDI attraction policies are among the most effective in the region, according to the OECD (2018); however, these policies are not in line with state aid rules and leave domestic companies underserved.** The state provides services, which enable swift installation and operation, and in addition offers tax breaks and subsidies for new employment to foreign investors. On the other hand, the budget for SME policies is growing but remains modest compared to the amounts of state aid and tailor-made services offered to big investors. Good policies to support (foreign) investors need to become more inclusive and better financed. Those most in need of such support are domestic business, particularly those that are smaller and innovative, which have the possibility of reaching international markets or establishing links with incoming FDI.

**The revenue collection system needs more predictability and fairness.** Local companies most often complain about the unpredictable taxation system and the large discretionary levies of local authorities or independent agencies employ into collecting revenue (para-fiscal charges) for their services, regardless of the actual cost of this service. In Parliament, many of the business-related laws are still passed by urgent procedure. When it comes to curbing the powers of independent authorities to levy fees and taxes, a new law on fees on the use of public goods was passed, by urgent procedure, in December 2018. It remains to be assessed to what extent the law will contribute to predictability of para-fiscal charges and ensure that these fees represent a fair value of a particular service.

**The lack of effective rule of law is one of the main factors that hampers the private sector and enables informality.** Effective and independent judicial systems are needed for developing of the business environment and attracting more FDIs. A strengthened rule of law would positively contribute to a more predictable regulatory framework, contract enforcement and increase of transparency, leading to a more competitive economy. Moreover, it will also help reduce corruption.

***Key challenge #3: Tapping energy saving potentials and fully opening the energy market***

**Serbia's competitiveness continues to be hampered by a polluting, inefficient and not properly regulated energy sector.** The energy sector represents 4% of GDP. Its regular underperformance leaves an important mark on growth. The energy supply is generally uninterrupted but continues to rely mostly on lignite, polluting heavily. Electricity tariffs are too low to enable necessary investment in infrastructure; the country performs badly in energy efficiency terms.

**Adjustments in the electricity tariffs and further restructuring of the sector are needed to improve its performance.** Most energy companies are state-owned and have through the years relied to a different degree on support from the budget. The government has made efforts to professionalise the governance of the electricity generator EPS. Furthermore, it had restructured the debts that the gas provider Srbijagas accumulated, due to supply of gas to non-paying publicly owned companies. While these companies no longer represent a threat to public finances, their restructuring is still not finalised. Moreover, electricity tariffs are not cost-reflective and should increase gradually by 50% to reach full cost recovery level. This should be accompanied by appropriate social programmes to mitigate possible adverse effects.

**Proper regulation is a key priority for the sector.** While Serbia's primary legislation is compliant with the third energy package and its rules on the internal energy market, implementation is lagging behind, particularly in gas. In the past years, Serbia has stalled its gas market reforms. In breach of its obligations under the Energy Community Treaty, Serbia continues to delay unbundling in the gas sector and fully finalising unbundling in electricity. Proper regulation of electricity and gas markets is key to increase the sector's efficiency and effectiveness.

**The energy sector has attracted non-EU investors.** In some occasions, their investments do not seem to undergo proper screenings for EU public procurement, state aid and technical rules. This can potentially lead to breaches of obligations vis-a-vis the agreements signed with the EU and create hiccups in interoperability. Therefore, the state needs to exercise particular caution when it engages with investors from third countries.

**Serbia's energy sector is at the core of the Western Balkans connectivity agenda.** Infrastructure and cross border connectivity have been improving, but significant further large investments are needed. These include the upgrade of the Trans-Balkan electricity corridor and the construction of the Serbia-Bulgaria gas interconnector. To further regional connectivity on energy, Serbia should swiftly implement the connection agreement reached in the dialogue between Belgrade and Pristina.

**Large investments are needed in environmental upgrading in order to reduce pollution.** Due to its large reliance on coal burning, EPS needs to invest significantly in combatting air pollution. According to a study by the Energy Community Secretariat (2013), Serbia needs to invest EUR 640 million in the energy sector to comply with the Large Combustion Plant Directive and EUR 710 million to comply with the Industrial Emission Directive. Environmental protection fees should be fully allocated to finance environmental investments (polluter pays principle). Serbia needs to increase its environmental investments substantially, also in view of obligations arising from the EU *acquis*.

**The poor energy efficiency is a key challenge for the near future.** Energy intensity in Serbia is four times higher than that of OECD countries. The introduction of energy efficiency measures largely depends on local governments, which have neither the necessary resources nor the capacities. The role of the central government is therefore crucial: It needs to address energy efficiency by pursuing a more strategic approach, investing more into stepping up financial and human resource capacities and ensuring better coordination with stakeholders at local government level and outside the government. The introduction of an energy efficiency fee in early 2019 was a first, although limited step in the right

direction. Improving Serbia's institutional set-up and financing mechanisms are needed to enable scaling up urgently needed investments into energy efficiency.

#### 4.4.2. Labour market, education and social policies

##### Labour market developments

**The labour market continued to improve slightly in 2018, although at a rate below economic growth and less pronounced than in 2017.** The activity rate (15-64 years) continued to increase with 1.1 pps year-on-year (2018: 67.8%, 2017: 66.7%), while the employment rate improved with 1.5 pps year-on-year (2018: 58.8%, 2017: 57.4%). Employment reached its highest level since 2014 with more than 2,8 million people in work in 2018. The recent decrease in unemployment from 2017-2018 (-0.8 pps) was less noticeable compared to 2016-2017 (-1.8 pps). Positive labour market trends were moderated however by continued emigration at estimated 50,000 to 70,000 potential workers in 2018, caused by lack of jobs, low wages and living standards. Pronounced regional and urban/rural disparities in employment persist.

**Women, young people and low skilled people are still underrepresented in employment.** Although positive economic trends have substantially reduced youth unemployment, which has fallen faster than overall unemployment in recent years, it still remains over two times higher than for the overall workforce (2018: 29.7%). A further reduction of the proportion of young people not in employment, education or training (NEET) by 0.7 pps (15-24 years) was seen in 2018 (16.5%), but the problem remains significant for the age group 25-29 years with a NEET rate of 29.5% (2017). The new national youth strategy 2018-2020 was adopted recently. The employment gender gap persists at 13.6 pps (15-64 years), and female unemployment, in particular when young, remains constantly higher than for men (3.7 pps in 2018). There is no comprehensive approach for activation and retention of women in employment. The employment rate of recent graduates (20-34 age group) of 56.9% in 2017 is well below the EU average of around 80%, representing untapped potential for developing value-added economic activities.

**Active labour market policies (ALMPs) in Serbia remain insufficient in scope and content.** Funding for carrying out ALMPs is very low (2017: 0.08% of GDP). The measures provided under the yearly National Action Plan on Employment (NEAP) are mostly one-day services such as job fairs and job-search training, covering around 120,000 participants per year. Measures may be useful but have limited impact on improving job prospects for unemployed people. Only around 3% of registered unemployed people have been included in measures such as training, employment and self-employment subsidies or public works. Training measures are mostly for medium and highly educated jobseekers. No comprehensive data are available about the scope of ALMPs provided at local level, based on agreements between the National Employment Service and local self-government units.

**High informal employment and low-work intensity are problematic trends in the employment increase in recent years.** Informal employment remains constantly high at around 20% and is present in agriculture and other sectors as well. A new law on seasonal work in agriculture enters into force in 2019 aiming to reduce informal work in the sector. No targets have been set for its implementation. Low work-intensity in marginal jobs is twice as high as the EU average, one worker in five is employed in seasonal, part-time or casual jobs. The recent economic improvements have not yet led to substantial income increases; the average monthly wage reached around EUR 420 in 2018. However, three out of four workers' earnings are lower. The minimum wage was increased to RSD 155 per hour (EUR 1.30) in 2019. Public sector wages nominally increased by close to 10% in both 2018 and 2019.

**Social dialogue is weak, in particular for the private sector.** Since the cancellation of all collective agreements in 2015 after the Labour Code revision in 2014, new collective agreements have been mostly concluded in the public sector including in public companies. Very few agreements at branch level exist in the private sector, due to non-conducive rules for extending agreements. Tripartite social dialogue, in particular within the Economic and Social Council of Serbia, has become more regular in 2018, but Social Partners consider their impact on political decisions as rather limited. The revision of the law on strike has been further postponed.

**Box II.4.3: Monitoring performance in light of the European Pillar of Social Rights**

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights on equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion to benefit citizens in the EU. Since the 20 principles are essential for countries if they are to achieve fair and well-functioning labour markets and welfare systems, they are equally relevant for candidate countries and potential candidates. The new reinforced social dimension for the Western Balkans includes an increased focus on employment and social reforms through greater monitoring of relevant policies (EC, 2018). The Western Balkans Ministers' Declaration on improving social policy in the Western Balkans (6 November 2018) confirms that they will use the Pillar to guide the aligning of their labour markets and welfare systems with the EU's.

**In most of the principles of the European Pillar of Social Rights, Serbia performs weaker relative to the EU average, according to the indicators of the Social Scoreboard<sup>(1)</sup>.** Improving trends in employment have been observed over recent years. While in some areas lower performance is in a certain way unavoidable, since Serbia is poorer than any one of the EU Member States, more attention needs to be paid to fields that are less dependent on the level of national income, such as gender equality and inequality.

SERBIA		
<b>Equal opportunities and access to the labour market</b>	Early leavers from education and training (% of population aged 18-24)	N/A
	Gender employment gap	Worse than EU average, improving
	Income quintile ratio (S80/S20)	Worse than EU average, no change
	At risk of poverty or social exclusion (in %)	Worse than EU average, improving
	Youth NEET (% of total population aged 15-24)	Worse than EU average, improving
<b>Dynamic labour markets and fair working conditions</b>	Employment rate (% of population aged 20-64)	Worse than EU average, improving
	Unemployment rate (% of population aged 15-74)	Worse than EU average, improving
	GDHI per capita growth	N/A
<b>Social protection and inclusion</b>	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU average, deteriorating
	Children aged less than 3 years in formal childcare	Worse than EU average, improving
	Self-reported unmet need for medical care	Worse than EU average, improving
	Individuals' level of digital skills	Worse than EU average, improving

**Women in Serbia have a significantly lower employment rate than men.** The gender employment gap is wider than the EU-28 average (14.1 pps vs 11.5 pps in 2017) with no significant change in the last 5 years. The wide employment gap is mainly due to the low activity of women in the labour market. The lower statutory retirement age for women and low level of part-time work (12% for women) combined with care responsibilities are some of the root factors.

**Serbia's performance on social inclusion, social protection, income equality and poverty alleviation could be significantly improved.** The at-risk-of-poverty rate stands around 25%, among the highest in Europe. Children and young people below 25 years of age face an at-risk of poverty rate of 30%. Disposable income of individuals in the top income quintile is on average almost ten times higher than of those in the lowest quintile. Serbia's tax-benefit system is not as efficient

as elsewhere in Europe in reducing market inequality. Furthermore, high government expenditure does not reduce income inequality much. Pensions, for example, although they comprise some 12% of GDP, among the highest shares in Europe, are less effective in reducing inequality in the EU.

**Serbia has a well-developed statistical system.** The Statistical Office of the Republic of Serbia is the main producer of primary data from the Labour Force Survey and the Survey on Income and Living Conditions (SILC). The Institute of Public Health produces detailed statistics related to public health and demographic

<sup>(1)</sup> The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance (<https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators>). The 12 indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-28 average (performing worse/better/around EU-28 average) and a review of the trend for the indicator based on the latest available 3-year period for the country (improving/deteriorating/no change). Data from 2014-2017 are used.

*(Continued on the next page)*



*Box (continued)*

trends. The semi-governmental Social Inclusion and Poverty Reduction Unit is especially active in processing and interpreting data on poverty and inequality as well as developing indicators for monitoring of the social situation. In academic and civil society circles the monitoring of the social situation in Serbia is critically discussed, regarding methodology and results.

### Social Protection System

**Despite continuing positive economic trends, poverty and income inequality remain high.** Over 2014-2017 the at-risk-of-poverty-and-exclusion rate fell by 5.9 pps to 36.7%, due to lower material deprivation levels. The at-risk-of-poverty rate did not change, with one quarter of the population at risk (2017: 25.7%, -0.2 pps from 2014). The share of the population at risk in at least 3 consecutive years increased in 2017 to 18.4% (up 1.7 pps from 2014). Households of two adults with three or more children (55.8%), single individuals over 65 years old (39.6%) and children (nearly one in three) are most at risk. There is no strategic policy approach to lift people in substantive numbers above the threshold in the short-to-medium term. Income inequality measured by SILC is markedly above EU level.

**The minimum income scheme (FSA) does not provide sufficient coverage nor is it sufficiently effective.** Around 3-4% of the population receive FSA (EUR 69 per month for adults, less for children), less than half of the number of people living in absolute poverty according to national criteria. The FSA is well-targeted and cost-effective, as around 75% of benefits reach the poorest population quintile, but the funds provided do not cover basic living needs. The gap between the FSA level and the poverty threshold widened in recent years and stands around 45 pps. Amending the Social Protection Law was postponed after public consultations in mid-2018. Envisaged changes focused on improving the capacities of the public welfare service, strengthening FSA conditionality and activating FSA recipients able to work. No measures for increasing the adequacy of cash benefits were proposed. Spending on FSA is around 0.35% of GDP, below not only European but also regional standards. There are no plans for a targeted increase in social spending in this area.

**Incentives for increasing birth rates were enacted in 2018, but are not accompanied by improved provisions for early childhood education.** The new financial support for the first four children is means-tested (but quasi universal) and it comprises specifically monthly instalments for the third and fourth child over the first 10 years. The proportions of children up to 6 years old attending kindergarten increased markedly from 27.3% in 2014 to 39.6% in 2016. The attendance level is very high for children from well-off families (78%), but only 9% for children from the poorest families and 6% for Roma children (data: UNICEF MICS5). This is despite the priorities set by law for children from vulnerable groups. Kindergartens are funded by local governments but not all of them have sufficient financial means for providing the necessary services.

**A new law on pensions adopted in September 2018 gives the government the discretionary right to regulate future increases of pensions.** The law abolishes the temporary progressive cut on higher pensions affecting 40% of pensioners, which was enacted since 2014 for fiscal consolidation reasons. The replacement of the previous indexation method based on inflation and GDP growth by a discretionary right to regulate future increases of pensions endangers the stability and predictability of the public pension system, which is already under strong pressure due to the ageing population.

### Education and skills

**Serbia's education system outcomes are not contributing sufficiently to longer-term socioeconomic development.** The education level of the population is growing relatively rapidly, due primarily to the far lower educational achievements of the older population exposed to demographic attrition. In 2015, about

71% of people over 25 years of age had completed at least upper secondary education (men 77%, women 65%). At this level, Serbia still ranks below those EU Member States that joined in 2004 and later (81.7%), but it is catching up. Tertiary level attainment is increasing (31.4% in age group 30-34), but this potential is not translated into high quality occupations. The analysis of skills mismatch in Serbia shows that one in four workers with tertiary education is employed in occupations below their attainment level (which means they are over-qualified) while among the medium-educated the incidence is about 7%. PISA results (2016) indicated high shares of underperforming pupils (40% in mathematics and 30% in reading). Further insights on longer-term trends will be obtained from PISA 2018, TIMSS 2019 and PIRLS 2021.

**The education strategy and its action plan are being implemented, albeit with important delays.** Some progress was made in improving school curricula, including pre-school education. The regular training of school staff is not yet consistent with new outcome-based curricula; innovation in teacher education relies primarily on individual initiatives and international development projects. A larger donor-driven initiative was launched in 2018 with the teacher training program for implementing outcome-oriented learning. The Roma and other ethnic minority groups continue to significantly underperform in a school system that replicates social inequalities. A national action plan on inclusive education was adopted in 2018. The legislative and institutional framework of the national qualifications framework is in place now and 12 sector skills councils have been set up.

**Vocational education and training (VET) is still the dominant option to take in secondary education.** At present nearly 75% of students follow VET (involving classroom-training), which shows better employment outcomes (52.1% employment rate in 2017) than the general education path (41.2%). A new type of VET involving work-based-learning has been tested since 2016 and the corresponding legislative provisions were complemented in 2018. The system is still in its pilot stage with around 4500 students enrolled so far (equal to around 2% of all students in secondary education). Quality assurance mechanisms have not yet been introduced, and first evaluation results will become available in 2021 when the first four-year cycle is concluded. Entrepreneurship has been introduced as a separate subject in general education for the first time in 2017. University curricula have been modernised and new start-up development and intellectual property management courses have also been developed. Rapid strides have been taken to improve the innovation infrastructure to link business with academia through science and technology parks in Serbia's three main economic hubs.

**Adult education and lifelong learning opportunities are insufficient to improve the labour market integration of vulnerable groups.** Lifelong learning participation is low (4.4%), as well as second chance education for adults. There is little coordination between public and private institutions involved in implementing education and training policies for labour market integration and social inclusion. The high proportion of adults with lower education attainment presents a serious obstacle to their better inclusion in the labour market as well to mitigating poverty. Measures for improving educational attainment cannot be successfully implemented because the adoption of a number of relevant by-laws did not follow the Law on adult education.

#### 4.4.3. Competitiveness and sectoral issues

##### Business environment

**There is a political commitment to further improve the business environment.** Serbia is ranked favourably in the World Bank's Doing Business (2019) report, but the latest reports show that the pace of progress has slowed down as reforms are becoming more difficult to design and implement. The most significant measure to improve the business environment was the introduction of a simplified construction permit procedure in 2015. It has contributed to the boom in the construction sector and availability of real estate. Serbia also ranks high when it comes to opening a new company or trading across borders. The macroeconomic stabilisation significantly improved the access to finance for companies, but financing remains primarily in the form of loans, while more complex financial instruments are underdeveloped. Serbia is now perceived as one of the most attractive investment destinations in southeast Europe,

supported principally by the low cost of labour, geographic proximity to the EU's most developed markets and generous tax incentives for FDI.

**At the same time, more difficult reforms to improve the business environment face delays both in design and implementation.** This concerns more complex business support services, such as protection of investors, enforcement of contracts or fair competition and taxation. Progress has been made with adoption of an e-government law in April 2018. The implementing legislation and a new e-government strategy for 2019-2021 are being developed and should contribute to improve the services for both citizens and businesses. Some further e-services have been developed, such as on e-payments. Digital signatures are being used but uptake of this service is only around 5% of the population. A more modern e-government portal is currently being designed. Introduction of these e-government services is a much welcome initiative as it can help improve the environment for business by speeding up procedures and reducing the scope of favouritism or corruption by the administration.

**The role of SMEs in the economy is not as pronounced as in the EU although they are receiving increasing attention from policymakers.** The Ministry of Economy of Serbia launched a policy initiative in 2016, the Year of Entrepreneurship, which subsequently became the Decade of Entrepreneurship initiative, increasing overall financial and non-financial support to SMEs. The Ministry of Economy also adopted in 2015 an SME Development Strategy & Action plan 2015-2020, envisaging the establishment of a legal framework for non-bank, non-deposit credit institutions by end-2016, in order to ease access to funds for micro-enterprises and entrepreneurs. The uptake of SMEs for these services is remarkably high, demonstrating their needs and willingness to engage with public agencies. Loans in local currency increased, improving SMEs' access to bank finance, but more complex instruments are still not developed and regulated. The uptake of SMEs in public procurement tenders remains relatively low.

#### Research, development and innovation

**Investment in research, development and innovation is weak and industrial innovation in particular needs more support to increase the value-added of exports.** Although the country has a relatively good scientific base, the level of investment in research and development is only 0.9% of GDP. The share of private investment in research is only 0.3% of GDP. Cooperation between the public and private sectors remains weak and is not systematically supported. Most public funds for research end up in public research institutes while companies receive a very small share. Infrastructure for science and technology parks is being expanded, but support services for these institutions remain limited and need to be expanded. Similarly, the Innovation Fund, which provides grants for industrial research, needs a more prominent role in the national funding system.

#### Digital economy

**Digital transformation is a key priority for Serbia.** The government established an Office for information technology and electronic government, which deals with a comprehensive introduction of e-services. A key challenge for public policy is also to improve broadband roll-out, which is still below the EU average and keeps the country trailing behind when benchmarked against its peers in the World Economic Forum's Network Readiness Index and the EU Digital Economy and Society Index. The lack of broadband prevents uptake of e-government and business services and is slowing down the transformation of the economy, decreasing its efficiency. In particular, provisions of business-to-business and public services over the network are assessed as being very weak.

**The ICT sector needs more support as it has the potential to help modernise the economy.** A number of ICT clusters across the country have been established and technology parks have most incubated companies in this area. Investment of the ICT sector in research is above the national average, but still low compared to EU averages. Some Serbian ICT firms and researchers are highly successful in the EU Horizon 2020 programme, pointing at pockets of global excellence. The sector now employs just 2% of total labour, but it is estimated to contribute significantly to the export of services (17%), has higher

employment growth (10% per year) and pays higher salaries. The challenge remains to ensure there are links between the ICT sector and traditional industries so as to speed up the latter's modernisation.

### Investment activity

**FDI inflows are increasing, but positive spillovers could be better captured by domestic firms, particularly SMEs.** Due to the conflicts in the 1990s, Serbia was late in attracting foreign investors. First waves of investment in the early 2000s occurred in services, such as telecommunications or banking. The global financial crisis significantly reduced the willingness of investors to expand. Incoming FDI recovered only with the recent macroeconomic stabilisation and the start of EU accession negotiations. Serbia continued working closely with investors and FDI inflows grew to EUR 3.2 billion in 2018, the highest recorded in recent years. The stock of FDI is now at around 80% of GDP. Investment is spread across many sectors, with more than a quarter going into manufacturing. The top 15 exporters are mainly foreign-owned, securing jointly just under 30% of total exports. The backward linkages between FDI and domestic firms remain weak. Tailor-made measures are needed to link incoming investors with domestic suppliers, integrating them further in their value chains. To this end, economic clusters remain limited and their activities are not systematically supported by the government. Similarly, the ongoing programmes for internationalisation of SMEs need to be stepped up to reach a higher number of beneficiaries.

### Trade performance

**Trade performance improved further in 2018, but external imbalances increased.** Trade openness rose to above 110% of GDP from 88% five years earlier as both imports and exports maintained strong growth. Access to the EU market without customs duties applies for 93.3% of Serbian products. Exports rose by more than 9% in 2018 despite some loss in price competitiveness due to a strong dinar. However, external imbalances increased as higher investment and consumption pushed up imports by 11% in 2018. Nevertheless, the current account deficit remained fully covered by net FDI inflows. Metals, cars, car parts and electric appliances were the most significant sectors of exports. The same sectors are the most significant on the import side as well, along with energy imports, which is the top import category, amounting to EUR 2.5 billion or 11.6% of total imports of goods.

**Foreign investment and trade are well-placed to continue driving growth, but the potential of trade integration with the EU and countries in the Central Europe Free Trade Agreement (CEFTA) is still not fully realised.** Serbia's FDI and trade integration levels with the EU are still below some of its peer countries. The frameworks of the Stabilisation and Association Agreement and the Central European Free Trade Agreement (CEFTA) can be better used. A number of non-tariff barriers hinder trade with the EU, particularly in the area of food and agriculture. The regional economic area (REA) commitments need to be pursued with determination, including finding pragmatic solutions to political obstacles under CEFTA.

### Transport

**Transport infrastructure suffers from years of bad maintenance and underinvestment and hampers faster trade expansion.** Its quality is ranked by the World Economic Forum as lower than in most other Western Balkan countries, with poor scores in all four categories (rail, road, water and air). An intelligent transport strategy, as required by the EU *acquis*, has not yet been put in place in Serbia. On the other hand, Serbia ranks better in terms of logistics, as it provides enough services on its transport routes to secure shipments of large volumes of goods. Critical improvements are needed in the areas of traffic management, maintenance, and road safety. Adequate funds for these goals have now been secured, but timely implementation remains a challenge. The reform of the railway system has started but needs to be completed. River ports have started to become an important trade channel, but they need to be further upgraded and their full inter-operability with roads and railways needs to be secured.

## Agriculture

**The importance of agriculture for the economy is slowly diminishing, but remains significant when coupled with the more dynamic food processing sector.** Agriculture accounts for slightly more than 7% of gross added, although it employs around one-fifth of the labour force. Agriculture and food products exports contribute significantly to employment and the balance of payments (15% of all exports). Exports to the EU even dropped. Weather conditions continue to have a strong influence on the sector performance. The other challenges facing the agricultural sector are (i) high exposure to weather, (ii) land fragmentation, (iii) low productivity due to outdated technologies, (iv) small economic size and (v) low utilisation of agricultural land per farm. In addition, the sector faces EU obligations in the areas of food safety, veterinary and phytosanitary regulation, strengthening of responsible authorities in those areas, and a need to improve border inspections as regards risk analysis and risk-based performance. Moreover, the real estate market for agricultural land is hindered by the weak cadastre/property registration, as well as the lengthy procedures for case settlements in courts.

## Industry

**The competitiveness of industry is key to growing the economy.** Support for incoming FDI is principally oriented towards attracting manufacturers. After years of declining industry, the share of industry in GDP has now stabilised. Industry constitutes a quarter of the value added with stable manufacturing, but includes a very variable performance from traditional industries such as mining and electric production. The government is planning to adopt a new industrial strategy, which should be based on smart specialisation. Its measures should be better targeted towards the sectors and firms with most potential. While support for investment is well rolled-out, other services are less developed. Clusters, technology parks, internationalisation, and industrial research do exist, and new standards or digitalisation in traditional industries have been introduced; however, these have not yet had a systemic impact. These kinds of measures should be stepped up, also in view of their full compliance with state aid rules. The smart specialisation strategy should address the issue of skills, which need to accompany modernisation.

## Services

**Services represent more than half of the economy and close to 30% of total exports.** Around half of the value-added by services comes from retail, real estate and healthcare. Services have been increasing their share in total exports and have a potential to expand further. The export structure by service type is dominated by tourism, transport and ICT services. To further expand these fast growing and competitive services, investments in infrastructure and skills need to be adjusted to their needs. A dedicated effort is needed to slow down the brain drain of most skilled labour. Under the Stabilisation and Association Agreement with the EU, there is no framework for the liberalisation of services, but this does not significantly affect the above sectors. The CEFTA agreement highlights further sectors in which services could expand regionally, provided that a significant work on mutual recognitions of qualifications and certificates is accomplished. Belgrade is well-positioned to function as a hub for the regional provision of many skill-intensive services.

#### 4.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2018

<b>Overall: Partial implementation (40.9%) <sup>(17)</sup></b>	
<b>2018 policy guidance</b>	<b>Summary assessment</b>
<p><b>PG 1:</b></p> <p>Use any revenue over-performance in 2018 for debt reduction.</p> <p>Target a balanced budget over the medium term, in order to lock in recent fiscal consolidation gains and create sufficient buffers against fiscal risks. Adopt a credible and binding system of fiscal rules, capable of anchoring fiscal policy.</p>	<p>There was <b>partial implementation</b> of PG1.</p> <p>1) <b>Substantial implementation:</b> The 2018 revenue outcome was better than expected by RSD 70 billion. Most of the over-execution was saved and the budget ended in a surplus of 0.6% of GDP.</p> <p>2) <b>Substantial implementation:</b> The medium-term fiscal programme targets a budget deficit of 0.5% of GDP, i.e. close to a balanced budget.</p> <p>3) <b>No implementation:</b> There were no administrative or legal measures taken to address this policy guidance. Although it reconfirms the authorities' commitment, the ERP 2019 does not include any specific plans or a timeline for strengthening fiscal rules.</p>
<p><b>PG 2:</b></p> <p>Further improve the composition of government spending by reducing non-interest current expenditure and increasing capital spending as a share of GDP over the medium term.</p> <p>In order to better plan and execute public investments, develop a single mechanism for prioritising and monitoring all investment regardless of the source of financing.</p>	<p>There was <b>limited implementation</b> of PG 2:</p> <p>1) <b>Partial implementation:</b> The composition of government spending improved somewhat in 2018. Current non-interest expenditure fell from 35.0% in 2017 to an estimated 34.8% of GDP in 2018, while capital expenditure went up from 2.8% to 3.6% of GDP. The current non-interest expenditure is expected to decline further over the medium-term by 0.4-0.5 percentage points per year but the decline comes mainly from the group of other current spending and social benefits. Collective consumption (wages and good and services) is actually envisaged to increase slightly to 16.0% of GDP in 2019. Capital expenditure are also levelling off at 4.0% of GDP.</p> <p>2) <b>No implementation:</b> The adopted decree maintains a double system for the screening of investment.</p>
<p><b>PG 3:</b></p> <p>Conduct monetary policy in line with achieving the inflation target.</p>	<p>There was <b>substantial implementation</b> of PG3:</p> <p>1) <b>Full implementation:</b> Monetary policy was kept accommodative in 2018 and inflation</p>

<sup>(17)</sup> For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission's Overview and Country Assessments of the 2017 Economic Reform Programmes available at [https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments\\_en](https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en).

<p>Consider to gradually allow for more exchange rate flexibility as macroeconomic stability is cemented.</p> <p>Implement the remaining action points from the NPL resolution strategy</p> <p>and finalise the privatisation process of the remaining state-owned banks.</p> <p>Continue to promote the use of the local currency inter alia by maintaining a favourable treatment of dinar reserve requirements compared to those in foreign currency and by fostering the development of interbank markets and secondary markets for government securities.</p>	<p>fluctuated within the tolerance band, in the lower part, on account of low imported inflation and existing spare capacity.</p> <p>2) <b>Limited implementation:</b> The NBS intervened to curb appreciation pressures through the year such that the dinar exchange rate toward the euro was broadly unchanged. As a result, the IMF reclassified the exchange rate as crawling peg.</p> <p>3) <b>Substantial implementation:</b> The authorities have implemented most measures of the NPL resolution strategy. The government adopted a new programme for NPL resolution 2018-2020, focusing on limiting the rise of new NPLs.</p> <p>4) <b>Partial implementation:</b> There are delays in the restructuring of Banka Poštanska štedionica. More progress has been made regarding the privatisation of Komercijalna Banka. The restructuring of small state-owned banks is ongoing.</p> <p>5) <b>Substantial implementation:</b> The authorities have kept the spread between reserve requirements in foreign and local currency unchanged. An update of the dinarisation strategy was published in December, which provides for, among other things, measures to foster developments of secondary markets for government securities.</p>
<p><b>PG 4:</b></p> <p>Gradually adapt electricity tariffs so they reflect real costs including necessary investments to upgrade the energy network and to meet environmental standards.</p> <p>In parallel, increase investments in energy efficiency.</p> <p>Finalise the unbundling of state-owned enterprises alongside accelerating their restructuring, in particular Srbijagas and EPS.</p>	<p>There was <b>limited implementation</b> of PG 4:</p> <p>1) <b>Limited implementation:</b> Electricity prices have slightly increased but the reform of the system of tariffs remains a significant challenge.</p> <p>2) <b>Partial implementation:</b> The law on fees has been adopted and includes an energy efficiency fee, which should have a positive impact on the financing of energy efficiency projects.</p> <p>3) <b>Limited implementation:</b> The restructuring of Srbijagas continued but progress on unbundling was negligible. The restructuring of EPS continued but not all outstanding issues regarding unbundling were addressed.</p>
<p><b>PG 5:</b></p> <p>Use findings of the smart specialisation exercise to finalise a new industrial strategy</p> <p>and ensure that all instruments of support to companies are in line with state aid rules.</p>	<p>There was <b>limited implementation</b> of PG 5:</p> <p>1) <b>No implementation:</b> While the analytical work on smart specialisation proceeded, the process of the drafting of the industrial strategy has not yet started.</p> <p>2) <b>No implementation:</b> Investment incentives provided to companies based on the Law on Investments and the relevant by-laws are mainly in line with state aid rules. However, companies</p>

<p>Implement the law on fees so that parafiscal charges will be predictable and based on a fee-for-service principle.</p> <p>Ensure predictability and risk based control of phytosanitary checks at the border.</p>	<p>also benefit from numerous other types of aid, which are not notified to the Commission for Control of State Aid. There is no mechanism to ensure accumulation of aid that companies receive. Overall, companies receive different types of aid from both national and local authorities.</p> <p>3) <b>Partial implementation:</b> The Law on fees was adopted in December 2018. However, the rulebook on its implementation is not finalised yet. There is no assessment pm the extent to which the fees will be reduced.</p> <p>4) <b>Partial implementation:</b> Border inspections involved in control of food import consignments appear to apply risk-based approach based on the implementing legislation in force. This legislation and procedures require further improvements, in particular the risk-based approach and the use of IT tools. The newly established committee on trade facilitation has indicated this area as a priority.</p>
<p><b>PG 6:</b></p> <p>Reduce the high non-wage labour cost of jobs at the lower sections of the wage distribution.</p> <p>Increase substantially the inclusion of unemployed in active labour market measures, in particular women and Roma.</p> <p>Involve closely all relevant actors for the country-wide roll-out of dual learning.</p> <p>Accelerate the envisaged reforms for better targeting of social assistance.</p> <p>Further attention should be devoted to tackling undeclared work.</p>	<p>There was <b>limited implementation</b> of PG 6.</p> <p>1) <b>Limited implementation:</b> The elimination of the employers' contributions of 0.75% of gross salary for unemployment benefit is not targeted to jobs at the lower sections of the wage distribution.</p> <p>2) <b>Limited implementation:</b> The number of unemployed included in ALMPs of the national employment action plan remained broadly unchanged in 2018. No aggregate figures are available on ALMPs provided at local level.</p> <p>3) <b>Substantial implementation:</b> The Government established a Commission for the Development and Implementation of Dual Education. Three by-laws to the Law on Dual Education were adopted, whose development involved expert community and relevant stakeholders. The Government Decision on the establishment of 12 sector skills councils was adopted and their members are nominated, but employers are not yet sufficiently included.</p> <p>4) <b>No implementation:</b> Plans to adopt new legislation in the sector have been postponed to 2019.</p> <p>5) <b>Partial implementation:</b> Additional efforts have been made to address the issue of undeclared work through Labour Inspectorate activities. However, the problem remains.</p>



#### 4.6. THE 2019 POLICY GUIDANCE

### **JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TURKEY**

The Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

Brussels, 17 May 2019

[...]

In light of this assessment, Participants hereby invite Serbia to:

1. Maintain the identified medium-term budgetary objective close to balance. Contain overall spending on wages and pensions as a percentage of GDP. Implement the public sector wage system reform under the 2020 budget covering also security sector employees.
2. Increase government capital spending supporting long-term growth as a share of GDP in 2019 and over the medium term. To this aim, develop a single mechanism for prioritising and monitoring all investment regardless of the source of financing. Strengthen the fiscal responsibility framework by improving the system of fiscal rules, increasing its credibility and making it more binding and capable of anchoring fiscal policy.
3. Continue promoting the use of the local currency inter alia by fostering the development of interbank markets and secondary markets for government securities, and by considering additional ways to enhance long-term bank funding in dinar and hedging instruments. Implement the measures included in the recently adopted programme for resolving non-performing loans (NPLs) and the related action plan, including those aimed at further addressing NPLs in state-owned banks and government agencies. Finalise the privatisation and restructuring process of the remaining state-owned banks.
4. Use findings of the smart specialisation exercise to finalise a new industrial strategy. Adopt specific legislation on the alternative investment vehicles. Ensure that businesses and all social partners are consulted in time on all drafts of new legislation concerning their operations.
5. Gradually adjust electricity tariffs to reflect actual costs, including the costs of necessary maintenance and investments to upgrade the energy network and of meeting environmental standards and climate goals. Finalise unbundling of state-owned energy enterprises, in particular fully implement the long-delayed unbundling of Srbijagas and EMS and complete the functional unbundling of EPS in a compliant manner, as well as provide third-party access to gas infrastructure.
6. Significantly increase funding and the implementation of active labour market measures adjusted to the needs of the unemployed, in particular women, youth, including highly skilled persons. Adopt measures to incentivise the formalisation of labour in non-agricultural sectors. Reduce the high non-wage labour cost of jobs at the lower sections of the wage distribution.

## ANNEX A: ASSESSMENT OF THE STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP

### **Measure 1: Energy market development coupled with energy infrastructure construction**

This measure is rolled over from the two previous ERPs. The planned works, if implemented, will help the energy network to function better. However, the reform would be more credible if other measures to improve the functioning of the network and the market were added, such as the further restructuring of the inefficient producer EPS or a revision of energy prices, which are low and do not secure sufficient funds for further investment nor provide incentives for energy efficiency.

### **Measure 2: Improvement of conditions for increasing energy efficiency and improvement of the existing infrastructure in the energy consumption sector**

Energy efficiency is appropriately included in the ERP for the first time. The new law on fees will provide more funds for energy efficiency, while amendments to the law on energy efficiency are planned so as to ensure that eco-design could be financially supported at a later stage. This should enable much needed investment in this field. However, to achieve more ambitious results, many more measures are needed. The government should also commit to engaging with international financial institutions that are willing to provide more substantial amounts of funds for this purpose.

### **Measure 3: Improvement of the capacity and quality of transport infrastructure and services**

The measure proposes to plan and budget road safety audits and road maintenance more efficiently. It clearly and realistically envisages how safety audits will be performed and maintenance agreements costed and contracted. However, the ERP does not address issues related to the preparation of documentation for constructing, modernising and restoring the transport infrastructure regulated by the Law on planning and construction and the set of relevant by-laws. The recent experience gained throughout the implementation of transport projects shows that often the quality and accuracy of preparatory activities e.g. geotechnical investigation, is not done to a sufficient level. In addition, in the majority of cases, projects are not selected and technically prepared, based on the results of the previously conducted cost-benefit analyses. This leads to projects running above their capacity, which implies high maintenance costs and a mismatch between the quality of infrastructure and required services.

### **Measure 4: Reform of the railway sector**

The liberalisation of the railway sector, announced in previous ERPs, is progressing and this measure presents two more steps to achieve this. In addition to the activities contained in the measure, the process needs to ensure the granting of train driving licences and safety certificates to foreign operators and mutual recognition of the rolling stock. Railway needs to be included in the intelligent transport system (ITS) rulebook in order to ensure interoperability with the EU. Using rail as a means to export and import goods should be more systematically encouraged in order to reduce the pressure on the environment and roads.

### **Measure 5: Improvement of competitiveness of agricultural producers and processors**

This measure is rolled over from the two previous ERPs and identifies the implementation of IPARD as the main factor to increase competitiveness. However, IPARD resources are comparatively scarce to cater for the sector's needs. The full rolling out of IPARD has also faced some delays. Therefore, more nationally funded measures are needed to address more specific challenges, especially in processing food. The authorities propose land consolidation as a new part of the measure, in order to address a key challenge in the sector. This part of the measure consists of a new law, but there are only vague proposals on how the law will be implemented.

### **Measure 6: Raising the competitiveness of industry**

This is one of the key issues for the Serbian economy as the manufacturing industry continues to be dominated by labour-intensive activities, which cannot secure sustainable growth. Serbia is focusing its industry-related activities towards attracting foreign investors. However, there has not been much development in preparing a comprehensive strategy, although the smart specialisation exercise already provides the authorities with insight on key sectors. The credibility of the process will depend also on the strategy having a proper budget, which is not included in the ERP.

### **Measure 7: Tax administration transformation**

Tax Administration transformation has been a key structural reform for years. The announced activities are ongoing but the progress is rather limited and major tasks remain. The action plan for the transformation programme for 2018-2023 remains valid. Activities planned in 2018 are being carried out, albeit with delays. For 2019, further consolidation of core activities is planned in a smaller number of branches in parallel with the restructuring of the Head Office, which is identified as the main challenge. Long-term challenges, such as the need to train and retain the most valuable human resources and to channel resources to core tasks and prevent them being deployed for non-core administrative activities, remain and should be given more attention. The measure remains appropriate, but the commitment to implement it needs to be stepped up.

### **Measure 8: Improved management of capital investments**

The planning of public investment remains troublesome and affects the growth potential. The initiative to improve management of capital investments and to establish a single capital investment platform (including the single capital project database) remains relevant, appropriate and necessary. Once again, the measure is rolled over from previous ERPs as previous efforts to implement it focused only on improvements in the nationally funded projects. The updated initiative recognises the complexities of the planning system and the need for more coordination. However, it remains unclear whether all stakeholders are willing to work on the system and whether there are adequate capacities across many layers of the administration.

### **Measure 9: Improved access to finance for SMEs and sole traders**

The measure to improve access to finance for SMEs and sole traders intends to focus on the adoption of a development financing strategy aimed at improving different financial market segments and introducing new financial instruments that are lacking. SMEs would benefit from improved regulation of financial markets to provide additional financing instruments, beyond traditional loans. Several challenges need to be addressed in the new instruments, which are only partially spelled out in the ERP's plans: (i) high cost and collateral requirements for innovative and young companies, (ii) underinvestment in areas such as innovation financing, infrastructure financing, and environmental projects, and (iii) inadequate support for long-term finance, guarantee instruments and equity financing. The ERP announces the introduction of new financial regulations and instruments for the fourth year in a row. There are obviously delays with this measure, but they are not explained. The goals look ambitious, but lack real commitment.

**Measure 10: Establishment of a sustainable system for environmental protection financing by improving the functioning of the green fund**

This new measure is welcome, as environmental protection is one of the most budget intensive and complex chapters in the process of Serbia's EU accession negotiations. Serbia is obliged to significantly increase investment in this area, with estimated investment needs of about EUR 8.5 billion in the next 10 years. The allocations need to triple from the current 0.3 to 0.4% of GDP in order to meet the prescribed standards. Most environmental protection investment will come from the national budget funds. However, the existing funding system does not ensure the necessary level of investment. In order to ensure a steady inflow of finance into a green fund and greater use of IPA funds, an efficient financial, legal and institutional framework, which will ensure predictability, stability and continuity of investment in environmental protection, needs to be established. The proposed measure is a first cautious step in this direction, which proposes to identify the conditions needed to establish a fund that functions better. At this stage, the measure is not budgeted, which needs to be changed in the future.

**Measure 11: Improvement of corporate governance in public enterprises**

This measure aims to improve corporate governance of public utilities and state-owned companies — this is of key importance for competitiveness given the large share of these companies in the Serbian economy. The reform in governance of public companies has been identified as a core part of the ERP since the very first programme. Although some good results have been achieved in terms of restructuring and privatising some companies (these companies now pose less of a tax risk), public companies in general remain largely inefficient and influenced by politics, which go beyond managerial appointments. The proposed measure focuses on improvements in managerial appointment and training as well as improving the supervision boards in the public authorities. More ambitious steps are needed in order to properly restructure the big public sector.

**Measure 12: Simplification of procedures and other conditions for doing business**

The measure aiming to unify the system of public registries of administrative procedures is a continuation of activities from previous ERPs. The ERP indicates that the government adopted a new law on fees at the end of 2018, which should rein in para-fiscal charges (though a significant portion of the charges is set and collected by municipalities, and their contribution to the reform remains unclear). The ERP does envisage further steps in simplifying and digitalising procedures, but lacks ambition as it leaves major activities (adoption of a law and establishment of the register) for the later stage of the process.

**Measure 13: Improving the effectiveness of inspection oversight**

The measure aims to improve the effectiveness of inspection oversight by combining measures from previous ERPs (a common information platform for all inspections through e-inspection), but also through strengthening human resources, i.e. recruitment of new inspectors. Despite good results in combating the grey economy lately (according to IMF estimates its share has fallen but was still above 25% in 2017) and increased revenues stemming from improved inspections, the informal economy remains large. Improvements in coordination and in inspection oversight planning, now based on risk analysis, have contributed to better performance and need to be continued. The specific issue of border phytosanitary controls, which is often raised by the business community as highly problematic, is identified as posing a particular challenge and should be seriously tackled.

**Measure 14: Improvement of the geospatial sector to support the investment decision-making process**

This measure is rolled over from previous ERPs and should help further improve the clarity of ownership and thus contribute to an easier investment decision-making process. Initial steps have been taken to establish the National Spatial Data Infrastructure (NSDI) and improve the address register together with

some other major activities. The implementing legislation and an NSDI strategy are expected to be adopted in the coming years. The process should significantly contribute to the real estate taxation system and increase property tax revenues for local authorities, which collect and use them. The process requires strong cooperation from a large number of institutions and organisations and this is rightly identified as the major potential challenge. More involvement from ministries and the judiciary is also needed; at the moment activities are under the sole responsibility of the Geodetic Authority. Moreover, the establishment of the land parcel identification system in Serbia, prescribed by EU law, as part of the integrated administration and control system may be sped up due to better access to the geospatial data infrastructure. The measure is ambitious, but will face serious challenges.

#### **Measure 15: Set of measures providing support to research and innovation**

This measure supports the functioning of the Innovation Fund, which provides finance for industrial research. Both EU and national funds are used for this purpose. However, the budget of the Innovation Fund is marginal compared to all other public funds for research and the measure is not a real reform as it has been in place for years. More ambitious goals and a more reformist approach should be established. In particular, significant changes are planned regarding the funding of research in the public sector and a new science fund has been established. In addition, findings of the smart specialisation exercise will need to be applied in the governance of the national innovation system.

#### **Measure 16: Improvement of e-government services through the development of national ICT infrastructure**

The broadband network needs to be improved and more public e-services developed to support businesses and citizens. This measure addresses these two main challenges, by committing to further regulate on broadband and by establishing a new data centre. The first process is already now affected by delays and it is not clear whether the regulation will be adopted in time and how private broadband will be able to contribute to the process. Regarding the new data centre, the goals are ambitious because the feasibility part is not accomplished yet. Moreover, in addition to the establishment of technical infrastructure, more consideration should be given to the service that the government plans to roll out due to the existence of this new data centre.

#### **Measure 17: Improving conditions for product safety and removing barriers to trade**

Support for further trade integration with the EU and CEFTA demands more facilitation at the border and beyond. The measure focuses on the implementation of the Regional Economic Area Multinational Action Plan. Significant practical steps need to be made in order to speed up and reduce the cost of shipping goods across the region. Similar steps would be much welcome at the EU border. In addition, Serbia is committing to put in place changes to its law on genetically modified organisms, which are a main stumbling block in the WTO accession process. The announcements need to be followed up with speed and determination, unlike in the past.

#### **Measure 18: Qualifications oriented to labour market requirements**

The establishment of the national qualifications framework (NQF) is included in the ERP since 2016 and again being rolled over, outlining the further steps to be taken until 2021. The measure presents only partial segments of ongoing and planned reforms in the field of qualifications, which concern NQF, validation of non-formal and informal learning, comprehensive VET reform, short study cycles in higher education, introduction of final examinations in secondary education, curricular reform and its successive introduction in pre-university system, and new quality assurance mechanism in higher education. The overview of the activities planned for 2019/20/21 is narrow and does not outline any activities relating to the building of capacities of new institutions and creating ownership over the new qualifications system. Activities do not include any plans on a wider VET reform. In addition, activities are described in rather general terms. Potential risks rightly identify the low level of participation of economic operators and social partners in the NQF system and dual education, but do not foresee mitigation measures.

**Measure 19: Increased labour activation of social welfare beneficiaries who are fit for work, hard-to-employ unemployed persons in line with employment legislation and other hard-to-employ persons from particularly vulnerable groups, and strengthened formal employment**

Design and focus of this measure are poorly developed. The measure consists of three components, adoption and implementation of a Law on Social Entrepreneurship, implementation of the law on seasonal work in agriculture adopted in 2018, and adoption of a legislative framework for the operation of private employment agencies. While all three components are relevant activities as such and close gaps in the labour market framework, it remains unclear how the primary objective of this measure, the increased activation of vulnerable categories of jobseekers, shall be achieved. No employment targets are defined. The budget for this measure is not sufficiently elaborated. The possible expected impact on the competitiveness of the economy appears limited.

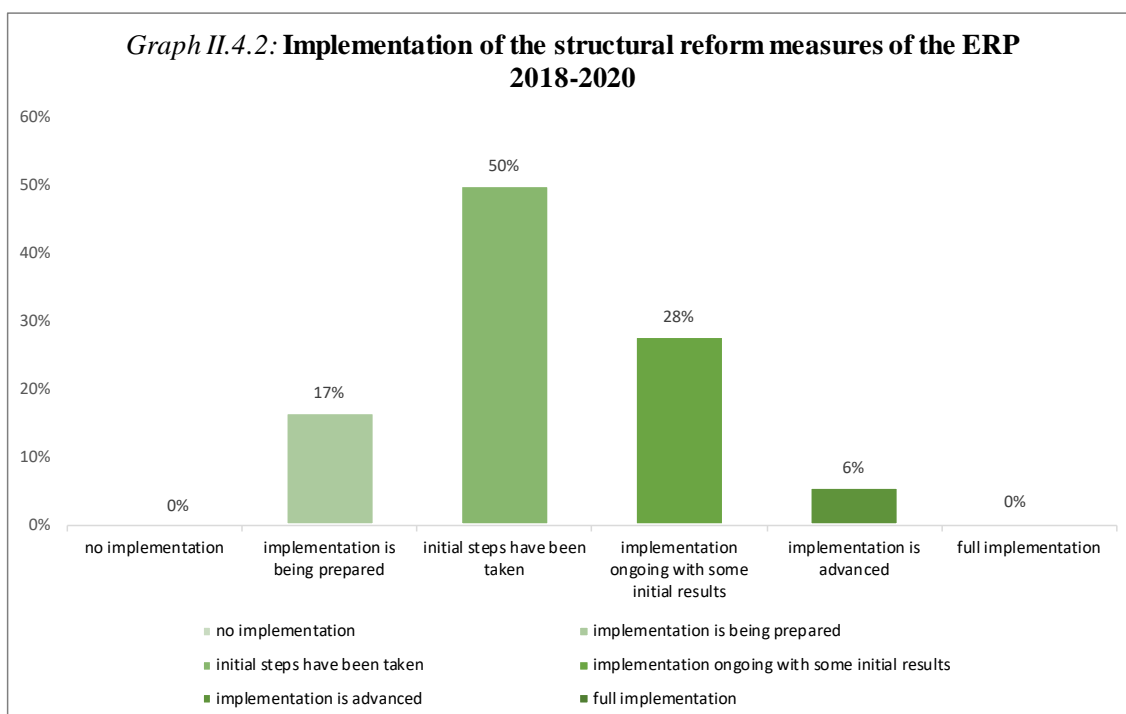
**Measure 20: Improvement of the adequacy, quality and targeting of social protection measures**

A measure to improve adequacy, quality and targeting of social protection is being included in the ERP since 2016 and has brought some partial results so far. The presentation in this year's ERP continues to suffer from a lack of strategic vision for this sector. It includes two activities, amending the Law on Social Protection and the introduction of Social Cards (supposedly for beneficiaries of cash benefits). Amendments of the law have been further postponed after the public consultation in 2018. The proposed amendments did not include sufficient steps for improving the adequacy of financial social assistance. The outline of the measure lacks a discussion of budgetary aspects. No information is given on whether there are any plans for increasing the level of public spending on financial social assistance, which is currently very low.

## ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM ERP 2018-2020

There was some progress in implementing the measures in 2018, with an average score of 2.6 out of 5. The reporting on the planned activities is precise and fair. Some relatively easy reform steps contribute to higher grades, but overall there is a good description of the level of implementation and indication on what remains to be done.

The highest level of implementation involves the measures on active labour market policies and agriculture, reflecting well-prepared steps in the preceding years. However, for more complex measures, the implementation rate drops significantly, often to below 50%. The reform of management of public investment was not implemented at all and as a result this measure has completely changed in this year's ERP. There is also a slow pace of implementation in the area of governance of public enterprise. However, in this area this year's measure remains largely unchanged and has even become less ambitious.



## ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government adopted and formally submitted the Economic Reform Programme on 31 January 2019. The programme is in line with the medium-term fiscal strategy and the 2019 budget and covers 2019-2021.

### *Inter-ministerial coordination*

The preparation of the programme was centrally coordinated by the Ministry of Finance, which established an ERP working group. Relevant ministries and other institutions (the National Bank of Serbia, the National Employment Service, and the Statistical Office of the Republic of Serbia) are associated with the work and have contributed in their areas of responsibility.

### *Stakeholder consultation*

Two public consultations were conducted to give social partners, civil society and all relevant stakeholders an opportunity to contribute, especially to the drafting of chapter 4 on structural reforms. However, the draft ERP was not discussed in the Economic and Social Council of Serbia.

### *Macro framework*

The programme presents a clear and concise picture of past developments. It also covers all relevant data at the time of drafting. The macroeconomic framework is sufficiently comprehensive and coherent. The baseline macroeconomic scenario is broadly plausible and major uncertainties and risks are clearly outlined and recognised. The programme presents an alternative macro-fiscal scenario. Although not sufficiently elaborated upon, it is based on an assumption of lower economic growth, and higher budget deficit and debt levels.

### *Fiscal framework*

The fiscal framework is based on the baseline medium-term macroeconomic scenario and is sufficiently comprehensive and integrated with the overall policy objectives. In general, revenue and expenditure measures are explained well, although the medium-term impact of some of them is not sufficiently elaborated upon. The programme does not present long-term projections of population trends or of the implications of an ageing population on the labour market and public finances, in particular on health and pension systems. Significant further efforts would be needed to ensure the fiscal data is compatible with the ESA 2010.

### *Structural reforms*

The reporting on the implementation of the policy guidance and the structural reform measures from 2018 is sufficient and up-to-date. However, the reporting on the implementation of the policy guidance in the area of education, employment and social protection is limited. The quality of the measures vary. In some cases they are focused and planned in good detail, while in others — especially in the fields of employment and education — they have declined compared to previous years. Overall, the measures' scope of ambition is often too limited and refers to a single procedural reform rather than a systemic long-term reform with real impact on competitiveness, despite the recognition of serious systemic challenges in the analyses of these areas. The annexed tables are filled in appropriately.



## 5. TURKEY

### 5.1. EXECUTIVE SUMMARY

**The Turkish economy fell into recession in the third quarter of 2018 with a recovery expected to gain momentum in the second half of 2019.** Turkey's domestic financial conditions deteriorated sharply due to capital outflow from the country following the sharp depreciation of the Turkish lira (TL). In March 2019, the central bank reaction to renewed TL volatility strongly affected financial conditions and risks having a lasting adverse impact on investors' perceptions of Turkey. The Government's baseline macroeconomic scenario is for the economy to bounce back in 2019. The strongly positive net trade contribution is expected to kick-start a recovery that will only fully gain traction in 2021. However, Turkey's heavy dependence on foreign finance and high past credit growth suggest more protracted economic headwinds in line with economic developments of credit crunches more broadly. Adding to these is the persistently high inflation, which shifts the debt burden from debtors to creditors and also risks creating expectations of a permanent rise, feeding corresponding wage inflation.

**Fiscal discipline is the main pillar of the Turkish medium-term economic strategy.** Turkey has a track record of fiscal prudence dating back to the reforms of the early 2000s. The credibility of its fiscal policy and low government debt levels were the main reasons for Turkey's ability to weather the currency crisis, as were a central bank rate hike, a financially sound banking system and easing international tensions. The stated ambition of fiscal austerity is reflected in the projected improvement of the primary balance by 2.8% of GDP between 2018 and 2021, driven mainly by expenditure restraint, in particular on capital spending. However, recent years have seen a slackening in public finances and the ambitious austerity agenda is heavily front-loaded. The relatively optimistic projections for economic growth and revenues at a time when spending pressures are emerging pose risks to the budget plans. Turkish budgetary policymaking would still benefit from greater transparency and better fiscal governance.

The main challenges for future economic policy are the following:

- **Promote domestic savings.** Renewed domestic demand growth is expected to renew pressure on the current account deficit. Policies to encourage domestic savings are now more needed than ones pushing reinvigorated credit growth while investment incentives should be carefully targeted.
- **Budgetary policy needs to become more transparent.** The institutional set-up of Turkish budgetary policymaking lacks credibility-enhancing elements such as numerical rules and an independent fiscal institution. Introducing these elements would improve transparency and credibility.
- **While the state of emergency has been lifted, important uncertainties remain in the investment climate and in the economy as a whole.** The volatile fluctuations in inflation combined with restrictions on capital flows have increased uncertainties in the business environment and have reduced the willingness to invest. A large number of companies remain under trusteeship after having been seized following the 2016 attempted coup, and have no clear prospects of timely due process for obtaining compensation. Additional work is also needed to shorten lengthy and costly insolvency procedures.
- **Despite efforts to increase formalisation, Turkey's informal sector remains substantial.** It continues to obstruct the establishment of a level playing field and fair competition, e.g. by permitting price competition based on factors such as health and safety standards or payment of social security contributions. Informal businesses find it more difficult to access finance and thus to invest, which increases the dual nature of the economy. More than one third of workers are in informal employment, yet there is a lack of integrated approach to address it.

- **Key challenges are low labour market participation, particularly for women and young people, and an underperforming education system.** Overall unemployment increased towards the end of 2018, as did the youth unemployment. Gender gaps and regional disparities remain significant. The Education system is facing challenges on all levels. Turkey's Programme for International Student Assessment (PISA) and Programme for the International Assessment of Adult Competencies (PIAAC) scores are far behind the average of other OECD countries, indicating the need to step up the quality and coverage of school education. In a knowledge-based economy educated and skilled labour is a prerequisite for further growth.

**The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2018 has been implemented to a limited extent.** In terms of the macro-fiscal framework, external imbalances have reduced, although this can hardly be attributed to deliberate policy action, and macroeconomic projections have become more realistic, but fiscal transparency has not improved. The Turkish authorities have been able to avoid the worst possible outcome from the rebalancing to date but a structural improvement of the drivers of previous current account imbalances, low household savings and high credit growth needs still to emerge. While the state of emergency has been lifted, no significant improvements in the rule of law have been observed. The number of companies under trusteeship actually increased without clear and timely prospects of due process for compensation. Concerning insolvency, Turkey introduced the possibility of obtaining post-commencement credit, improved voting arrangements in reorganisation and greater creditors' participation in the proceedings. No R&D strategy was adopted. Turkey has focused on improving the employment subsidies for the unemployed and has launched some programmes targeting women. However, more efforts are needed to address the labour market participation of women and youth, which has been deteriorating. Measures to address the fragmentation and effectiveness of social assistance have not yielded sufficient results, as shown by the increase in poverty rates. There is further need to step up the quality and coverage of education at all levels.

**Overall, the programme sets a combination of commendable objectives reflecting high levels of ambition but it would be better served by a more realistic stance.** The Turkish authorities have shown high levels of ambition in the past, but momentum for reform has waned recently. The medium-term macro-fiscal scenario is highly optimistic in assuming that high growth ambitions can be combined with improving government finances, a reduction in the external imbalances, and a reduction in the inflation rate. Although longer-term improvements cannot be excluded, these depend on the implementation of an ambitious reform agenda. The implications of structural reforms for public finances have not been identified. Measures in the area of education, employment and social policies are relevant in addressing structural bottlenecks and improving labour market participation. However, their implementation might be challenging as has been proven in the previous years. More efforts should be placed on linking social protection measures with employment and gender.

## 5.2. ECONOMIC OUTLOOK AND RISKS

**Turkey's Economic Reform Programme (ERP) expects the recession that began in the wake of the 2018 currency crisis to be short, followed by a strong recovery.** The economy entered into recession after the pronounced deterioration in foreign financing conditions in the third quarter of 2018. Domestic financial conditions sharply worsened following the substantial depreciation of the TL in the third quarter. The biggest immediate impact has been on private investment and, in particular, on construction. Private consumption growth also slowed considerably. The impact on GDP growth of the fall in domestic demand was softened by the decline in import demand and some positive impact of the TL depreciation on exports.

**The ERP's baseline macroeconomic scenario is for the economy to bounce back in 2019 but only fully gain traction in 2021.** A strongly positive net trade contribution is expected to lead the recovery in 2019. Gross fixed capital formation is expected to display negative growth, and consumption low growth, compared with earlier years. Public consumption will continue to follow a pro-cyclical path throughout the planning horizon. The Turkish authorities project an initial decline in the negative output gap in 2021, and expect that it will not close over the programme horizon. The growth forecast and potential output have been revised downward significantly compared to the 2018 ERP. In the 2018 ERP, the Turkish Government still expected growth of 5.5% in 2019. Potential output growth has been lowered from 5.3% in last year's ERP to 4.4% for the years 2019 and 2020. This reflects a lower contribution of gross fixed capital formation to potential growth. Total Factor Productivity growth projection has gone from very low to negative. Nominal growth is expected to be high as a consequence of continued high inflation. This will favour the debt-to-GDP ratio and implies a large expansion of the tax base despite low real economic growth.

**The macroeconomic scenario reflects more realism but is still relatively optimistic when compared to the Autumn Forecast.** Experiences of credit crunches and the large dependence on foreign finance, together with high inflation and the credit-intensity of the economic boom in preceding years, however, suggest more protracted economic headwinds. The ERP's growth scenario, based on the new medium-term scenario published in the autumn, does, however, display more realism than growth scenarios in earlier ERPs. In this ERP, the growth rate of 3.5% in 2020 is the most conservative and closest to other forecasts, including the Commission's Autumn Forecast and those of market participants.

Table II.5.1:

**Turkey - Comparison of macroeconomic developments and forecasts**

	2017		2018		2019		2020		2021	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
<b>Real GDP (% change)</b>	7.4	<b>7.4</b>	3.8	<b>3.8</b>	-1.5	<b>2.3</b>	3.0	<b>3.5</b>	n.a.	<b>5.0</b>
<i>Contributions:</i>										
- Final domestic demand	6.7	<b>6.7</b>	3.1	<b>3.3</b>	-4.4	<b>0.5</b>	3.6	<b>3.2</b>	n.a.	<b>4.7</b>
- Change in inventories	0.6	<b>0.6</b>	-0.1	<b>-0.9</b>	0.2	<b>0.2</b>	-0.1	<b>0.0</b>	n.a.	<b>0.0</b>
- External balance of goods and services	0.1	<b>0.1</b>	0.7	<b>1.4</b>	2.7	<b>1.5</b>	-0.3	<b>0.2</b>	n.a.	<b>0.2</b>
<b>Employment (% change)</b>	3.9	<b>3.6</b>	3.0	<b>1.7</b>	0.2	<b>1.5</b>	2.6	<b>2.6</b>	n.a.	<b>3.6</b>
<b>Unemployment rate (%)</b>	10.9	<b>10.9</b>	10.1	<b>11.3</b>	12.8	<b>12.1</b>	12.7	<b>11.9</b>	n.a.	<b>10.8</b>
<b>GDP deflator (% change)</b>	10.8	<b>10.8</b>	14.9	<b>16.0</b>	15.3	<b>16.3</b>	13.1	<b>11.8</b>	n.a.	<b>6.2</b>
<b>CPI inflation (%)</b>	11.1	<b>11.1</b>	16.7	<b>16.3</b>	15.4	<b>18.4</b>	12.4	<b>13.3</b>	n.a.	<b>7.9</b>
<b>Current account balance (% of GDP)</b>	-5.6	<b>-4.5</b>	-6.8	<b>-3.5</b>	-2.9	<b>-2.7</b>	-3.4	<b>-2.3</b>	n.a.	<b>-2.1</b>
<b>General government balance (% of GDP)</b>	-2.3	<b>-1.8</b>	-2.5	<b>-2.4</b>	-1.9	<b>-1.5</b>	-2.2	<b>-1.6</b>	n.a.	<b>-1.6</b>
<b>Government gross debt (% of GDP)</b>	28.3	<b>28.3</b>	31.2	<b>31.1</b>	31.9	<b>28.5</b>	30.5	<b>28.2</b>	n.a.	<b>27.2</b>

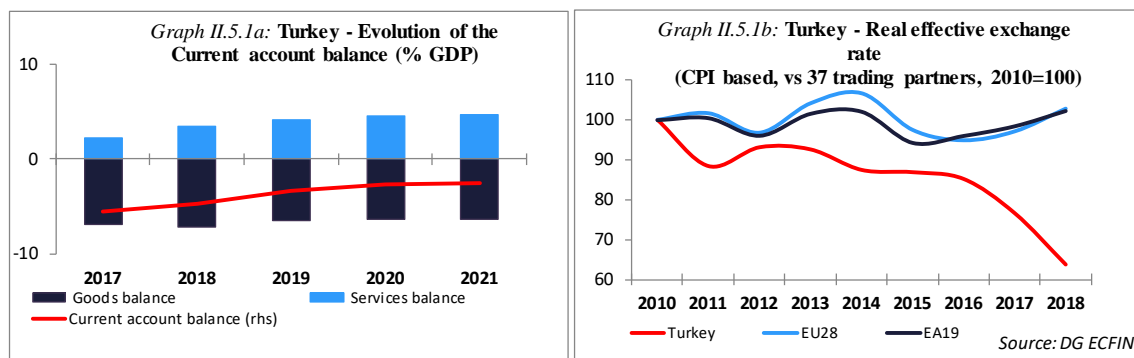
Sources: Economic Reform Programme (ERP) 2019, Commission Autumn 2018 forecast (COM).

**The ERP's inflation scenario would require firm action by the central bank to rein in unanchored inflation expectations.** The ERP predicts a decline in the inflation rate from a relatively high 18.4% in 2019 to an ambitious 7.9% in 2021. The inflation rate jumped to a high of 25.2% in October 2018 following the sharp TL depreciation but in recent months the stabilisation of the TL, a temporary lowering of tax rates on consumption goods and the fall-out in domestic demand have reduced upward pressures on price levels. The year-on-year inflation rate hovered around 20% in the first three months of 2019. The minimum wage was increased by 26% year-on-year at the beginning of 2019. Repeated large nominal wage rises risk triggering a wage-inflation spiral. Consumers' inflation expectations have been on the increase since 2016 but have remained below actual inflation so far. The inflation expectations of businesses jumped significantly in the second half of 2018. Increasing inflation expectations and the jump in minimum wages will make it harder for the central bank to permanently lower inflation. Recent actions like the lowering of reserve requirements in February and the early pay-out of dividends, interpreted by some as a way to smooth public finances, could also undermine attempts to regain public confidence. Moreover, the temporary lower VAT rates will provide upward pressure on inflation once expiring in June and December of this year. On the other hand, the large interest rate hike in September and the fall-out in domestic demand will deliver significant downward pressure on the inflation rate in 2019. The main difference between the Commission Autumn Forecast's and the ERP is attributable to the larger impact of the cyclical position.

**The current account sharply corrected following the TL crisis, making a lower current account deficit for 2019 likely whereas the projected further decrease in the current account deficit in subsequent years is at odds with the expected recovery.** The current account balance turned positive in the final four months of 2018. As analysis by the Turkish central bank shows, the reduction in the current account deficit is mainly due to the drop in imports that resulted from recent declines in the real exchange rate and domestic demand. The correction of the current account was supported by declining energy prices from October, a fall in demand for petrochemicals and a near-complete fall-off of gold imports. These factors are likely to be temporary and the recovery can be expected to be accompanied by a renewed increase in the current account deficit. In addition, although tourist numbers have recovered, the amount they spent in 2018 was 16% below 2015 levels and the services balances was at about the same level in percent of GDP as in 2015 (2.9%). The projected rise in the services balances to 4.7% of GDP in 2021 assumes that Turkey will be able to move away from price competition to higher-value tourists in a historically unprecedented way. The improving trade deficit in the ERP thus seems rather optimistic.

**Except for foreign direct investment (FDI) capital flows have been volatile.** FDI has historically been a relatively small share of capital inflows into Turkey and the country has a history of relying on more volatile forms of capital inflows. In late 2018 and early 2019, government debt instruments constituted the major capital inflows. Banks have seen their roll-over ratios fall to well below 100 percent as domestic credit expansion reversed. Future growth will likely come with renewed credit growth. Past economic growth has been associated with high credit growth with the credit-to-GDP ratio increasing from 25% in 2005 to a high of 89% in Q2 2018. A sizable part of this increase in credit was financed from abroad with foreign debt increasing from 36% of GDP in 2005 to 52% in Q2 2018. On a remaining maturity basis short-term debt consisted of 26% of GDP in Q3 2018 (23% in Q2 2018).

**The ERP's projected increase in savings would suggest continued rebalancing of balance sheets, which is at odds with domestic demand driving the recovery from 2019 onwards.** Despite attempts to increase private savings, the success of the most important policy instrument to achieve this - the obligatory enrolment into a private pension scheme - has been mixed. The government premium (25% after 10 years for minimum wage earners) has lost its attractiveness due to high inflation. Indebtedness has remained high with a large share of corporate debt denominated in foreign currency.



**The sharp depreciation of the TL has tested the solidity of the banking sector and will continue to weigh on asset quality and the size of the balance sheet.** Headline figures in the banking sector continue to be solid even after the strong volatility in the capital markets. Following the TL crisis, the Turkish Banking Regulation and Supervision Agency did introduce several changes in accounting practices which reduced the transparency of the financial system and, seemingly, lowered the impact of deteriorating asset quality and the TL depreciation on banks' balance sheets. Banking stocks have recovered well following the trough in November but renewed pressure emerged towards the end of March 2019 when the central bank reduced liquidity in reaction to renewed TL volatility. Turkish banks have taken a pro-active role in addressing the crisis, among other things by restructuring loans; restructuring means that banks do not have to rely on the less efficient business courts. Asset quality, nonetheless, has deteriorated as shown by the increase in non-performing loans (NPLs), which in multiple sectors has risen above 5%, and the increase in loans 'under close watch', which is partly related to the introduction of IFRS 9. The impact on banking soundness is heterogeneous with state owned banks continuing to take on risks, easing credit conditions for households (changing credit card debts into personal loans, offering mortgages at below market rates) and the corporate sector (extending loans to SME's). The central bank has preferred measures that soften market differentiation (such as a lowering of the reserve coefficient of the Reserve Options Mechanism, lowering reserve requirements, and using overnight lending rather than steering banks to the upper rate of the interest rate channel). High inflation will reduce the real burden of TL debt, transferring the real burden of deleveraging from households and the corporate sector to the banking sector. In a stress test published on 27 December 2018, the Turkish Banking Regulation and Supervision Agency estimated that in a worst case scenario NPL's could rise to 6% of total cash loans and the capital adequacy ratio would decline to 15.5%. These figures are still relatively sound. The stress test was not particularly rich in background information, though, and attracted some criticism for the lack of transparency.

*Table II.5.2:***Turkey - Financial sector indicators**

	2014	2015	2016	2017	2018
<b>Total assets of the banking system (EUR million)</b>	705	744	735	715	636
<b>Foreign ownership of banking system (%)</b>	21.0	30.8	30.0	28.2	26.8
<b>Credit growth</b>	17.7	20.7	16.7	20.9	16.0
<b>Deposit growth</b>	11.6	18.6	17.7	17.7	22.1
<b>Loan-to-deposit ratio</b>	1.12	1.13	1.12	1.15	1.08
<b>Financial soundness indicators</b>					
- non-performing loans	2.8	3.1	3.2	3.0	3.9
- net capital to risk-weighted assets	16.3	15.6	15.6	16.9	17.3
- liquid assets to total assets	14.0	13.0	13.6	8.0	10.7
- return on equity	10.6	9.9	12.5	15.9	14.7
- forex loans to total loans (%)	29.0	31.8	34.8	32.6	39.9

\* including the impact of write-offs.

Sources: National Central Bank, Macrobond.

### 5.3. PUBLIC FINANCE

**The central government almost met the October 2018 revised deficit target for 2018, despite underlying trends in public finances turning negative at the end of the year.** The central government had set an initial target for the budget deficit of TL 65.9billion. In October 2018, Parliament agreed on a budget amendment that saw a new target of TL 72.1 billion or 1.9% of GDP. The actual budget deficit of the central government was TL 72.6billion. The revised budget target was almost met, due to exceptionally high end-of-year non-tax revenues and postponement of capital outlays. The budget deficit as a percentage of GDP did not change between the original and the revised budget as a consequence of higher nominal GDP growth. An exceptional increase in other revenues, originating in particular in an ad hoc measure for conscripts to pay a fee for exemption from military service, mitigated the impact of the tax revenue short-fall on overall revenues. A sizable part of the capital outlays (capital expenditures and capital transfers) was carried over into the New Year. Normally, capital outlays in January are about one tenth of those in December but, in January 2019, they were almost as high (96%) as in December 2018. The development of the budget balance throughout the year was, however, worse on average than since (at least) 2009. The general government's budget deficit was an estimated 2.4% of GDP in 2018 according to the ERP. Throughout the ERP different concepts are used for the general government and the numbers for budget outcomes, including for central government, do not always match (Tables 3.2, 3.4, and 3.6 as well as table 2 from the Annex).

**The 2019 budget continues the pro-cyclicality of earlier years, now aiming for lower budget deficits in a time of recession.** The 2019 central government budget was approved on 21 December and, in line with the medium-term planning, anticipates a budget deficit of 1.8% of GDP in 2019. The general government deficit is expected to be smaller (1.5%) and has been reduced from last year's ERP by 0.4 percentage points. Compared to the 2018 outcome, the budgeted expenditures of the central government are projected to increase by 23.9% and revenues by 25.2%. Capital outlays (capital expenditures and capital transfers together) are reduced in nominal terms by 27.8% year-on-year. The decrease in capital outlays is consistent with the stated intention to freeze infrastructure investments. At the same time, almost half of the allocated budget of capital transfers was spent in the first month of the budget year. There are significant increases budgeted for personnel expenditures (+35.1% year-on-year), state premiums paid to the social security institutions (+40.1% year-on-year), current transfers (+25.8% year-

on-year) and interest payments (+63.6% year-on-year). It is, however, hard to match these expenditure figures with those for the respective categories in the ERP (Table 3.4) where the increases are more moderate. The Government uses a relatively optimistic growth assumption of 2.3% in 2019. General government tax revenues are expected to increase which is rather optimistic given the downward pressure on nominal GDP growth. No specific measures to increase the tax base are mentioned in the ERP, either, to substantiate an increase in tax revenues relative to nominal GDP. Budget discussions in the Turkish Parliament do not rule out a redistribution of expenditures between categories in the current budget year. Those expenditure categories that see an increase in the budget allocation can be used to cover cost overruns in other categories. Figures presented under the ESA methodology (Table 2 in the Annex) suggest a central government deficit of 0.9%. No explanation is given regarding the source of the difference from the headline budget deficit.

#### Box II.5.1: The budget for 2019

The draft budget for 2019 was presented to Parliament on 17 October and was accepted on 21 December, within the 45 days deadline. Parliamentary discussions did not lead to any changes in the proposed central government budget. The central government is aiming for a budget deficit of 1.8% of GDP in 2019. It aims to reduce expenditures by TL 60 billion and increase revenues by TL 16 billion. The Turkish Government does not work with expenditure ceilings and revenues are estimated from the bottom up. This adds to the difficulty in identifying a benchmark for budgetary savings. Total budgetary savings would amount to 1.7% of 2019 GDP but, in absence of a benchmark for the savings, it is hard to measure the real impact on the budget. In broad terms, overall projected budget developments and budget components do follow the structure of proposed budgetary measures.

#### Main measures in the budget for 2019

Revenue measures*	Expenditure measures**
<ul style="list-style-type: none"> <li>Higher tax revenues (+0.4% of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>Lower capital spending (+0.7% of GDP)</li> <li>Rationalised government incentives (+0.3% of GDP)</li> <li>Social security cuts (+0.2% of GDP)</li> </ul>

\* Estimated impact on general government revenues.

\*\* Estimated impact on general government expenditure.

Source: ERP

**The Turkish authorities identify fiscal discipline as the main pillar of their medium-term economic strategy.** Turkey's fiscal policy credibility and low government debt levels have been the main reasons for Turkey's ability to weather the TL crisis along with the central bank interest rate hike, a financially

sound banking system and easing international tensions. The ambition of fiscal austerity is reflected in the projected decrease in primary expenditures by 2.9% of GDP over the programme period and an increase in tax revenues by 0.7% of GDP. Interest expenditure is projected to increase by 1.0% of GDP from 2018 to 2021. This is also reflected in the primary balance, which is projected to improve more than the general government balance – from -1.6% of GDP in 2018 to +1.2% of GDP in 2021. The structural primary balance as defined by the Turkish authorities, which compensates for temporary factors like privatisation revenues on top of a cyclical adjustment, shows even more improvement (3.4% of GDP between 2018 and 2021). This also reflects the planned pro-cyclical nature of a budgetary policy that was expansionary through both fiscal and quasi-fiscal channels at a time of high growth and now aims for austerity at a time of economic contraction. Fiscal austerity is heavily front-loaded in the ERP with 72% of the total adjustment in the structural primary balance and 69% of the total actual primary balance adjustment taking place in 2019.

**The lower budget deficit anticipated in the ERP lacks specificity and there is a risk that *ad hoc* measures are needed to meet the budget target.** The programme anticipates cuts in government spending of TL 59.9 billion and revenue increasing measures of TL 16 billion in 2019. This is in line with the budget and the medium-term “New Economy Programme” (NEP) presented in September 2018. While the ERP does not give further numerical details on the expenditure cuts, the NEP itemises them but does not provide a benchmark. As a consequence, it is difficult to match the more detailed figures from the NEP with the ERP figures. However, like the NEP, the ERP projects falling current and investment expenditure as a percentage of GDP with a higher emphasis on cuts in investment expenditures. Relative to GDP, consumption and investment expenditure are projected to fall to levels below those recorded in recent years. Recent government action is pointing in the opposite direction, however, and likely to lead to an increase in the budget deficit. Moreover, the recent pick-up in quasi-fiscal operations also complicates the assessment of the fiscal stance and fiscal discipline in a broader sense. Additional measures will likely be needed to achieve the envisioned budget target and would need to be more structural in character than the *ad hoc* measures undertaken at the end of 2018 and beginning of 2019.

Table II.5.3:

**Turkey - Composition of the budgetary adjustment (% of GDP)**

	2017	2018	2019	2020	2021	Change: 2018-21
<b>Revenues</b>	33.1	32.7	32.1	31.9	31.6	-1.1
- Taxes and social security contributions	26.7	26.1	26.0	26.1	26.3	0.2
- Other (residual)	6.4	6.5	6.1	5.7	5.4	-1.1
<b>Expenditure</b>	34.9	35.1	33.6	33.6	33.2	-1.9
- Primary expenditure	33.0	32.9	30.8	30.5	30.0	-2.9
<i>of which:</i>						
Gross fixed capital formation	3.7	3.6	2.4	2.2	2.2	-1.4
Consumption	15.5	15.8	15.1	14.9	14.6	-1.2
Transfers & subsidies	13.9	13.5	13.4	13.4	13.3	-0.2
Other (residual)	0.0	0.0	0.0	0.0	0.0	0.0
- Interest payments	1.9	2.2	2.8	3.0	3.1	0.9
<b>Budget balance</b>	-1.8	-2.4	-1.5	-1.6	-1.6	0.8
- Cyclically adjusted	-2.4	-2.6	-1.2	-1.1	-1.2	1.4
<b>Primary balance</b>	0.1	-0.2	1.3	1.4	1.5	1.7
- Cyclically adjusted	-0.4	-0.4	1.5	1.9	1.9	2.3
<b>Gross debt level</b>	28.3	31.1	28.5	28.2	27.2	-3.9

Sources: Economic Reform Programme (ERP) 2019.



**The government debt ratio increased due to the TL depreciation but remains low.** The longer-term trend has been for a larger proportion of Turkish debt to be foreign. Foreign debt has grown from 28% of total debt at the end of 2011 to 45% at the end of 2018. The greater reliance on foreign debt has allowed for a lengthening of maturity and, thereby, allowed Turkey to benefit from relatively low yields at the long end of the yield curve. However, the higher share of foreign debt has led to a higher exposure to exchange rate developments. The domestic value of foreign debt increased by 35% between July and August 2018 as the TL depreciated. Still, the debt remained modest compared to GDP. Government debt reached 32.6% of GDP in the third quarter of 2018. The jump in the third quarter following the depreciation of the TL fits in with the sustainability scenarios given in last year's ERP. However, while the shock was larger than anticipated in the extreme scenario, the sharp rise in nominal GDP throughout 2018 helped limit the increase in the debt ratio. In the first two months of 2019, the Treasury has resorted to foreign debt markets and has issued over half of the scheduled foreign currency denominated debt despite the objective, stated in the ERP, to finance mostly through domestic debt. The high savings in foreign countries and easy monetary conditions continue to offer the Turkish government favourable long-term conditions despite Turkey's downgrading to below investment grade. However, both domestic and foreign debt have risen substantially in recent years which will necessitate higher roll-overs in the future. Turkey also has an unpublished amount of contingent liabilities not just from infrastructural projects but also through state banks and other sources.

*Box II.5.2: Debt dynamics*

High inflation is expected to be the main driver of a decrease in the Turkish government debt-to-GDP ratio. Real GDP growth and a positive primary balance are expected to contribute to the lower debt ratio as well whereas interest expenditure and further depreciation of the lira are expected to provide upward pressure.

*Table:*

<b>Turkey - Composition of changes in the debt ratio (% of GDP)</b>					
	2017	2018	2019	2020	2021
<b>Gross debt ratio [1]</b>	<b>28.3</b>	<b>31.1</b>	<b>28.5</b>	<b>28.2</b>	<b>27.2</b>
Change in the ratio	-0.2	2.9	-2.6	-0.4	-1.0
<i>Contributions [2]:</i>					
<b>1. Primary balance</b>	<b>-0.1</b>	<b>0.2</b>	<b>-1.3</b>	<b>-1.4</b>	<b>-1.6</b>
<b>2. "Snowball" effect</b>	<b>-2.9</b>	<b>-2.7</b>	<b>-2.3</b>	<b>-1.0</b>	<b>0.1</b>
<i>Of which:</i>					
Interest expenditure	1.9	2.2	2.8	3.0	3.1
Growth effect	-2.0	-1.0	-0.7	-1.0	-1.3
Inflation effect	-2.8	-3.9	-4.4	-3.0	-1.6
<b>3. Stock-flow adjustment</b>	<b>2.7</b>	<b>5.4</b>	<b>0.9</b>	<b>2.0</b>	<b>0.5</b>

[1] End of period.

[2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).

The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other effects.

*Source: Economic Reform Programme (ERP) 2019, ECFIN calculations.*

**The ambitious budgetary policy agenda has substantial risks attached and the budgetary plans would benefit from greater transparency.** First, lower-than-expected nominal GDP growth constitutes a risk to the realisation of revenue forecasts. Second, previous experience of lowering inflation from high levels and reining in inflation expectations suggests that nominal declines in revenues are likely to lead to nominal declines in expenditures. Third, tax revenues from international trade constituted 18.9% of all government revenues in 2018, up from 17.0% in 2008-2017. When Turkish economic growth decelerated in 2009 and 2016 tax revenues from international trade underperformed significantly compared to other

budget revenues. Fourth, transparency of public finances continues to be limited. Turkey does not have any numerical fiscal rules or independent fiscal institutions that could enhance the credibility of fiscal policy. There is still no published inventory of all contingent liabilities, which means that Turkey has not implemented the 2018 policy guidance. The contingent liabilities listed in the ERP are only those covered by the Ministry of Treasury and Finance.

**The ERP provides very limited information on the quality of public finances.** It does not divide government spending into components that would allow an understanding of how the quality of public finances is evolving. No clear strategy is presented to increase the quality of public finance. In the budget for 2019, however, investments on infrastructural works and on technology and science have been reduced compared to 2018 which would generally be considered to lower the quality of public finance. The ERP does suggest that tax reform is imminent, which could improve the quality of public finances. However, an overhaul of the tax system has been envisioned for some years and it remains to be seen whether it can be designed and implemented in the coming years.

**The Turkish budgetary framework lacks important elements from the 2011 EU Budget Directive, such as numerical rules and an independent fiscal institution.** The Government has to present a revised draft to Parliament if the budget deficit exceeds the nominal target agreed with Parliament by more than 5%. Parliament has agreed to a revised budget in the past 2 years. Positive budget outcome have relied mostly on commitment by the authorities. The conservative bias has historically been due to a relatively low estimate of tax revenues compared to forecasted economic growth. The growth forecast has become more realistic in the 2019 ERP but tax revenue estimates appear relatively optimistic. More generally, and taking into account the absence of a published inventory of contingent liabilities and the transition to the presidential system, Turkish budgetary planning would benefit from independent fiscal institutions to improve transparency and, thereby, credibility.

#### 5.4. STRUCTURAL CHALLENGES AND REFORM PRIORITIES

**Turkey is endowed with a strategic geographic position, a strong and entrepreneurial business sector, a large domestic market and a growing young population.** It also has a privileged access to the EU market through the Customs Union with the EU. To provide jobs for the many new entrants to the labour market, the Turkish economy has been allowed to grow fast in recent years, mostly thanks to cheap foreign financing. As a consequence, a number of known structural imbalances were exacerbated, amplifying the vulnerability of the economy. Triggered by political tensions with the USA, this led to a currency crisis in August 2018. In addition, measures taken after the 2016 attempted coup and the 2018 TL crisis had a profound impact on the business environment.

The Commission has conducted an independent analysis of the Turkish economy to identify the key structural challenges to boost competitiveness and inclusive growth, drawing from the Turkish ERP itself, as well as other sources. This analysis of the economy shows that Turkey is experiencing a number of structural weaknesses across many sectors. However, the the main challenges in terms of boosting competitiveness and long-term and inclusive growth are (i) raising the performance level of the education system, (ii) improving transparency and predictability in the regulatory and institutional environment affecting businesses, and (iii) formalisation of the economy.

##### 5.4.1. Key challenges

###### ***Key challenge #1: Raising the performance level of the education system***

**The labour market is characterised by low activity rates and the underused labour potential of women and youth. Education is key to address these structural deficiencies.** Turkey has focused on advancing the employment subsidies for the unemployed and has launched some programmes targeting

women. However, more efforts are needed to address labour market deficiencies, notably the participation of women and youth. It is important to further step up the quality and coverage of education at all levels as it is key for improved labour market participation. Studies on pupil (PISA) and adult education (PIAAC) reveal a considerable gap to the OECD average, which is an impediment for the further development of a knowledge based economy, in which hundreds of thousands young people enter every year into the labour market. VET training needs to be further extended and further streamlined.

***Key challenge #2: Improving transparency and predictability in the regulatory and institutional environment affecting businesses***

**The effective application of the rule of law is key to improving the business environment.** Effective, efficient and independent judicial systems are crucial for creating an environment that is investment- and business-friendly, since they instil confidence throughout the entire business cycle. Effective measures to further strengthen the rule of law, ensure adequate and timely contract enforcement and increase the transparency of legal changes will be key to improve the business environment in Turkey. Moreover, corruption will make Turkey a less attractive place for doing business unless it is forcefully addressed.

**Commercial judicial processes are slow and the large backlog of commercial court cases remains.** Resources for judicial procedures, notably for commercial cases, have been increased and regional appeal courts and courts specialised in commercial litigation have been established. Alternative dispute resolution mechanisms have been promoted.

**In addition, the number of companies transferred to management under the trusteeship of the Savings Deposit Insurance Fund (TMSF) has increased further.** As of 13 November 2018, 1,008 companies across Turkey with a total asset value of TL 55.9 billion (EUR 8.8 billion) and a total of 45,364 employees had been seized or had a trustee appointed, since the attempted coup (the February 2018 figure was 985 companies). The fact that the number has increased since last year indicates that politically-motivated actions against private companies continue. Furthermore there is no adequate, effective and timely means of legal redress in these cases.

**The regulatory environment is not stable.** In the course of 2018, the Turkish authorities took a range of actions that significantly affected the business environment and the proper functioning of the markets. These included: banning the use of foreign currencies in high value transactions (car lease and property), blocking price hikes for specific consumer goods, and forcing transfers of foreign currency proceeds into domestic currency. The Government also influenced price setting by coordinating a voluntary price reduction while intensifying the monitoring of prices and offering groceries at below market prices in government outlets. Turkey still does not have an overarching public financial management reform programme. Transparency of public investment programmes and state assets is weak.

**Turkey's long-term growth is constrained by provisions, which are not friendly to competition.** While the ease of doing business has improved (see the 2019 World Bank rankings), regulations in Turkey are still significantly less competition-friendly than in many other OECD-countries. There is insufficient implementation of competition and State aid provisions. Weaknesses have been identified in the level of state control (with concerns about the government involvement in network sectors, price controls and command and control regulations), in barriers to entrepreneurship (with protection of incumbents in e.g. energy and telecom and administrative burdens for obtaining licenses and permits, especially for start-ups) and in barriers to trade and investment (with differential treatment of foreign suppliers and barriers to trade facilitation, OECD 2013). Procurement rules still favour local bidders in crucial sectors, and many public sector bodies have been granted exceptions from compliance with public procurement legislation. In the Support for Improvement of Governance and Management (SIGMA) monitoring report *'The Principles of Public Administration'*, Turkey scores low on efficiency, non-discrimination, transparency and equal treatment in public procurement. Localisation requirements (e.g. in pharmaceuticals and renewable energy) and the increase in both other non-tariff trade barriers and

additional tariff duties encountered in the Customs Union also hamper competition. Finally, there is little transparency regarding the granted State aid.

**The lack of competition comes at a cost.** It is estimated that if Turkey were to align its product market regulations with the three best performing countries in this regard, GDP per capita could be 9.7% higher in the long run (OECD, 2016a). Consequently, Turkey has a lot to gain from aligning with international best practice. Competition is further distorted by the weak rule of law, corruption and the large informal sector. Turkey scores low on governance indicators, and gaps with international good practices have widened lately in the areas of rule of law, public administration reform, control of corruption, and government effectiveness, (OECD, 2018).

### ***Key challenge #3: Formalisation of the economy***

**Informality is very high in the Turkish economy exacerbated by the high influx of refugees.** Recent estimates put the share of informal activities in the total added value at approximately 27%, which is substantial in itself and higher than that of its peers, such as Poland and Hungary (OECD, 2018). Undeclared work is similarly high at 33% of all employment (Turkstat, 2019). The potential productivity gains of addressing this issue are significant: an earlier study estimated that shifting all informal firms in the Turkish manufacturing and service sectors into the formal sector could raise total output by 5% and 25% respectively (Taymaz, 2009). The large influx of refugees and the associated high rate of informality are significant challenges for the reduction of informality in the Turkish labour market, while also complicating the social inclusion of these refugees.

**Informality has a number of negative consequences for the competitiveness of the economy.** Informality is an obstacle to a level playing field and distorts fair competition. A larger informal sector is associated with lower productivity, reduced tax revenues, and higher levels of poverty and inequality (because of the lower wages paid to informal workers compared with formal workers (World Bank, 2019a)). Some studies suggest that informal employment can damage long-term career prospects and entrench income differentials (Taymaz, 2009). The many small informal businesses, which employ the largest share of Turkey's labour force, have very limited access to bank credit, and so find it difficult to fund long-term investments.

**The high level of informality has several underlying causes.** The agricultural sector still employs a significant amount of people with typically very high rates of unregistered work. In addition, the large influx of (mostly unskilled) Syrian migrants provides for a steady supply of workers who have few other options than informal work in construction or agriculture. Lastly, the high costs of dismissal (through severance payments) may also be pushing firms into informality.

**The importance of formalisation is recognised by the Turkish Government.** To reduce informality, the NEP proposes increased audits and improved taxation practices by integrating various data sources. Turkey's 2019-2021 ERP sets out the launch of an action plan covering 2019-2021, which has the ambition of bringing the informal sector down to the EU average in the medium term. Turkey has already made a number of reforms, which are steps in the right direction. Since 2018, employer contributions for each newly-hired worker in eligible firms have been reduced by 50% (the Government pays all taxes and insurance premiums of additional employment for one year). The minimum wage, which increased by 0.2% in 2017 and 3.0% in 2018 in real terms was kept below the previous year's labour productivity growth. The same is true for the 26% increase in the monthly net minimum wage in January 2019, designed to compensate for the depreciation of the TL. Since March 2016, retired individuals working on their own account are exempt from social security contributions, encouraging continuing work in the formal sector after the official retirement age. Social security and tax incentives have been increased to incentivise recruitment, with a focus on female, young or disabled employees, in an effort to include and formalise vulnerable groups (EBRD, 2018).

**Given the large size of the informal sector, reforms should continue in a more focused way.** In particular, informal employment could be further reduced through an increase in inspection capacities, with particular focus on non-agricultural employment. Such capacities are currently decreasing in Turkey

because the increased number of inspectors, even if already below ILO standards, does not match the increase in the work force. Increasing inspection capacity is deemed critical for enforcing labour law and reducing informal labour. In addition, it is important to evaluate the uptake of the various recent social security contribution cuts in order to make permanent those, which have proven most supportive of formalisation (OECD, 2018).

#### 5.4.2. Labour market, education and social policies

##### Labour market developments

**Employment remains at a low level, and the challenge of creating jobs for the young remains.** In 2018, the overall employment rate increased to 52% (15-64). The employment rate of older workers (60-64) is particularly low at 30.1%. The labour force participation rate in the 15-64 age group is also low at 58.5% with a large gender gap of 40.3 percentage points (78.6% for men and 38.3% for women). The unemployment rate has increased to 11% in the yearly average of 2018. However, the unemployment rate has been even further increasing by the end of the year (M12-2018 13.5%). In addition, there are strong regional disparities in regional employment and unemployment figures. Particularly affected are young people in Turkey: Although youth unemployment decreased in the yearly average for 2018 slightly to 20.3%, the share of young persons (15-24) not in employment, education or training (NEETs) has further increased to 24.5%. The rate for men is 15.6% and the one for women a striking 33.6%. The growth-induced job creation lags behind the demographic development.

**Women's labour market participation and informality remain among the essential shortcomings of the labour market.** The male employment rate in the 15-64 age group is 70.9% and the female employment rate is only 32.9%. This leads to a gender employment gap of 38 pps. Poor working conditions, deficits in decent jobs, low wages, skills mismatching and gender segregation among occupations are among the barriers women face in the labour market. The lack of institutions and services to provide care for children, the sick and the elderly and the cultural divide on female education and labour between urban and rural communities of Turkey adds further obstacles to the employment of women. A big proportion of the female population in rural areas never enters the formal labour market. More than one third of the workforce is still in informal employment. Although the figure has been declining in the last 10 years, which were characterised by high growth rates, the absolute level of informality is still too high. Although there are sporadic efforts to tackle informality there is no integrated framework addressing the issue.

**The main active labour market policies are employment subsidies.** In 2017, more than TL 5.5 billion was allocated for employment incentives covering social security contributions of employers. There is no integrated policy framework in place to address the low rates of labour market participation of women and young people, the informal sector or the skills mismatch of the labour force. Turkey has launched a women's employment programme which offers vocational or on-the-job training and individual action plans prepared by special units in public employment centres. Unemployment benefits amount to 40% of the average gross salary of the last four months, but are limited to 80% of the minimum wage (currently TL 2020 per month). Unemployment benefits are paid for a maximum of 300 days. In total 577, 054 persons were receiving unemployment benefits in December 2018.

**Social dialogue has deteriorated.** The Economic and Social Council has not convened since 2009 and the Labour Assembly has not convened since 2015. The Tripartite Consultative Committee, which is the main social dialogue forum, held one meeting in 2018 and produced no tangible results. Trade union density in the private sector is low at 13.86%. This is mainly due to the high rate of informal employment, which discourages workers joining trade unions. In addition, 85% of the Turkish economy consists of SMEs with fewer than 30 staff that makes unionisation difficult. The trade union density is higher in the public sector (67.65%), but has been falling since 2016. Generally, Turkey has a very low collective bargaining coverage. Collective agreement coverage is below 10% in the private sector. In addition, trade union activities are in some cases obstructed with union members facing dismissals, harassment and in

some cases even detention. The limitation of the right to collective bargaining and freedom of association has attracted the attention of the International Labour Organisation (ILO). In order to reinvigorate social dialogue ILO has together with the Turkish Ministry of Family, Labour and Social Services implemented an EU-funded project “Improving Social Dialogue in Working Life” in 2016-2019 with a focus on capacity development of all related institutions and parties. Numerous tripartite and bipartite consultation processes were carried out during the span of the project. However, the regular social dialogue mechanisms (Economic and Social Council, Labour Assembly, Tripartite Consultative Committee) are not functioning.

**Box II.5.3: Monitoring performance in light of the European Pillar of Social Rights**

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights on equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion to benefit citizens in the EU. Since the 20 principles are essential for countries if they are to achieve fair and well-functioning employment markets and welfare systems, they are equally relevant for candidate countries and potential candidates.

**Turkey faces considerable challenges concerning the indicators of the Social Scoreboard<sup>(1)</sup> supporting the European Pillar of Social Rights.** This is notably the case for equal opportunities and fair working conditions, especially for those in informal employment. Turkey has a high rate of early school leavers (31%) and young people not in employment, education or training (NEETs). In 2018, the gender employment gap is at 38 pps the highest among the enlargement countries. Both the at-risk-of-poverty-rate (2016: 22.8%) and the income quintile ratio are higher than EU-28 averages. Social dialogue has been deteriorating in the recent years.

**Low participation in the labour market applies in particular to women.** The labour force participation rate of women is 38.3%. A significant part of the female population never enters the formal labour market. The unemployment rates and overall unemployment are increasing. Enrolment figures for pre-primary and

primary education have improved starting from a low level over the years but the quality of education remains an issue, as indicated in the result of PISA testing.

**Skills mismatch and limited reskilling opportunities limit labour market integration and mobility.** Overall, education outcomes remain low at various levels. While primary education is nearly universal, there are low enrolment and high dropout rates in secondary education. Teacher training and quality of education are other areas which require investment.

**The impact of social transfers on poverty reduction is small.** It accounts for only 7.69% (EU average 33.2%). The risk of poverty and social exclusion in the country has been increasing, and so have the income inequalities.

**Turkey has a well-developed system for labour market and social statistics.** The Turkish Statistical Institute (Turkstat) is the main producer and coordinator of the statistical system of Turkey. Turkstat publishes the Labour Force Survey (LFS)

TURKEY		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Worse than EU average, improving
	Gender employment gap	Worse than EU average, improving
	Income quintile ratio (S80/S20)	Worse than EU average, deteriorating
	At risk of poverty or social exclusion (in %)	Worse than EU average, deteriorating
	Youth NEET (% of total population aged 15-24)	Worse than EU average, deteriorating
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-64)	Worse than EU average, improving
	Unemployment rate (% of population aged 15-74)	Worse than EU average, deteriorating
	GDHI per capita growth	N/A
Social protection and inclusion	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU average, improving
	Children aged less than 3 years in formal childcare	N/A
	Self-reported unmet need for medical care	Worse than EU average, improving
	Individuals' level of digital skills	Worse than EU average, improving

quarterly and annually and the Survey on Income and Living Conditions (SILC) annually.

<sup>(1)</sup> The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance (<https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators>). The 12 indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-28 average (performing worse/better/around EU-28 average) and a review of the trend for the indicator based on the latest available 3-year period for the country (improving/deteriorating/no change). Data from 2014-2017 are used.

## Social protection system

**Income inequalities remain at high rates and above the level of EU countries.** Standing at 0.426 the Gini coefficient is considerably higher than in the EU (0.308) and so is the income quintile ratio (S80/S20) at 8.6 (EU: 5.2). The at-risk-of-poverty rate remains at around 22%. The reduction in the poverty rates is linked to the availability of new and better-paid jobs as social security transfers and the minimum wage do not significantly mitigate poverty risk. The high level of informal employment aggravates the situation. The impact of social security transfers on poverty reduction is small at 7.69%, but has been improving in recent years. However, it is nonetheless still much lower than the EU average of 33.2%.

**Turkey has a number of fragmented social assistance schemes.** There are pensions for the elderly, for widows and for the disabled. There is no minimum income scheme in Turkey. There is neither a strategy for homeless nor a long-term care strategy in place. Some social benefits provide relatively discretionary and irregular in-kind and cash assistance to poor households. There are also targeted assistance schemes where households receive conditional cash transfers based on their children's school attendance or visits to healthcare providers. All of the schemes are subject to means-testing. In the absence of reliable income indicators, estimations are made, which renders the final decision on social assistance largely discretionary. Formally employed persons covered by social security are not eligible for social assistance.

**Early childhood education and care services are limited in Turkey.** The enrolment rate for children up to the age of 2 years is less than 1% and not much higher at the age of 3. It is 50.42% for the 4-5 age group and for the age group 5 it increased from 58.8% in 2017 to 66.8% in 2018. Funded by the EU, the Social Security Institution (SSI) provided a childcare subsidy to women who were working or returning to work and who had children younger than 24 months. The programme lasted from March 2015 to November 2017 and reached a total of 11,400 women at a cost of TL 38.9 million (EUR 6.88 million). Through another programme initiated in March 2017 by the Ministry of Family, Labour and Social Services, a subsidy was offered to grandmothers who cared for their grandchildren. The project covered 6,000 women and lasted for 1 year. However, it has been discontinued, as it did not have any structural impact on the employment of working mothers. Available grandmothers provided the service with and without subsidies and hence the number of working mothers did not increase.

## Education and skills

**Progress in increasing provision and quality of education is mixed. The net enrolment rates in primary school increased from 91.2% in 2017 to 91.5% in 2018.** Turkey's PISA (Programme for International Student Assessment) and PIAAC (Programme for International Assessment of Adult Competencies) scores are far behind the average of other OECD countries, indicating the need to step up the quality and coverage of school education. In secondary education, the net enrolment rate increased from 82.5% in 2017 to 83.6% in 2018. Since 2014, Turkey participates in Erasmus+ on the same footing as EU Member States. The country has access to actions in the field of higher education, youth, sport, vocational education and training (VET) as well as school and adult education projects for cooperation and mobility. Turkey can also cooperate with partners outside Europe under international projects.

**The implementation of a national vocational qualifications system by the Vocational Qualifications Authority (VQA) is ongoing.** The Turkish qualifications framework (TQF) is now referenced to the European Qualifications Framework. Incentives are offered to provide vocational training. Between February 2017 and June 2018, 3,109,971 incentives were paid to businesses. Apprenticeships were introduced into 12-year compulsory education. An important step has been taken to further develop skills using enhanced on-the-job training. Students can now become graduates from high school by passing the complementary courses leading to a mastership in a trade and if they wish they can sit for the university entrance exam, and attend higher education. Turkey will need to develop skills development strategies to ensure the continual renewal of skills in a changing world. This will require a focus on the transitions



individuals face (for example, moving from the informal to the formal economy or from the manufacturing to the service sector), so that each person successfully adapt to the labour market and can interrupt, reskill and re-engage in employment throughout their careers.

**The Education Vision 2023 was approved in November 2018 with a very inclusive approach involving all the public and private stakeholders including civil society.** As a result of Turkey signing the European Alliances for Apprenticeship (EAfA), there has been increased involvement of the private sector in skills matching for all levels of education.

**Tertiary education tends to concentrate on fields which are less relevant for the labour market.** Based on the Adult Education Survey, these are humanities and social sciences, business and law. Industrial and technological sectors require increasingly mathematics, IT, natural sciences and technology (MINT) qualifications.

**Adult education in lifelong learning is 5.8% lower than the EU average of 10.8%.** Adult education takes place in a broad range of institutions but its performance regarding literacy, numeracy and problem solving skills in technical contexts is weak.

#### 5.4.3. Competitiveness and sectoral issues

##### Business environment

**The ease of doing business and access to finance have improved, but as outlined above, concerns about commercial justice processes and competition continue to hamper the business environment.** The 2019 World Bank Doing Business report ranked Turkey 43 out of 190 economies, recognising it for its reforms by lifting it from 60<sup>th</sup> place in 2017. Specific measures were implemented to make it easier to: start a business, apply for construction permits, access credit, pay taxes, trade across borders, enforce contracts and resolve insolvency. The protection of intellectual property rights was also improved. However, other aspects of the business environment are deteriorating. Concerns over commercial justice processes and unfair competition, not least from the informal sector, are outlined above. Insolvency also remains an important issue. The process still takes a long time (five years on average) and is expensive (requiring 14.8% of debtors' assets) with a recovery rate of only 14.7 percent (World Bank, 2019b). The impact of the insolvency reforms remain to be seen. The OECD also points to Turkey as having one of the largest gaps between entrepreneurial dynamics and institutional capacity (OECD, 2018).

**The fight against corruption is seen as important to attracting FDI and upgrading the business environment.** Turkey scored 41 points out of 100 and ranked 78 out of 180 countries (down from a high of 50 points and 53<sup>rd</sup> ranking in 2013) on the 2018 Corruption Perceptions Index reported by Transparency International. The OECD estimates that a one percentage point increase in the World Bank corruption index reduces FDI from selected countries by 4-9%. Turkey's policy response remains weak. While Turkey has indicated the ambition to enter the top 20 in the WB Doing Business ranking within two years, no specific measures are set out in either in the NEP 2019-2021 or the ERP to further combat corruption.

##### Research, development and innovation

**R&D expenditure is increasing, but more and continued support is needed.** The share of R&D expenditure in GDP has risen fourfold since 2005, outstripping countries such as Mexico and Greece and comparable to that of Poland. R&D tax incentives have become the main tool for the government to boost R&D (e.g. by exempting key R&D salaries from income tax: 90% for staff holding a PhD). Nevertheless, tax credits and tax allowances are among the lowest in the OECD. While the number of full-time equivalent R&D personnel increased by 12%, Turkey's overall research capacity is still limited in terms of the number of researchers per million inhabitants (a third of the European average).

**Turkey's R&D expenditure as share of GDP (0.96% in 2017) is below the EU average (2%) and significantly below the target, which Turkey has set for itself (1.8% in 2018).** Only 0.07% of GDP is

spent on private sector R&D activities, which is very low compared to OECD countries. Current institutional capacity and resources spent on R&D, and the level of commercialisation of innovation, are insufficient to support Turkey's ambition for higher value added production. In this regard, it is important to increase domestic savings, as it is generally considered difficult to attract external financing for R&D (OECD, 2018).

### Digital economy

**Turkey has the ambition to move towards a digital economy, but insufficient competition and limited digital skills are challenges.** Fixed broadband subscriptions rose to 14.8 per 100 people in 2017. Mobile broadband penetration significantly increased to 73%, though it is still below the OECD average of 102.4%. The share of households with access to the internet at home increased from 81% to 84% between April 2017 and April 2018. Over the same period, internet usage by individuals aged 16-74 increased from 67% to 73%. The number of 4/5G subscribers reached 68 million within two years. However, Turkey's digital sector suffers from insufficient competition in the telecom markets and excessive taxation and costs for operators and for consumers of information and communications technologies. In addition, digital upskilling is urgently needed, as earlier studies highlighted limited proficiency in information processing skills (OECD, 2016b). Turkish firms increasingly invest in digitalisation, although the adoption of digital applications related to core business management functions should be expanded.

**Turkey has made progress in integrating digital government into its public administration reform.** It provides an e-government portal as a single access point for electronic services for its citizens. The Government has also promoted digitalisation by facilitating the connection of business to public authorities by, for instance, online filing of tax and social security returns and online applications for construction permits. The number of registered users reached 40 million in 2018, a significant increase from 25.2 million in 2015. However, other public administration areas in Turkey remain a concern.

### Investment activity

**Turkey's objective to scale up the value added of its production requires more productive investment.** Investment in construction outpaced the investment in machinery: during the period 2013-2018, the average quarterly growth rate in investments in construction was 8.6%, compared to only 4.2% for machinery. The credit crunch that Turkey experienced at the end of the year as a matter of fact hit machinery investments harder than construction. More specific measures would be needed and this also fits into the broader need for raising domestic savings in order to finance these productive investments. With investments outpacing domestic savings, foreign investment is essential. FDI flows have been the most stable, but continue to play a relatively limited role, registering a net inflow of 1.0% of GDP in the first three quarters of 2018 (compared to a peak of 3.65% in 2006). The EU remains the largest source of FDI in Turkey with a 71% share of stocks in 2017, although the rate has been declining (77% in 2013).

### Trade performance

**Turkish remained an open economy, with trade openness, measured as exports and imports as a proportion of GDP, at 54% in 2018.** This is a relatively high figure compared to the past two decades. Price competitiveness benefited from the continuous depreciation of the TL in 2018. Calendar adjusted exports grew by 7.0% while imports fell by 4.6%, resulting in a 28% reduction of the trade deficit, and increased export coverage (to 75.3% from 67.15%). The ratio of exports of high-technology products in manufacturing industries was 4.3%, indicating the relatively low innovative component of locally produced goods. Turkey's trade integration with the EU is high, and rising, although a particularly pronounced decrease in imports from the EU, and hence adjustment of the trade balance, took place in 2018. Turkey is the EU's fifth largest trade partner and the EU remains by far Turkey's largest trade partner, accounting for 50.0% of exports and 36.2% of imports. In 2018, the main export destinations were Germany, the United Kingdom and Italy, and the main sources of imports were Russia, China and Germany.

**In addition to Turkey's continuing introduction of additional tariff duties diverging from the Common Customs Tariff, several non-tariff barriers remain between Turkey and the EU, which restrict imports and exports in several sectors.** This is despite Turkey's high level of legislative alignment with EU law under the Customs Union. Such non-tariff barriers include the requirement for foreign firms exporting pharmaceutical products to relocate part of their production to Turkey, export restrictions in certain sectors, excessive testing and certification requirements at customs, heavy import surveillance etc. In addition, public procurement does not provide a level playing field, since it favours local companies and some public bodies are exempt from the provisions of public procurement law.

## Energy

**Turkey's energy sector is heavily reliant on imports of fossil fuels and suffers from a lack of price competition.** Turkey's dependence on imported energy is one of the main drivers of its external imbalance. Oil and gas are mostly imported from Russia, Azerbaijan and Iran. Turkey has made efforts to improve its security of supply, with the completion of the first phase of the Trans-Anatolian Pipeline (TANAP) and the offshore section of the Turkstream pipeline as well as by expanding its LNG Floating Storage Regasification Unit capacity and gas storage capacities. Turkey has a large programme of construction of coal burning power plants. Further steps to diversification were made by the launching of three big tenders for solar and wind energy last year (although the tenders failed to attract tenderers). Renewables account for 35% of total energy production (mostly hydropower and wind), and 44% of the total installed capacity. Electrical power transmission and distribution losses are estimated at 12.1% (TEİAŞ 2017).

**There is still a need to fully liberalise the energy market to make it fully aligned with the Third Energy Package.** The large increase in energy costs (31% over 2018, Producers Price Index increase of 75% for the electricity industry) has reduced the competitiveness of Turkish manufacturers and the local-content requirements do not provide a level-playing field in procurement. As a country dependent upon energy imports, energy efficiency is a priority. The national energy efficiency action plan has been approved and is under implementation. The key focus of the SME strategy in the context of SME greening is the promotion of eco-efficient products, services and processes, as well as eco-innovation. Business support schemes assist SMEs in greening their projects (with a focus on energy efficiency) and also aim to improve the quality and quantity of the energy efficiency consulting companies.

## Transport

**Turkey's transport sector is heavily reliant on road transport, with little diversification into other transport modes such as rail.** Road transport is still the primary mode of domestic freight transport in Turkey, accounting for more than 85% of total freight, measured in tonne-kilometers (Turkey, 2018). This reliance on road transport continues to generate environmental and traffic safety problems. Moreover, there are a number of urban mobility issues especially in large cities such as Istanbul that reduce economic efficiency. The logistics master plan and the strategy for intelligent transport systems have both been finalised and aim at a more balanced, multimodal approach to transport; however, implementation has not started yet. A large program of track renewal and modernisation is being completed to restore the rail infrastructure to a normal condition after a long period of neglect (Turkey, 2018). The rail sector still needs to be liberalised. Current investments in rail infrastructure will only gradually shift the modal split for passenger and freight transport. Projects to increase transport by water do not seem like immediate prospects. Border crossings remain as a key bottleneck, with significant cost implications for the time lost.

## Agriculture

**The agricultural sector is characterised by informality, a lack of reliable data, land fragmentation and a lack of modern technologies.** Agriculture is important in Turkey's economy, providing 5.8% of

gross value added and 18.4% of total employment in 2018. Typically associated with a prevalence of low-productivity informal activity, the share of agriculture in total GDP has been decreasing (from 6.9% in 2013, for example) as has the share of total employment. The lack of reliable agricultural data complicates the development of a proper policy response. Land fragmentation, which limits economies of scale, illustrated by the small average farm size (7 ha, compared to the EU average of 16 ha), is exacerbated by distorted territorial integrity caused by inheritance by family members (EBRD 2016). While agricultural value added and agricultural production have grown moderately over the last decade, major crops such as wheat have difficulty to compete in the market, and depend on subsidies for their economic viability. The level of agricultural subsidisation in Turkey is considered moderate, close to the EU average (support amounting to 28% of gross farm receipts, compared to the EU average of 21%, OECD, 2019). Poor access to finance and lack of a predictable support system discourage any attempts at modernisation or innovation by individual farmers. The system as a whole suffers from weak irrigation systems. The protectionist aspects of Turkey's agricultural policy also need to be addressed. This is especially important to allow further liberalisation of agriculture.

### Industry

**Turkey's industrial sector is dynamic, but performs below potential and suffers from a high dependency on foreign energy sources and raw materials, and regional disparities in industrial development.** Helped by its geographic location, it is generally well integrated into European and global value chains. Recent regional development strategies promote local efforts to cultivate technology, industry and service clusters (in the absence of industrial strategies). Industry also accounted for 19.7% of employment and 22.2% of GDP in 2018. Exports have diversified over the past decade, with vehicles, machinery, mechanical appliances and jewellery now being the commodities which contribute most to exports. Labour productivity has increased to 79% of the EU average and now is higher than in e.g. Portugal and the Czech Republic.

**Turkey's ambition is to increase the proportion of high technology in its industries.** Currently, however, high-technology products from manufacturing industries represent only 4.3% of the value of exports. In addition, R&D investment is still relatively low: even listed firms (large corporates, generally considered the most competitive segment) show R&D investment rates lower than those of their peers (Cilasun, 2019). Lastly, the generally poor performance of the education system creates obstacles to Turkey's ambition. To decrease dependency on foreign input, efforts are being made to boost the domestic energy supply and support domestic inputs. Regional disparities among Turkey's 81 provinces are substantial: three provinces together account for more than 46% of GDP. Turkey's less-advanced regions have relied increasingly on low-technology and low-skilled manufacturing. For the future, it will be key to help these businesses upgrade the quality of their products and increase their productivity. The formalisation of informal and semiformal activities in these regions will be essential for inclusive growth in this regard (OECD, 2018).

### Services

**The service sector is expected to remain the fastest growing sector in terms of value added and employment, but could benefit from liberalisation.** The service sector dominates in terms of gross value added (54%) and represents 54.9% of employment in 2018. The services sector grew 5.6% y-o-y, and represented 21% of the value of exports in 2017. Turkey is not fully aligned with EU legislation on the right of establishment and freedom to provide services. It is important that this is addressed in possible further liberalisation of the services market. As a major export sector, tourism is expected to grow and contribute significantly to the rebalancing of the economy. To tap into this potential, a policy of inclusive and ecologically sustainable growth should be pursued (OECD, 2018).

## 5.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2018

<b>Overall: Limited implementation (28.9%)<sup>(18)</sup></b>	
<b>2018 policy guidance</b>	<b>Summary assessment</b>
<p><b>PG 1:</b></p> <p>Lower external imbalances in light of high external funding needs constituting a substantial risk for the Turkish economy.</p> <p>Promote domestic savings by incentivising higher private sector savings</p> <p>and by following a sufficiently tight fiscal stance over the medium term in light of external vulnerabilities built up over the years.</p>	<p>There was <b>limited implementation</b> of PG 1:</p> <p><b>1) Limited implementation:</b> The current account deficit decreased significantly by 42% over the last year, from USD 47.1 billion in 2017 to USD 27.1 billion in 2018. Turkey recorded a current account surplus over 4 consecutive months between August and November 2018. However, the government did not pursue this correction of external imbalances but was, instead confronted with an abrupt unravelling.</p> <p><b>2) Limited implementation:</b> The Government continues to offer incentives to encourage households to bring their gold to banks to be deposited. The Treasury has been issuing gold denominated bonds and lease certificates. The premium on pension savings continued but high inflation eroded its impact.</p> <p><b>3) Limited implementation:</b> The budget deficit widened significantly from TL 47.8 billion in 2017 to TL 72.6 billion in 2018 and the structural government balance went further into deficit in 2018. The Government has made significant tax cuts and introduced incentives during election periods.</p>
<p><b>PG 2:</b></p> <p>Increase the prudence and transparency of fiscal policy by (i) making a sufficiently prudent inventory of risks to public finances stemming from Public Private Partnerships and other contingent liabilities</p> <p>(ii) limiting the accumulation of new contingent liabilities reflected in the budget</p>	<p>There was <b>limited implementation</b> of PG2:</p> <p><b>1) No implementation:</b> There is no publicly available inventory retracing the risks to finances stemming from public private partnerships and other contingent liabilities.</p> <p><b>2) No implementation:</b> The Government announced that public investment projects for which tender processes have not been launched or for those which have started but not yet been finalised, will be suspended. However, the 2019 investment programme suggests investments are continuing according to plan. It is envisaged that large infrastructure projects will be implemented using foreign investment and international financing (and</p>

<sup>(18)</sup> For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission's Overview and Country Assessments of the 2017 Economic Reform Programmes available at [https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments\\_en](https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en).

<p>(iii) avoiding ad hoc increases in tax exemptions and subsidies,</p> <p>and (iv) making the medium-term economic scenario more conservative.</p>	<p>expectedly through PPPs) only, and, therefore, will most likely add to the existing contingent liabilities.</p> <p><b>3) No implementation:</b> Turkey introduced temporary tax cuts and opportunities for capital repatriation and restructuring for a wide range of taxes and penalties during the first half of 2018. Afterwards, almost all of them were extended until the end of March 2019. Turkey maintains its policy of introducing temporary tax-cutting schemes particularly before elections and after economic fluctuations.</p> <p><b>4) Partial implementation:</b> In the NEP (2019-2021), the macroeconomic indicators were revised compared with last year's medium term economic programme (2018-2020). The new macroeconomic forecast seems to be somewhat more realistic, at least for some of the indicators, such as economic growth (considering the rebalancing process in the Turkish economy) and the inflation rate (in light of recent developments including the weakening of the TL and the increase in food prices).</p>
<p><b>PG 3:</b></p> <p>Focus monetary policy on the pursuit of price stability and ensure that the monetary policy stance is sufficiently tight to bring back to the target band, anchor inflation expectations and increase trust in the local currency.</p> <p>Simplify the monetary policy framework by returning to the main policy rate as the key signalling device for the monetary policy stance in order to increase transparency of monetary policy.</p> <p>Closely monitor asset quality amid buoyant credit growth, especially for loans backed by the credit guarantee fund.</p> <p>Continue addressing possible risks associated with corporate forex borrowing.</p>	<p>There was <b>partial implementation</b> of PG3:</p> <p>1) <b>No implementation:</b> The monetary policy stance remained loose (with a real average interest rate of 1.5% in 2018). Inflation, core inflation and inflation expectations have further increased with inflation reaching a 15-year high.</p> <p>2) <b>Partial implementation:</b> In June, the Turkish central bank (CBRT) reverted to a simplified monetary policy framework by using the one-week repo rate as the key policy rate and putting a surrounding interest corridor of 150 basis points in place. However, during the financial turmoil in August and September 2018, and as of late March 2019 the CBRT deviated from the simplified monetary policy framework..</p> <p>3) <b>Partial implementation:</b> The authorities undertook an asset quality review, but did not communicate the methodology used or any more specific outcomes except for the headline ratios, which lacks transparency and did not help restore confidence in the banking sector.</p> <p>4) <b>Partial implementation:</b> Effective from May 2018, the government banned foreign exchange borrowing by SMEs that are not naturally hedged against forex risks, and it imposed certain limits on forex borrowing for exporting SMEs. However, the authorities did not explore further measures except for taking some ad-hoc measures after the financial turmoil in August.</p>
<p><b>PG 4:</b></p>	<p>There was <b>partial implementation</b> of PG 4:</p>

<p>With a view to improving the business environment, strengthen the rule of law and the judiciary.</p> <p>Further reduce the administrative burden for companies, including by shortening the timing and lowering the cost of insolvency procedures through the effective implementation of the amended law on bankruptcy.</p>	<p>1) <b>Limited implementation:</b> Turkey lifted the state of emergency in July 2018 and new civil courts judges were recruited and trained. However, a large number of companies remain under trusteeship after having been seized in the wake of the attempted coup with no clear prospects of timely due process.</p> <p>2) <b>Partially implemented:</b> Legislative amendments helped to reduce the administrative burden mainly by removing the paid-in minimum capital requirement, eliminating notarisation requirements and reducing registration costs. Concerning insolvency, Turkey introduced the possibility of obtaining post-commencement credit, improved voting arrangements in reorganisation and granted creditors greater participation in the proceedings.</p>
<p><b>PG 5:</b></p> <p>Adopt the strategy in support of research and development.</p> <p>Encourage private companies' uptake of innovative production processes.</p>	<p>There was <b>partial implementation</b> of PG 5:</p> <p>1) <b>Limited implementation:</b> According to the second 100 day action plan of the Presidency, the Science, Technology and Innovation (STI) Policy Board is expected to adopt the new national strategy for research, development and innovation (RDI) in the course of 2019.</p> <p>2) <b>Partial implementation:</b> The 100 Day Action Plan of the Presidency included priorities on business-academia cooperation. Several initiatives (to improve innovation networks, strengthen research capacity and increase access to finance) have been launched by the Scientific and Technological Research Council of Turkey (TUBITAK). A comprehensive roadmap for digital transformation has been developed to increase the use, development and production of digital technologies.</p>
<p><b>PG 6:</b></p> <p>Ensure a balanced regulation of the labour market combining flexibility with security including the reform of the severance pay system</p> <p>and reduce informal employment through, inter alia, increase of inspection capacities, with particular focus on non-agricultural employment.</p>	<p>There was <b>limited implementation</b> of PG 6.</p> <p>1) <b>Limited implementation:</b> In December 2017, a state of emergency decree came into force in which subcontracted workers in public service were given the right to become permanent staff under certain conditions. The decree was implemented in the first half of 2018, but does not address similar challenges in the private sector. Plans for reforming the severance pay system were announced in the 2019 annual presidency programme.</p> <p>2) <b>Limited implementation:</b> Informal employment has been around 33% since 2015. Inspection capacities have not sufficiently increased. The Social Security Institution has continued the "KİDEP" project to promote registered employment. The project has a guidance and inspection component where programmed inspections based on a risk</p>

<p>Target support for job creation to young people and women.</p> <p>Focus support to the expanded provision of vocational training on sectors with growth potential and skills needs.</p>	<p>analysis are expanded. The project had also a nationwide awareness raising component. However, the results remain to be seen.</p> <p>3) <b>Partial implementation:</b> Employment subsidies to help businesses hire new employees were further expanded. Certain social security-related costs of employees, with a focus on youth and women, have been covered from the unemployment insurance fund. New employment subsidy programmes were launched and existing ones continued to be implemented in 2018. A new subsidy programme, the "New Generation Incentive", launched in 2018, aims to provide additional employment subsidies for youth in manufacturing and IT. A 2018-2023 Strategy and Action Plan on Women's Empowerment was adopted and includes support for female entrepreneurship and cooperatives. In 2018, 60 776 women participated in entrepreneurship trainings. Some of the Regional Development Agencies implemented programmes to support female entrepreneurship via trainings and grants.</p> <p>4) <b>Limited implementation:</b> In December 2017, a protocol on "Improvement of Vocational Trainings and Skill Development" was signed between the Ministry of Family, Labour and Social Services and the Union of Chambers and Commodity Exchanges of Turkey and some training was delivered under this protocol during 2018. However, there is no available assessment of this training on employment in the sectors.</p>
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## 5.6. THE 2019 POLICY GUIDANCE

### **JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TURKEY**

The Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

Brussels, 17 May 2019

[...]

In light of this assessment, Participants hereby invite Turkey to:

1. Promote domestic savings by following a sufficiently tight fiscal stance over the medium term and by reducing government credit guarantees and other incentives that increase the financial leverage of the corporate sector and strictly limit them to market failures. Further incentivise net savings of the household sector.
2. Enhance the prudence and transparency of fiscal policy by publishing a comprehensive inventory of risks to public finances stemming from Public Private Partnerships and other contingent liabilities as part of the budgetary process. Limit the accumulation of new contingent liabilities from public-private partnerships by using strict cost-benefit analyses. Prepare an options paper on introducing numerical fiscal rules and establishing an independent fiscal body.
3. Focus monetary policy on the pursuit of price stability and ensure that the monetary policy stance is sufficiently tight to bring inflation back to the target band, anchor inflation expectations and increase trust in the local currency. Publish the methodology and specific outcomes of the next asset quality review in a more transparent and detailed way in line with international standards. Ensure that no impediments to non-performing loan resolution exist to foster the clean-up of impaired assets, and explore potential further measures in order to address risks associated with corporate foreign currency borrowing.
4. With the view to improving the business environment, strengthen the rule of law and stabilise the business regulatory environment, including by improving efforts to reduce the number of companies remaining under trusteeship without jeopardising lawful process; unwinding of the measures to contain temporary financial market volatilities that might hinder the free flow of foreign currency; and reducing the share of goods in the Consumer Price Index basket for which prices are directly or indirectly influenced by the government.
5. Further reduce informality in the labour market, inter alia by strengthening inspection capacities, and by evaluating the impact of social security and tax incentives aiming to strengthen the transition to formal employment.
6. Ensure full enrolment for 5 year-olds in mandatory pre-school education. Ensure full enrolment and improve curricula in secondary education, including the provision of vocational education and training. Incentivise female labour participation by providing public and private childcare facilities and tax and social security incentives for formal employment, especially in female-dominant sectors and for part-time work.

## ANNEX A: ASSESSMENT OF THE STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP

### **Measure 1: Increasing share of renewable energy in electricity generation**

Increasing the share of renewable energy is expected to help reduce Turkey's dependence on energy imports and ultimately the current account deficit, and this measure is intended to support the trend of growing share of renewables in Turkey's total energy generation. It complements important investments that have been initiated in wind and PV energy. However, concerns have been voiced about special incentives and local-content requirements, which affect access by EU and other international companies to tenders in the renewable energy sector in Turkey. As regards the planned activities, energy sector stakeholders should be consulted on the legislation setting out the new renewable energy incentive mechanism and it should be adopted well in advance of the expiry of the current mechanism (i.e. end of 2020). This will provide predictability for investors.

### **Measure 2: Development of financial mechanisms regarding energy efficiency**

The national energy efficiency action plan (NEEAP) was finally adopted in 2018, but its actual implementation is yet to be rolled out. Priority needs to be given to the development of national energy efficiency financing mechanism, envisaged under the NEEAP. Involving and regularly consulting relevant stakeholders in the design, monitoring and evaluation of energy efficiency policies and measures will help ensure their feasibility and increase the rate of compliance.

### **Measure 3: Turkish railway transport liberalisation**

Proper liberalisation of railways will bring down the unit costs of transportation and significantly reduce the externalities from the transport sector. Railway liberalisation features prominently in the transport master plan adopted in 2018. Still, it is unclear how this measure will address the several significant obstacles to true liberalisation, such as ensuring that there is no public financial support in the freight sector, that all passenger lines should be supported through public service obligation contracts, that the government-owned TCDD Transport operates as an independent commercial company in an open market, that all freight and passenger rolling stock will be registered, irrespective of origin, and that there is fair competition.

### **Measure 4: Increasing the capacity of improvement and evaluation in agricultural statistics data collection processes**

An overall strategy is needed to address the shortcomings identified within the agricultural sector (still an important sector for the Turkish economy). The availability of complete and accurate agricultural statistical data is a precondition of evidence-based policy development. As such, the proposed measure is important and relevant. However, the description of the identified scope and activities (and their linkages) is not sufficient. Furthermore, it is not clear if the aim is to develop a methodology in accordance with that of Eurostat or a more country-specific one.

### **Measure 5: Project proposal call and implementation within the scope of KOBIGEL-SME development support programme**

It is unclear how this measure helps to boost the competitiveness of SMEs. More detailed information on the KOBIGEL (small and medium-sized enterprise development support programme)-programme is needed to be able to assess its relevance and importance. The impact on employment and gender is not really explained.

### **Measure 6: Supporting domestic manufacturing of products with high import and strategic importance to reduce the current account deficit**

The strategic product support programme, which is also a KOSGEB programme, is not sufficiently explained. When implementing this measure, it is essential to avoid violating international obligations or

the terms of the EU-Turkey Customs Union, i.e. the measure should not be implemented, in principle, by using trade protection measures that run counter to Turkey's obligations (for instance, as in the case of localisation of pharmaceuticals).

**Measure 7: Increasing tourism market share and brand value**

Tourism is an important economic sector and has performed strongly over the last two years with the number of tourists and total tourism income increasing significantly. However, the tourism sector remains below its potential, especially when considering the decline in average expenditure per visitor. In this context, the preparation of an action plan (the tourism master plan) to diversify tourism products/services and markets will help further boost the tourism sector and help increase the country's competitiveness and reduce the current account deficit. However, the proposed measure is too general (no details) and does not seem to be mature enough (no KPI) for inclusion in this year's ERP.

**Measure 8: Supporting the cooperation between SMEs or SMEs and large enterprises**

Better incorporating of SMEs into the value chain of large enterprises is relevant. The lack of exchange of knowledge and experience between SMEs, and between SMEs and large enterprises, has been presented for the first time as a constraint on growth. More detailed explanation on the cooperation support program is required to allow the credibility and the effectiveness of this measure to be assessed. The number of targeted enterprises is small compared to the total SME population.

**Measure 9: Establishment of SME guidance and counselling System**

Improving the operations and management of SMEs (especially middle-sized ones) has been identified as an important factor for their ability to remain competitive and to grow. As such, the proposed measure is relevant and credible. More detailed explanation is needed to allow the effectiveness of this measure to be assessed. The number of targeted enterprises is small compared to the total SME population.

**Measure 10: Increasing private sector investment by carrying out more effective support and promotion activities**

Investment promotion is not regarded as structural reform within the scope of the ERP. Government efforts to increase investment needs to be evaluated, including from a State aid perspective (because substantially fewer companies are being selected, which means that each is being awarded a proportionally higher amount of incentive, compared with previous years).

**Measure 11: Increasing the number and efficiency of business development, incubation and accelerator centers in order to support innovative entrepreneurship**

Several years ago, EU funds were used to establish enterprise development (ISGEM) centres in less-developed regions of Turkey to support local economic development. These centres are considered to be successful tools for boosting local economic potential, although their sustainability is yet to be assessed. The planned measure will further expand the number of centres and complements a planned measure under the competitiveness and innovation sector operational programme (CISOP), which is co-financed by the EU.

The suggested support to innovative enterprises will help reduce regional disparities and long-term growth and is considered feasible and credible provided that it ensures complementarity with other measures in the area of innovative entrepreneurship.

**Measure 12: Enhancing the R&D and innovation activities of SMEs**

The measure refers only to one activity, the "SME technological investment support programme" that was designed and launched by KOSGEB. However, the measure overlooks, and does not make explicit the link to relevant ongoing programmes, such as the tech-invest programme and industrial innovation networks mechanism from TUBITAK.

Although it is relevant and in line with the existing strategies, the measure is not based on a coherent approach (it takes into account one action only) and overlooks the parallel public support mechanisms. This may limit the overall impact of these mechanisms and result in duplication of some activities.

#### **Measure 13: Supporting competent research infrastructures on a performance basis within the new legal framework**

The measure refers to Law No. 6550 on Supporting Research Infrastructures. However, activities are outlined in terms of the expected results (e.g. plans to introduce four new research infrastructures), instead of setting out well-defined activities to be put in place to implement the law. A good example of well-defined activities is the “high technology support program 1004” that was initiated by TÜBİTAK for the production of high technology products through national capabilities. The program aims to provide up to TL 50 million to each of ten High Technology Platforms to be selected.

The measure is in line with the strategies and has already provided some results such as the selection of four research infrastructures. However, related activities should be better explained to enable an assessment of long term feasibility and credibility.

#### **Measure 14: Update of Turkey-EU Customs Union**

The ERP document presents again the prospective modernisation of the Customs Union as a trade related ‘reform’ measure. It has been repeatedly underlined by the Commission that it could, at best, be a trade policy objective.

Like last year’s ERP, this year’s ERP does not provide an account of the structural problems that inhibit Turkey’s closer integration into global value chains or that reduce its external competitiveness, nor does it present any autonomous measures that Turkey could take to address them. Instead, it refers to a few problems that can arguably be accounted for by Turkey’s underutilisation of the benefits of the Customs Union.

#### **Measure 15: Dissemination of pre-school education**

The measure is an important priority for the education system and for improving pre-school education coverage. Pre-school education for five-year-olds has been increasing steadily in recent years. It is expected that pre-school education will be compulsory in all provinces starting from the 2020-2021 school year. The proposed measure and its four sub-measures aim to put in place the necessary investments in infrastructure, equipment and support staff to ensure that hard-to-reach children are able to attend pre-school education.

#### **Measure 16: Increasing the 'reading culture'**

Boosting the habit of reading among pupils at an early age is important for their social and cultural development. There are plans to increase the number of schools with a 'Z-library'. Steps will be taken to achieve the average reading skills reflected in PISA testing, and school communities will be given information about the reading measure. There are plans to develop collaboration with teachers and joint teaching activities. The proposed activities are relevant, but they need to be closely monitored and supplemented with guidance for teachers.

#### **Measure 17: Updating curricula and strengthening education**

This measure plans to update the curricula by identifying student skills and needs by school and programme type, to improve the quality of education. The proposed activities are suitable for primary and lower secondary schools. For secondary schools, however (including general secondary, vocational secondary and private secondary schools), there are other important priorities. A modular credit system based on learning outcomes is needed in order to create coherence between non-formal and formal training institutions (secondary schools) from a lifelong learning perspective. The proposed activities, especially for VET secondary schools, need to include the development of such modules. Pilot

implementation of the credited modular passing system needs to be implemented, replacing the existing class passing system.

**Measure 18: Redirection of people on social assistance into active employment programmes in order to increase their productivity and find sustainable employment**

This measure, designed to enhance the link between social assistance and active labour market programmes, is relevant for inclusive growth, as it increases the qualified labour supply and helps reduce dependence on the social assistance system. The planned activities are very specific. However, the indicator for the number of referred and employed people formerly on social assistance (130 000 and 20 000, respectively, for 2019) seems extremely ambitious when compared with last year's outcome. There is no focus on a tailor-made approach to the design and effective delivery of active labour measures for this group. The design of a measure which creates employment incentives only by reducing the burden on employers seems questionable in terms of effectiveness and sustainability. This measure would have benefited from gender mainstreaming elements.

**Measure 19: Job clubs**

The measure concerns the establishment of 49 new job clubs, and is a way of increasing the employability of disadvantaged persons. The planned activities, focusing on establishment of new job clubs and training job and career counsellors, appear credible. However, there may be a need to focus on boosting awareness of the job clubs, to avoid lack of uptake. It is important to establish a system to monitor and assess the impact of the clubs. In terms of gender equality, there is a focus on bringing women into the clubs. An impact assessment should also consider how effective this measure is in terms of gender equality. The cost of the measure is provided indicatively, yet the budgetary source is not mentioned.

**Measure 20: Social assistance plus (+)**

The measure is designed to increase the social protection of poor people while establishing a link between social assistance and social protection services. As an ongoing measure, however, it showed limited progress in 2018. The planned activities for 3 years do not include concrete steps to support ASDEP (the family social support programme) in the Social Assistance Plus (+) approach, such as increasing the number of ASDEP staff and improving ASDEP staff capacity in order to ensure links between ASDEP, social assistance programmes, the labour market and social protection services in specific ways. Moreover, the resources allocated and the set indicators do not give the impression that this measure will contribute significantly to ensuring that there is inclusive social protection which will decrease social exclusion and poverty within 3 years. This measure would have benefited from better employment and gender links.

**ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM ERP 2018-2020**

The ERP 2019-2021 submitted by Turkey did not include any reporting on the implementation of the structural reform measures of the ERP 2018-2020.

## ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The 2019-2021 Economic Reform Programme was sent informally to the Commission on 11 February 2019 and was formally submitted on 26 February 2019, with almost one month's delay. Overall, adherence to the Commission Guidance Note has improved.

### *Inter-ministerial coordination*

Following the transition to the new presidential system, the central coordination of the ERP was given this year to the newly established Presidency's Strategy and Budget Directorate. However, the work was carried out by the same team as last year, just inside a new structure. This year, each line ministry designated a coordinator for the ERP. The line ministries and institutions involved in the ERP process had approximately one month to provide inputs to the ERP coordinator. Afterwards, the ERP coordinator, when deemed necessary, got in touch with the different line ministries and relevant institutions to request additional inputs.

### *Stakeholder consultation*

According to the Government, the social partners were involved in the preparation of the ERP document, although it is not clear how. Business associations and civil society were not consulted. No comprehensive consultation of external stakeholders was done and no draft was made available to the public before the adoption of the programme.

### *Macroeconomic framework*

The set-up of the chapter on the macroeconomic framework broadly follows the outline given in the guidance note. It covers nearly all the main elements. Some rebalancing between the section on recent economic developments and the sections on the medium-term scenario and, in particular, on alternative scenarios and risks would be welcome. The guidance note suggests that the first section should be very brief (it is 11 pages in the 2018 ERP) whereas the section "main risks in projections" is less than one page. The medium-term scenario does not explain differences with the Commission's services forecast. Nor is it fully clear how the IMF World Economic Outlook of October 2017 and its update of January 2018 are integrated into the forecast (second and third footnote of table 6 of the Annex).

### *Fiscal framework*

The set-up of the chapter on the fiscal framework closely follows the outline given by the guidance note. It covers all of the main elements and gives significant detail on some elements which helps assessing the state of the Turkish public finances and its medium-term scenario. This year, a more elaborate analysis of debt sustainability is added which is welcome. Still, how the 2018 budget fits into the medium-term fiscal scenario is unclear. The section on contingent liabilities covers only Treasury-related contingent liabilities and excluded contingent liabilities of line ministries and state-owned financial institutions (including the KGF credit guarantee fund and the Turkish Wealth Fund).

### *Structural reforms*

The structural reform priorities section improved this year. Reform measures are better specified than last year, although the quality of these measures in terms of description, timeline, estimated impact and risks could be improved. Further improvement of the key performance indicators is also needed. The number of reforms is limited to 20, but the page limit of 40 is not respected. Section 5 on budgetary implications of structural reforms is again completely missing, as is Table 9 on selected employment and social indicators. Table 11 on the reporting on the implementation of the structural reform measures of the 2018-2020 ERP is not complete and contains only very few activities.

## 6. BOSNIA AND HERZEGOVINA

### 6.1. EXECUTIVE SUMMARY

**Economic activity is forecast to gain some momentum, with output growth accelerating rather modestly** from 3.3 % in 2018 to 3.8 % in 2021. The main drivers of this are an inventory build-up and increased private consumption, thanks to rising employment and low inflation. Investment is forecast to increase after a weak performance in recent years. Overall, the ERP's baseline projection reflects the lack of government policies to lift the country's growth potential through stronger public and private investment. Key downside risks are a sharper-than-expected deterioration in the external environment, and a continuation in delays to implement reform measures. Upside risks in the form of stronger growth could materialise if the new government embarks on a more growth-supportive policy path, driven also by reforms related to the EU-accession process.

**The fiscal framework forecasts increasing budgetary surpluses, based on significant expenditure-driven consolidation.** Like in previous programmes, both revenues and expenditure are scheduled to fall substantially as a share of GDP. The already-low share of public investment is set to fall from its 2018 level. This is not in line with the country's needs. The programme lacks a convincing approach to improve the quality of public spending, such as by allocating more resources to investment and education; tackling an oversized public sector; reforming state-owned enterprises (SOEs); or better targeting social transfers. Driven by fiscal surpluses and solid nominal output growth, public debt is forecast to fall from 33 % of GDP in 2018 to below 30 % in 2021.

The main challenges include the following:

- **Fiscal policy does not devote sufficient attention to improving the quality of public spending.** Public spending remains heavily biased towards public sector employment and redistribution through cash transfers, clearly neglecting medium-term needs in the areas of education and infrastructure.
- **The quality of short and medium-term fiscal planning still suffers from a weak statistical underpinning and a short-term orientation of policy making.** Limited administrative capacities and frequent political stalemates remain key constraints. Necessary reforms are often delayed by fragmented responsibilities and insufficient cooperation among the various stakeholders.
- **Bosnia and Herzegovina's competitiveness continues to be hampered by a multi-layered public administration and a fragmented economic space.** This is detrimental to the business environment. The fragmented administrative structure in Bosnia and Herzegovina puts an added burden on businesses through excessive regulation, taxes and local fees. Starting a business remains cumbersome. Country-wide strategies and solutions to help businesses are long overdue. This includes quality infrastructure; reforming public financial management; e-authentication; reducing para-fiscal fees; reforming insolvency procedures; policies for small and medium enterprises (SMEs) and reforming the construction permits process.
- **Oversized, non-transparent and inefficient state-owned enterprises (SOEs), have been running up considerable arrears in payments.** This leaves little room to increase growth-friendly public investment. The SOEs' lack of efficiency means that significant state support is required for their survival. This causes great distortions and misallocation of production factors (labour, capital, land), and deters the private sector from investing.
- **Bosnia and Herzegovina suffers from very low labour force participation and high levels of unemployment.** Young people and skilled workers emigrate in large numbers. The level of informal employment is high. There is a high tax wedge on labour, particularly for low-wage earners, and other



disincentives to formal work. Multi-layered social protection schemes are insufficiently targeted at those most in need; they are therefore ineffective in reducing poverty. Enrolment in pre-school education is particularly low, contributing to a lower employment rate of women. The education system is also not attuned to the needs of the labour market.

**The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2018 has been implemented to a limited extent.** Election related political gridlock for most of the year delayed further progress with necessary reforms. Limited progress has been achieved in improving the country's capacities for medium term fiscal planning and analysis. Also, progress has remained limited in providing timely and reliable statistics. An energy framework strategy was adopted. However, there is still no legal framework in place that complies with the Energy Community Treaty. Some efforts were made to simplify business registration procedures through one-stop-shops and online registration. Mandatory electronic submission of VAT declaration was introduced on 1 January 2019. However, the Law on electronic signatures has not yet been fully implemented. No countrywide action has been taken with regard to reducing the tax wedge and disincentives to work. There was no real progress on better coordination between employment activation measures and social benefit schemes. No steps were taken to review enrolment policies in secondary and higher education.

**The ERP identifies reform challenges that are partly in line with those identified by the Commission.** Macroeconomic projections are largely plausible, with key assumptions strongly depending on the swift implementation of structural reforms. The fiscal framework is failing to shift towards a spending structure that does more to promote growth. The measures in the area of employment and social policies are relevant for addressing structural bottlenecks. However, there are many risks, including weak capacities and lack of priorities in practice, which put uncertainty on their effective implementation. More efforts should be placed on pre-school and higher education. More specific references should have been made to identify the fragmented and overly complex and non-harmonised regulatory environment as a significant obstacle to competitiveness and inclusive growth. Most measures presented in the ERP are not country-wide and only include entity-specific activities. Adopting a whole-of-government approach is a pre-requisite for addressing the challenges the country faces. Bosnia and Herzegovina should put in place a well-functioning coordination and consultation mechanism for the ERP process.

## 6.2. ECONOMIC OUTLOOK AND RISKS

**The ERP forecasts a moderate acceleration of output growth in the coming years, relying largely on strong private consumption, a build-up of inventory, and a slight improvement in investment.** The programme expects output growth to accelerate from 3.5 % in 2019 to 3.8 % in 2021. The main sources of growth are expected to be private consumption (benefiting from strong employment growth and low inflation), investment (reflecting an improved business environment), and a build-up of inventory. The expected annual increase in private consumption of 1.8 % is slightly above the country's five-year average, but this forecast is well supported by the expected increase in real disposable income. Private investment is expected to increase by 6.7 % per year on average, which is above the country's recent performance, but in line with the assumption of an improving business environment. However, during the programme period investment growth is projected to decelerate slightly, a projection that merited a more detailed explanation. Public consumption is expected to increase by some 0.2 % per year, reflecting commitments to contain public-sector wage spending. Inventories are forecast to increase, contributing nearly ½ percentage point to growth on average. This might reflect expectations of strengthening demand, but would have deserved a more detailed explanation in the text. Export growth is expected to decelerate somewhat, from 7.0 % in 2019 to 6.1 % in 2021, due to the expected slowdown in the main trade partners, in the EU, but also in non-EU countries, such as Turkey. With respect to imports, the programme forecasts a slight deceleration, which seems at odds with the faster pace of domestic demand and is not sufficiently explained in the programme. Economic output is expected to remain largely at its potential level throughout the programme, with a positive output gap of 0.3 % of GDP emerging in 2021.

*Table II.6.1:*

### **Bosnia and Herzegovina - Macroeconomic developments**

	2017	2018	2019	2020	2021
<b>Real GDP (% change)</b>	<b>3.4</b>	<b>3.3</b>	<b>3.5</b>	<b>3.7</b>	<b>3.8</b>
<i>Contributions:</i>					
- <b>Final domestic demand</b>	<b>2.3</b>	<b>3.5</b>	<b>2.7</b>	<b>2.6</b>	<b>2.7</b>
- <b>Change in inventories</b>	<b>0.8</b>	<b>-0.1</b>	<b>0.2</b>	<b>0.4</b>	<b>0.6</b>
- <b>External balance of goods and services</b>	<b>0.3</b>	<b>-0.1</b>	<b>0.6</b>	<b>0.7</b>	<b>0.5</b>
<b>Employment (% change)</b>	<b>1.8</b>	<b>0.8</b>	<b>2.5</b>	<b>2.6</b>	<b>2.5</b>
<b>Unemployment rate (%)</b>	<b>20.5</b>	<b>18.4</b>	<b>17.4</b>	<b>16.4</b>	<b>15.5</b>
<b>GDP deflator (% change)</b>	<b>0.7</b>	<b>1.3</b>	<b>1.1</b>	<b>1.1</b>	<b>1.5</b>
<b>CPI inflation (%)</b>	<b>1.3</b>	<b>1.3</b>	<b>1.2</b>	<b>1.4</b>	<b>1.5</b>
<b>Current account balance (% of GDP)</b>	<b>-5.0</b>	<b>-5.0</b>	<b>-4.8</b>	<b>-4.6</b>	<b>-4.4</b>
<b>General government balance (% of GDP)</b>	<b>0.9</b>	<b>-0.7</b>	<b>0.0</b>	<b>0.4</b>	<b>0.8</b>
<b>Government gross debt (% of GDP)</b>	<b>33.9</b>	<b>32.9</b>	<b>32.1</b>	<b>31.1</b>	<b>28.9</b>

*Sources: Economic Reform Programme (ERP) 2019.*

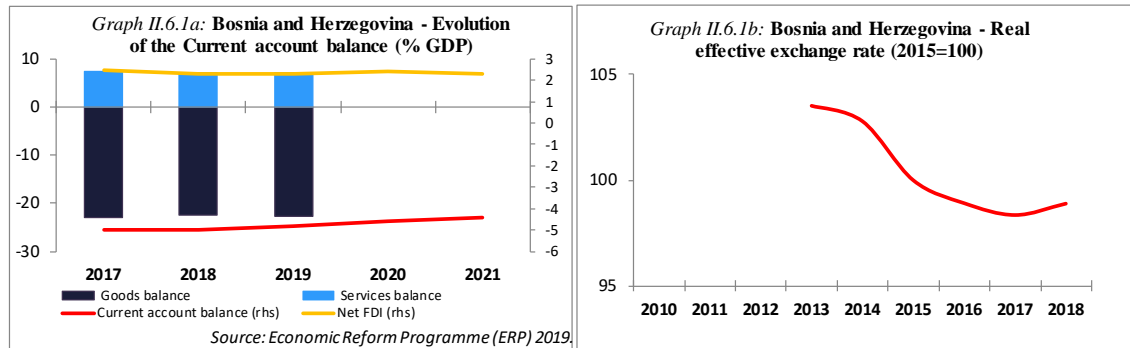
**The programme contains an alternative scenario, which expects a potential external shock to strongly affect output growth.** This scenario assumes lower export growth (1 pp. lower in 2019-2020 and 0.4 pps lower in 2021) as well as a decline (of unspecified magnitude) in foreign transfers. As a result, private consumption growth, the most affected domestic demand component, will be 0.2 pps lower than the baseline in 2019, and 0.5 pps lower than the baseline in 2021. Investment and imports are also expected to be negatively affected in this scenario, primarily in the first year. The overall effect in 2019-2021 is to reduce GDP growth by about 0.5 pps compared to the baseline scenario. This may appear quite a significant reduction, but it might be explained by the limited response of imports. If there was a larger import reaction, the negative impact on growth might be about half of the programme's calculations. The

ERP does not assess domestic risks, such as lower private consumption and investment due to protracted political tensions, or lower employment growth due to continued emigration.

**The programme’s baseline macroeconomic scenario is plausible.** This outlook is in line with the absence of a growth-supporting economic policy, and could change for the better or for the worse. For example, if there was a marked deterioration in the country’s export performance, a continued political stalemate, or a significant slowdown in workers’ remittances, output growth could be significantly lower. However, if the incoming government supported a more active, growth-supporting economic policy, output growth could also be markedly higher.

**Inflation is forecast to remain under control.** The ERP does not forecast significant domestic price pressures. This means that, in combination with expected low increases in international prices, there would be rather low increases in headline inflation of between 1.2 % and 1.5 % per year. High unemployment and moderate growth expectations are likely to contain domestic price pressures. However, if skilled workers continue to emigrate, skills shortages could become worse. This could lead to rising wage costs, which would erode the country’s competitiveness and trigger domestic price pressures.

**The external position and its financing are expected to improve.** The current account deficit is expected to narrow slightly, from 4.8 % of GDP in 2019 to 4.4 % of GDP in 2021. This improvement is not in line with the assumption of accelerating domestic demand, and is largely explained by special factors, such as forecasts for stronger exports of electricity and services (in particular tourism). A key contribution to the financing of the current account deficit is expected to come from foreign direct investment (FDI). This FDI will come from planned projects in tourism and energy production, and planned privatisation projects (such as a possible sale of two telecoms companies). This stronger inflow of FDI would be a welcome change from previous years.



**The country’s financial sector has strengthened, benefiting from a significant inflow of foreign exchange in the form of workers’ remittances.** This inflow supported a strong increase in deposits in 2017 and 2018, which helped to improve the loan-to-deposit ratio in the country’s banks. The banking sector’s soundness indicators continued to improve, while the percentage of non-performing loans (NPLs) fell below 10 % at the end of 2018. Furthermore, the liquidity position of the financial sector also improved, while the ratio of foreign denominated loans to total loans declined. The decline in this ratio will reduce exchange rate-related risks. Although the financial sector as a whole appears solid, some smaller banks are still struggling with high NPL ratios and an insufficient capital endowment. Credit provision to households and enterprises has improved in recent years, reflecting both the favourable international environment, and the sector’s increased liquidity due to strong inflows of capital transfers. This inflow also boosted the country’s stock of foreign exchange reserves. However, small and micro-sized enterprises still face difficulties in accessing credit.

Table II.6.2:

**Bosnia and Herzegovina - Financial sector indicators**

	2014	2015	2016	2017	2018
<b>Total assets of the banking system (EUR million)</b>	12 299	12 756	13 615	14 639	15 200
<b>Foreign ownership of banking system (%)</b>	81.2	82.2	83.5	84.9	86.0
<b>Credit growth</b>	3.7	1.8	2.1	5.3	6.6
<b>Deposit growth</b>	8.4	6.2	7.7	10.4	11.3
<b>Loan-to-deposit ratio</b>	1.1	1.0	1.0	1.0	0.9
<b>Financial soundness indicators</b>					
- non-performing loans	15.4	14.1	12.8	11.3	9.6*
- net capital to risk-weighted assets	17.0	15.9	15.7	15.7	15.5*
- liquid assets to total assets	26.2	25.9	26.3	27.6	29.8*
- return on equity	5.4	2.0	7.3	10.2	11.1*
- forex loans to total loans (%)	68.0	67.1	62.6	60.1	57.7*

\* Q3

Sources: National Central Bank, Macrobond, IMF.

**6.3. PUBLIC FINANCE**

**As in previous years, the programme lacks consistent and sufficiently detailed country-wide data on the country's actual fiscal performance in 2018 and on the 2019 budgets.** The document presents a medium-term fiscal projection for 2019-2021. For 2019, the programme expects a balanced budget, after the deficit of 0.7 % in 2018. This balanced budget will be the result of a 2.4 % reduction in nominal spending combined with a slight decline in revenues of just 0.7 %. Data on the fiscal performance in 2018 are neither complete, nor aggregated at country level. Unfortunately, information on the budgets for 2019 for the general government, but also for the entities, is either lacking or incomplete. To some extent, this reflects the fact that the adoption of the 2019 budgets had not yet been completed when the programme was being drawn up.

Table II.6.3:

**Bosnia and Herzegovina - Composition of the budgetary adjustment (% of GDP)**

	2017	2018	2019	2020	2021	Change: 2018-21
<b>Revenues</b>	37.8	39.2	37.3	36.0	34.9	-4.3
- Taxes and social security contributions	30.2	30.2	29.6	29.0	28.2	-2.0
- Other (residual)	7.6	9.1	7.6	7.0	6.7	-2.3
<b>Expenditure</b>	36.8	40.0	37.3	35.7	34.1	-5.8
- Primary expenditure	36.0	39.1	36.5	34.8	33.3	-5.8
<i>of which:</i>						
Gross fixed capital formation	1.8	4.2	2.8	2.1	2.0	-2.2
Consumption	16.6	17.5	16.6	15.9	15.2	-2.4
Transfers & subsidies	16.1	16.4	15.9	15.3	14.7	-1.7
Other (residual)	1.5	1.0	1.0	1.5	1.5	0.4
- Interest payments	0.8	0.9	0.8	0.9	0.8	0.0
<b>Budget balance</b>	0.9	-0.7	0.0	0.4	0.8	1.5
- Cyclically adjusted	0.8	-0.7	0.0	0.4	0.7	n.a.
<b>Primary balance</b>	1.8	0.1	0.8	1.2	1.6	1.5
- Cyclically adjusted	0.0	-1.6	-0.8	-0.5	-0.1	1.5
<b>Gross debt level</b>	33.9	32.9	32.1	31.1	28.9	-4.0

Sources: Economic Reform Programme (ERP) 2019.

The fiscal framework forecasts an increase in budget surpluses and a marked decline in expenditure and revenue ratios over the programme period. Such a decline would be unprecedented in the country's recent history. The fiscal balance is forecast to turn from a deficit of 0.7 % of GDP in 2018 to a surplus of 0.8 % of GDP in 2021. The switch to a surplus over the programme period is the result of: (i) a decline in the overall level of nominal spending by 0.5 % on average over the period; and (ii) an average increase in revenue of 0.9 % in nominal terms during the programme period. This increase in total revenue is relatively small, compared to an expected rise in nominal GDP of 4.9 % during the same period. This may reflect intentions to lower the tax burden on labour and to reduce direct taxes. However, the fiscal implications of tax reforms are not sufficiently addressed in the ERP. The significant drop in the revenue-to-GDP ratio of 4.3 pps over 2019-2021 is an important feature of the programme, although how this drop will be achieved is not properly discussed. On the spending side, freezing expenditure in some areas and cutting it in others will lead to a decline in the spending-to-GDP ratio of 5.8 pps.

On the structurally adjusted fiscal balance, the authorities expect the economy to register a small negative output gap in 2019 (-0.06 % of GDP). However, this gap will turn positive in 2021, reaching 0.33 % of GDP. The cyclically adjusted fiscal surplus will be slightly higher in 2021 (at 0.7 % of GDP compared to 0.4 % of GDP in 2018). Overall, the fiscal surpluses will dampen growth during the programme period, although this is in line with the programme's expectations for above-potential growth in 2021.

The ERP does not contain sufficient plans to improve the spending structure, and the fiscal programme lacks a pro-growth orientation. Spending on public consumption is projected to drop slightly in nominal terms in 2019 and 2020; it will return to 2018's nominal levels by 2021. Public investment is forecast to drop by half in nominal terms over the programme period, leading to a 2.2 pps reduction in GDP by 2021 compared to 2018. This planned reduction in investment is not in line with the Policy Guidance jointly adopted in the last 2 years. It is also in contrast to the projections in the macroeconomic part of the ERP, where public investment is forecast to increase. Spending on social

transfers are forecast to increase by 1.5 % on average. Because of stronger nominal GDP growth, this increase would actually lead to a 1.4 pps drop in spending on social transfers as a share of GDP. The planned fiscal adjustment is frontloaded, with about half of the adjustment taking place in 2019. However, the largest contribution to this adjustment comes from a drop in public investment. Overall, as in previous years, the policy orientation of the medium-term fiscal framework does not comprehensively address the country's main policy challenges. These challenges include improving education and upgrading the country's infrastructure and capital endowment.

**The quality of public finance and budget planning remains weak.** The programme refers to the importance of improving the quality of public finance management, but fails to elaborate concrete reform projects and their expected fiscal impact. More information would have been welcome, particularly elaborating on challenges such as the need to reform the often overstuffed public sector, where planned registers of public employment appear to be still not completed and where there seems to be no medium-term strategy on how to address this issue. Another area, which would have deserved a more elaborated discussion, is the overdue restructuring of state owned enterprises and its fiscal impact. Finally, more details could have been provided on plans how to improve the needs-based targeting of social spending, which appear to suffer from substantial inefficiencies. Compared to the previous programme, the revenue estimates are more elaborated. Medium-term budget planning remains weak and is impeded by fragmented responsibilities and insufficient cooperation across the country's entities.

#### Box II.6.1: Debt dynamics

**Table : Bosnia and Herzegovina**

**Composition of changes in the debt ratio (% of GDP)**

	2017	2018	2019	2020	2021
<b>Gross debt ratio [1]</b>	<b>33.9</b>	<b>32.9</b>	<b>32.1</b>	<b>31.1</b>	<b>28.9</b>
Change in the ratio	-5.1	-1.0	-0.8	-1.0	-2.2
<i>Contributions [2]:</i>					
<b>1. Primary balance</b>	<b>-1.7</b>	<b>-0.1</b>	<b>-0.8</b>	<b>-1.2</b>	<b>-1.6</b>
<b>2. "Snowball" effect</b>	<b>-0.8</b>	<b>-0.7</b>	<b>-0.6</b>	<b>-0.6</b>	<b>-0.8</b>
<i>Of which:</i>					
Interest expenditure	0.8	0.9	0.8	0.9	0.8
Growth effect	-1.3	-1.1	-1.1	-1.1	-1.1
Inflation effect	-0.3	-0.4	-0.3	-0.4	-0.5
<b>3. Stock-flow adjustment</b>	<b>-2.6</b>	<b>-0.2</b>	<b>0.6</b>	<b>0.9</b>	<b>0.2</b>

[1] End of period.

[2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).

The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other effects.

Source: Economic Reform Programme (ERP) 2019, ECFIN calculations.

The programme forecasts an accelerated reduction in the debt-to-GDP ratio. The key drivers of this reduction are expected to be primary surpluses and nominal growth. This will be offset to some extent by the costs of debt servicing, which increase the debt level by slightly less than 1 pp. of GDP per year. Moreover, a breakdown of the debt dynamics into various components points to an additional factor that increases debt. This factor is presented in the table as the 'stock-flow adjustment'. The 'stock-flow adjustment' raises the debt-to-GDP ratio by 0.6 % pps in 2019 and by 0.9 % pps GDP in 2020. Unfortunately, the programme does not provide

more details on the underlying assumptions behind this forecast debt profile. The data presented on debt is slightly different to the data provided by the central bank.

**Public debt declined to less than 33 % of GDP in 2018, and is set to decline further, mainly driven by sizeable primary surpluses and growth in output.** Public debt doubled after the 2008 financial crisis, reaching its peak in 2015 at about 42 % of GDP. By 2018, public debt had declined to some 33 % of GDP, mainly thanks to solid growth in nominal GDP and fiscal surpluses. Difficulties in accessing international financial markets, and the shallowness of the domestic financial market, mean that

international financial institutions such as the World Bank, the European Investment Bank and the IMF are still key sources for financing. It is largely thanks to this financing structure that the average implicit interest rate has remained low at some 2%. This rate is projected to rise to nearly 3% by 2021. Despite this expected increase, the costs of debt servicing are likely to remain relatively low, at slightly less than 1% of GDP. Unless there are significant changes in the international economy, this outlook of slightly increasing financing costs is plausible and consistent with previous programmes. There is a significant difference in the indebtedness of the country's two entities, with the Republika Srpska entity facing a significantly higher level of public indebtedness.

**The main risk to the fiscal surplus targets for 2020 and 2021 is a possible slippage in planned spending constraints.** The intended reduction in spending as a share of GDP appears quite ambitious. Unfortunately, the programme does not provide sufficient details on how those spending constraints will actually be implemented. On the revenue side, the programme assumptions are more conservative when compared to previous ERPs, but they also lack concrete details. A significant risk are substantial unrecorded fiscal imbalances, such as payment arrears, impeding the viability of private suppliers or negatively affecting the financial situation of social-security providers. A closure of unviable SOEs could also have significant budgetary implications. There are contingent liabilities in the form of guarantees for chronically non-viable SOEs, such as the railway company in the Federation, which by 2021 are expected to amount to some 3% of GDP. The planned loan guarantee for the construction of coal-power plant could raise contingent liabilities by another 4 pps of GDP. Overall, the country's fiscal system is plagued by poor transparency and weak reporting standards. This greatly reduces the reliability of risk assessments based on officially recorded data. The achievement of the presented fiscal-surplus target is dependent on planned spending constraints, although the low revenue estimates provide a certain buffer against the non-achievement of savings targets.

**The overall quality of public finances remains low.** Comparing the planned spending structure for 2019-2021 with the 2018 budget points to a significant cut in overall spending. This cut in spending will affect not only general public services and social protection, but also health and education. 2018 was an election year, and spending plans for that year may therefore have been driven by short-term-oriented priorities. However, even taking this into account, the data for the whole programme period shows insufficient focus on the type of public spending that stimulates growth. It is true that the ERP contains some efforts to reduce activity in the informal economy. The programme also presents plans to decrease social-security contributions in order to reduce the disincentive to register in the formal sector. However, there seem to be no concrete plans to address inefficiencies in the social-security sector, such as the poor targeting of social transfers. It is critically important to address these inefficiencies to compensate for the lower revenues caused by reduced rates. More information would have been welcome on challenges such as the need to reform the often-overstaffed public sector. This challenge has not yet been fully addressed — planned registers of public employment appear still not to be completed, and there is no medium-term strategy to address this issue. A significant issue is the broad use of para-fiscal fees, such as excise taxes, at municipal and cantonal level: this practice impedes the establishment of new companies, and thus has strong negative implications for the country's business environment.

#### Box II.6.2: Sensitivity analysis

The programme presents a sensitivity analysis of possible effects of the alternative, lower-growth scenario on tax revenues. The alternative scenario analyses the economic effects of export growth being 1 pp. lower, and arrives at rather moderate results. These moderate results are based on the assumption that the impact on domestic demand (private consumption and investment) would remain very limited. Based on this scenario, the programme also finds only limited negative effects on tax revenues, amounting to slightly less than 0.2 pps of GDP at the end of the programme period. This is not surprising, given the limited direct effects of exports on indirect taxes and the assumed low sensitivity of imports to reduced exports. It might have been more interesting to look at shocks with a more significant effect on revenues, such as the effects of a reduction in social-security contributions on the financial situation of the social-security system.

**The country's budgetary framework suffers from institutional fragmentation, low reporting discipline and a lack of cooperation among the various budget users.** Alignment with EU reporting standards and budgetary frameworks is still very limited. So far, only the Republika Srpska entity has adopted fiscal rules, and there is no independent fiscal council to monitor countrywide fiscal performance. The effectiveness of the medium-term fiscal framework is also very limited. In addition, the use of independent, unbiased forecasts for budget planning is still in its early stages. Finally, the availability and quality of fiscal data suffers from poor reporting standards, a lack of cooperation among the various budget users, and political resistance that impedes alignment with the standards of the European System of National Accounts (ESA). Due to these deficiencies, there could be a significant degree of fiscal underreporting. The programme refers to the importance of improving public financial management, but fails to initiate concrete reform projects and evaluate their expected fiscal impact.

#### 6.4. STRUCTURAL CHALLENGES AND REFORM PRIORITIES

**Bosnia and Herzegovina's economy is developing at a rate that is below its potential and sustained reform measures are necessary to significantly improve the living standards of its people.** The Commission has conducted an independent analysis of the economy to identify the key structural challenges to boost competitiveness and inclusive growth, drawing from Bosnia and Herzegovina's own ERP, but also using other sources. The economy's development is impeded by several structural weaknesses, leading to an underutilisation of the country's economic potential. High structural unemployment is a clear indication of those weaknesses, and is not only a result of an insufficient function of the country's education system, but also points to a poor business environment as a result of a weak rule of law and an inadequate legal framework, consisting of overly numerous and complex market entry and exit procedures, which are further aggravated by the country's institutional and economic fragmentation. The main challenges in terms of boosting competitiveness and long-term and inclusive growth are hence (i) improving labour market integration, (ii) enhancing the business environment through the creation of a single economic space, (iii) facilitation of starting a business and (iv) making the public sector more efficient, in particular improving the performance, transparency and accountability of SOEs.

##### 6.4.1. Key challenges

###### **Key challenge #1: Improving labour market transition**

**Nearly half of the working age population is inactive, pointing to an acute need to develop policies fostering transitions into the labour market and employment.** The labour force participation rate for 15-64 years old in Bosnia and Herzegovina is very low (54.2 % in 2018). It is 20 pps lower than the EU average and not showing any signs of improvement. Unemployment is very high (18.4 % in 2018) and



capacities of employment offices to provide quality services to jobseekers are weak. The scope and targeting of active labour market policies are also weak. Very high unemployment among young people aged 15-24 (38.8 % in 2018), including university graduates, points to a problem in aligning the education and training system with the needs of the labour market and a weak business environment still significantly under-developed to generate employment. Overall, much of the workforce lacks the necessary skills to find work. New opportunities for job creation are also scarce and localised, while labour mobility within the country is low. A significant number of jobseekers, including university graduates, were mediated into employment abroad. Even more people, often skilled and already in employment found jobs abroad on their own. There are also significant disincentives to work. One such disincentive is the relatively generous non-means tested social benefits, in particular for war veteran categories. Another disincentive to hiring or formal work is high social security contribution rates that create a high tax wedge on low-wage earners. The share of informal employment in total employment is significant (around 30 %). Enrolment in early childhood education and care is particularly low. In addition to the low availability of elderly care this contributes to low employment levels of women who predominantly assume the role of carer.

***Key challenge #2: Enhancing business environment through creation of a single economic space***

**The fragmented institutional set-up and the lack of proper cooperation and coordination among political stakeholders results in insufficient political ownership of reforms.** It also results in a low speed in overcoming the poor and fragmented business environment characterised by complicated and lengthy procedures and significant red tape. Institutional and government barriers are a significant obstacle to conducting business. The financial and administrative burden on business is significant, with high payroll taxes and over 1600 administrative procedures at all levels. Regulations differ between the two sub-state entities and the Brčko district. Moreover, within the Federation of Bosnia and Herzegovina, regulations and procedures vary from canton to canton. Even when the relevant regulations and procedures are very similar, there are significant differences in their implementation. The complex legal and regulatory frameworks create opportunities for corruption.

**Each governmental level (and within the Federation entity, each of the 10 cantons) has its own business laws, regulations and procedures.** Market entry and exit regulations are decided upon at the lower levels of government. This leads to a large number of different rules and implementation methods. Insolvency is regulated at the entity level and there is no country-wide framework for insolvency. Although a new bankruptcy law is already in place in the Republika Srpska entity, the adoption of a more modern bankruptcy law has been delayed in the Federation of Bosnia and Herzegovina. Overall, the required procedures for entering or leaving the product market are still numerous and lengthy, creating a significant impediment to market entry and exit.

**Furthermore, technical barriers to trade are still substantial.** There is no countrywide quality infrastructure system. There is also no unified approach for deciding what national infrastructure is necessary and then building it (OECD, 2019). There is a clear need to draw up a countrywide strategy on quality infrastructure and implement a mechanism to co-ordinate between different levels of government. EU legislation is currently not being transposed or implemented in a uniform manner throughout the country. This ultimately leads to an inadequate level of harmonisation with the EU *acquis* and to inadequate harmonisation between the entities. As a result, SMEs can have difficulties in exporting to the EU single market and can be forced to perform double registrations if placing their products in both entities. Given the limited resources of institutions in both entities, cooperation between them is important to further develop the quality infrastructure system and support SMEs in the country.

**E-authentication is critical for building trust in e-commerce and in government e-signature services. However, e-authentication still has not been introduced because of the varying legal frameworks across the different administrative levels.** Interoperability frameworks in IT systems allow different authentication schemes to interact and maintain high levels of trust. However, to have a

harmonised, countrywide system, the country needs to address the issue of non-harmonised laws on electronic signature and lack of interoperability of e-signature schemes at various levels of the country. Ensuring data inter-operability through e-authentication would enable an increase in the number of online services, such as tax payments, for enterprises. The lack of e-signature has far-reaching consequences. Bosnia and Herzegovina's Law on customs policy scheduled to take effect on 1 August 2019, cannot go ahead without it which would have a negative effect on (i) the submission, acceptance and proceeding of electronic transit declarations for the electronic transit procedure (NCTS), (ii) the Authorised Economic Operators scheme and (iii) electronic customs declarations for import and export customs procedures as regulated by the Law on customs policy. The lack of e-signature also prevents the issuing of qualified digital certificates to taxpayers, and hence e-services on taxation as per the Joint Conclusions adopted at the Economic and Financial dialogue on 25 May 2018.

**Businesses are subjected to numerous para-fiscal fees and charges emanating from overlapping administrations.** Para-fiscal fees and charges are levied by all three levels of government, creating a complex web of non-tax charges that facilitate corruption. The large number of local fees and charges are also considered a significant obstacle to businesses and local development. This makes it difficult to attract potential investors as the fees and charges increase the investor's cost of doing business in municipalities (NALAS, 2018). Registries of para-fiscal fees have been created at entity level and both entities have published lists of para-fiscal fees. The registries, which cover all levels of government, will help eliminate fees deemed harmful for the business environment, once relevant legislation has been adopted in both entities. The legislation will help ensure, as a first step, that no fees or charges can be levied unless they are part of the register. The legislation will also provide for the introduction of a methodology and proper procedure for the introduction of any new fees. At a later date, the country plans to gradually reduce para-fiscal fees and charges.

The lack of a unified country-wide approach to the planning and implementation of SME policy hinders the development of entrepreneurship and investments. Progress is lagging in the implementation of the Small Business Act. In all the 12 SME policy dimensions, the country scores lower than the regional average. There is very little evidence of effective co-ordination across different levels of administration in this area.

### ***Key challenge #3: Facilitation of starting a business***

**The business registration process is particularly troublesome, partly due to the separate laws and regulations that exist at different levels of government.** Businesses registered in one part of the country are not always automatically and unconditionally recognised in other parts, requiring a costly replication of registration procedures. In areas where the entities have no mutually harmonised legislation (e.g. chemicals, food supplements and cosmetics), SMEs are asked to formally register in both entities to be able to place their products on the market. SMEs in this situation are audited by market surveillance authorities in each of the entities. The World Bank's Doing Business Report (2018 edition), ranks the country 183<sup>rd</sup> (out of 190 countries) in the time it takes to start a business, as it takes 81 days and 13 procedures to start a business. The Global Competitiveness Report (2019 edition) gives a particularly low ranking for the country for the time it takes to start a business (134<sup>th</sup> out of 140). The overly complex business registration and licensing process is vulnerable to corruption, according to the U4 Anti-Corruption Resource Center (2018).

**Construction permits create a particular problem associated for new businesses.** The sub-national administration of business licences and permits is complex. By-laws governing licenses and permits are adopted at entity level. However, the application of these by-laws is the responsibility of municipalities, which also have the freedom to set corresponding fees. Obtaining construction permits (involving various public agencies) remains a significant obstacle to investment. A missing link in the complex chain of decision making can stall construction for a long period, and no agency has oversight or supervision of the entire process.

**Some reforms are being carried out, such as the establishment of one-stop-shops for company registration and an online business registration system.** Setting up a one-stop-shop (OSS) or 'single window' is a good practice to facilitate investment. They provide a single entry point where businesses can obtain information and undertake administrative procedures. They can significantly cut down investors' transaction costs. In Bosnia and Herzegovina, there is no such agency at the state level, but a single business registration agency began operations in the Republika Srpska entity in 2014 (OECD, 2018). As a next step, entities should ensure that business registration data in these entity registries are fully integrated into a centralised register. Ideally, all business licences and permits (as well as rulebooks for their implementation) should be harmonised across the country (UNCTAD, 2015).

***Key challenge #4: Making the public sector more efficient, in particular improving the performance, transparency and accountability of state owned enterprises (SOEs)***

**Country-wide public spending remains at a relatively high level, while the quality of provided services is low, in particular in the area of health, but also in education.** Payment arrears of the public sector are substantial, creating a burden for private companies. The public financial management (PFM) system is fragmented and is not in line with international standards, in particular the systems for budget formulation, budget execution, monitoring, transparency of budget data and forecasting. A country-wide programme to reform PFM has not yet been adopted. PFM reform strategies are in place at state level, in the Federation entity and in Brčko District, but not in the Republika Srpska entity. In the Republika Srpska entity, separate strategies for various aspects of PFM exist without clear consistency between them. The creation of a register of public sector employees has not yet been completed.

**SOEs are a particular problem as they form a large part of the country's economy, affecting macroeconomic performance, fiscal sustainability, labour market outcomes and competitiveness.** The SOE sector is characterised by weaknesses in transparency, accountability and performance. There is no single registry for SOEs, or at least not one that is updated regularly. Financial statements are incomplete and not easily available. No financial reports on the SOEs are submitted to the government. There is low managerial performance stemming from politically affiliated boards and executives lacking independence and appropriate professional background. Productivity is low within many large SOEs and many of them are not even profitable. Unlike its regional peers, many SOEs in Bosnia and Herzegovina are statutory corporations that are subject to preferential treatment deviating from ordinary corporate norms, i.e. they benefit from undue advantages compared to the private enterprises (OECD, 2018). SOEs and public enterprises dominate key sectors of the economy, including energy and telecommunications utilities (World Bank, 2018).

**Vested interests are largely responsible for the slow privatisation process.** The privatisation process is still not complete. Attempts to sell shares in public companies earmarked for sale have been largely unsuccessful. This is likely due to the influence of vested interests seeking to keep the status quo. There is a need to depoliticise the use of public resources and bring an end to political nepotism. There are no rules to ensure the presence of independent directors on the board of SOEs. In most cases, these boards are dominated either by civil servants or by people politically connected to the government. This leads to inefficiencies and conflict of interest. There is also a high degree of overemployment in public enterprises.

**SOEs are a significant burden on the public finances.** Some formerly successful SOEs have accrued significant arrears from unpaid health and pension contributions. Potential investors are required to assume these debts and maintain the existing workforce. These large payment arrears in SOEs impede the transparency of public sector accounting but are also a burden to private companies in the form of unpaid payment obligations. Various SOEs are loss making, requiring subsidies. Some of them no longer operate, but still maintain workers. The (fiscal) costs of this approach are substantial and divert productive resources away from more productive uses. SOEs are in a precarious financial situation.

According to IMF estimates, there are no SOEs in the Republika Srpska entity that are considered financially sound while in the Federation entity only 4 % of SOEs are considered to be financially sound.

**Overall, there are over 550 SOEs employing around 80,000 persons, or around 11 % of total employment. Together they are responsible for a third of outstanding tax arrears.** In 2017, the governments received €41 million in dividends from SOEs, but transferred EUR 109 million to them. Both revenues and losses are concentrated in a small number of public companies: around 95 % of dividends were paid by BH Telecom, Elektroprivreda BiH and RS Highways, while 20 companies are responsible for almost 90 % of arrears. The IMF estimates that SOEs are unlikely to reduce debt levels without government support. While the precise numbers has not yet been determined, consolidated debt is likely to be approximately 55-60 % of GDP. SOE total liabilities are around 26.4 % of GDP. The country will need to increase the transparency, fiscal sustainability and efficiency of SOEs, including through the adoption of OECD principles on corporate governance. A report comprising the commercial, financial and technical due diligence of BH Telecom and HT Eronet has provided the Government of the Federation entity in autumn 2018 with recommendations on possible scenarios for the future development of the telecom operators.

#### 6.4.2. Labour market, education and social policies

**The very low employment rate and the high unemployment rate are some of the many labour market challenges.** There has been no improvement in the activity rate of the 15-64 age group, which remains very low at 54.2 %. The recent increase in the employment rate (from 40.2 % in 2016 to 44 % in 2018) has been moderate compared to the stronger decline in the unemployment rate (from 25.4 % in 2016 to 18.4 % in 2018). Administrative data shows a similar trend: the increase in the number of employed between June 2017 and June 2018 was only half the decrease in the number of unemployed. While the underlying causes of this development are unclear, labour emigration may be one of them (see below). Almost 90 % of all unemployed are long-term unemployed and a large part of the working age population is inactive. There is a low internal labour mobility among the entities and cantons.

**Women and young people face particular challenges in employment.** The persistently high gender employment gap of over 20 pps has not improved in recent years, and is twice as high as the EU average. A particular obstacle to female employment is the low availability of childcare and elderly care. The youth (15-24) employment rate improved by 6 pps between 2016 and 2018, but is still extremely low at 19.7 % (2018), while the youth unemployment rate decreased substantially in the same period by 16.6 pps between 2016 and 2018 to 38.8 %. The share of young people not in employment, education or training dropped from 27 % in 2014 to 22.9 % in 2017, but remains very high. On the other hand, the gender employment gap for young people increased by 4 pps from 2016 to 13.5 pps (2018). More than half of the inactive population has at most primary level of educational attainment (52.6 %).

**Public employment services operate with low levels of funding and insufficient human resources.** The outreach and coverage of support services for jobseekers and the provision of active labour market programmes (ALMP) are limited. A large number of unemployed people do not actively search employment and are registered to receive free health insurance and other social benefits. The administration of these benefits limits the ability of public employment services to assist active jobseekers. Nevertheless, there has been some improvement in training on job mediation and advisory work of employment offices across the country. This has helped to improve service delivery, with a greater focus on work with clients. Expenditure on ALMP as a share of GDP almost doubled since 2013, but it still remains low (0.19 % of GDP in 2017). Many jobseekers, including university graduates, were mediated into employment abroad by the public employment services. However, an even higher number of people – often skilled and already in employment – found jobs abroad on their own initiative, contributing to high levels of labour force emigration.

**Around 20 % of workers are in vulnerable employment and about 30 % are in informal employment.** This concerns especially lower-skilled, young and older workers. Public sector employment (including state-owned enterprises) is more secure and generally better paid compared to the

private sector. Social contribution rates contribute to a high tax wedge for low-wage earners resulting in a disincentive on this category and their employers to formalise employment, confining them often to informal work. Some initial steps were taken to tackle this issue in 2018. The Republika Srpska entity adopted changes to labour and income tax legislation that reduced the tax burden on labour and increased worker's take-home pay, while the gross salary remained the same. In the Federation entity, legislative proposals were made to reduce the tax burden on low-wage earners and to reduce social contributions. However, non-means tested and relatively generous social benefits for war veteran categories might also stimulate labour market inactivity.

**Consultations with the social partners on the design and implementation of economic, employment and social policies have weakened.** In the Federation entity, the Economic and Social Council (ESC) has not convened for the last 18 months following a disagreement over the minimum wage. Important amendments to the labour law and the Law on pension and disability insurance were therefore not consulted on with the social partners. In some cantons, the ESC works well. In the Republika Srpska entity, the work of the ESC gained pace in 2018 compared to previous years. However, consultations in the ESC are limited to labour law and do not cover larger economic and social reforms. Overall in Bosnia and Herzegovina general collective agreements are not in place. The effectiveness of social dialogue has decreased and the labour dispute settlement mechanisms are pending reforms.

*Box II.6.3: Monitoring performance in light of the European Pillar of Social Rights*

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights on equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion to benefit citizens in the EU. Since the 20 principles are essential for countries if they are to achieve fair and well-functioning labour markets and welfare systems, they are equally relevant for candidate countries and potential candidates. The new reinforced social dimension for the Western Balkans includes an increased focus on employment and social reforms through greater monitoring of relevant policies (EC, 2018). The Western Balkans Ministers' Declaration on improving social policy in the Western Balkans (6 November 2018) confirms that they will use the Pillar to guide the aligning of their labour markets and welfare systems with the EU's.

**Bosnia and Herzegovina faces challenges in a number of indicators of the Social Scoreboard<sup>(1)</sup> supporting the European Pillar of Social Rights.** The employment rate remains very low, particularly for women and young people. Almost 90 % of unemployed people are long-term unemployed. The job generation is localised and the low mobility of workers limits the allocation of labour resources to emerging needs. The gender employment gap remains very high, at more than 20 pps for the population aged 15-64, and it has been deteriorating in recent years. This gap is exacerbated by the low availability of elderly care and early childhood education and care.

**Education continues to be of low quality, and the country suffers from a continuing skills mismatch.** There has been no change in levels of educational attainment in recent years. This indicates slow structural change in both the labour market and the education system. It is positive that the amount of early school leavers is very low at 4.9 % in 2018, less than half the EU average. However, there is a large share of the low-skilled people in the population. Upskilling strategies to increase the skill levels of the workforce are not sufficiently developed to accompany a gradual move of the economy towards a structure that requires a more skilled workforce.

BiH		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Better than EU average, no change
	Gender employment gap	Worse than EU, deteriorating
	Income quintile ratio (S80/S20)	N/A
	At risk of poverty or social exclusion (in %)	Worse than EU average (proxy), trend N/A
	Youth NEET (% of total population aged 15-24)	Worse than EU average, improving
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 15-64)	Worse than EU average, improving
	Unemployment rate (% of population aged 15-64)	Worse than EU average, improving
	GDHI per capita growth	N/A
Social protection and inclusion	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU average (proxy), trend N/A
	Children aged less than 3 years in formal childcare	Worse than EU average, trend N/A
	Self-reported unmet need for medical care	N/A
	Individuals' level of digital skills	N/A

It is positive that the amount of early school leavers is very low at 4.9 % in 2018, less than half the EU average. However, there is a large share of the low-skilled people in the population. Upskilling strategies to increase the skill levels of the workforce are not sufficiently developed to accompany a gradual move of the economy towards a structure that requires a more skilled workforce.

**Social transfers have a limited impact on reducing poverty. Although** social expenditure is comparatively high, means-tested social assistance does not cover basic living needs. Other non-contributory social benefits insufficiently target poor and vulnerable segments of the population. Participation in early childhood education and care is significantly lower than in the EU and elsewhere in the region. It stands at only around 5 % for children under 3. Most children enrolled in early childhood education and care come from urban

families where both parents are in employment, while children from rural areas or whose parents are unemployed almost rarely attend.

<sup>(1)</sup> The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance (<https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators>). The 12 indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-28 average (performing worse/better/around EU-28 average) and a review of the trend for the indicator based on the latest available 3-year period for the country (improving/deteriorating/no change). Data from 2014-2017 are used.

*(Continued on the next page)*

*Box (continued)*

**Further efforts are needed in the collection of timely and reliable data.** The availability of indicators is limited, particularly in the area of social protection and inclusion. A lack of data also holds back the development of evidence-based policies and measures. First Statistics on Income and Living Conditions data is planned for 2019.

### Social Protection System

**Updated and conclusive data on poverty is not available. However, poverty estimates show that the country faces challenges.** Household Budget Surveys (HBS) conducted since 2004 are the main reference point for poverty analysis. Statistics on Income and Living Conditions (SILC) data is planned for 2019, with two pilot projects already conducted in 2017 and 2018. Poverty measurement is also influenced by a high level of subsistence farming and the inflow of remittances (estimated to account for 11 % of GDP). According to the latest estimates made on HBS 2015 income data, the at-risk-of-poverty rate is around 27 % when using measurement methods similar to those used in EU indicators. Poverty is the highest among people with low educational attainment, the unemployed, large families and single-person households.

**Social protection systems in Bosnia and Herzegovina are complex and multi-layered.** In the Republika Srpska entity the system is centralised, while in the Federation entity it is decentralised with responsibility for social policy within a shared competence of the entity and its cantons. Overall, social protection expenditure is relatively high. Social insurance schemes include pensions, disability insurance, health insurance, unemployment insurance and in Republika Srpska entity also child and maternity benefits. Social insurance schemes make up the main part of the social protection systems in both entities. Payroll contributions provide the main source of financing for these schemes. In addition to social insurance schemes, there are also non-contributory social transfers. A larger part of these (1.9 % of GDP) are grants to war veterans and only a small part (0.8 % of GDP) is spent on disabled and on means-tested social assistance and family benefits. Poverty alleviation programmes are thus massively outspent by grants to groups falling beyond the scope of social assistance (World Bank 2019). While status-based war-related benefits are relatively generous, the amount of means-tested social assistance given to the poor is not sufficient to cover basic living expenses and only a small part of the poor is covered because of restrictive conditions.

**Social transfers have a limited capacity to reduce poverty.** Based on Household Budget Survey (HBS, 2015) data, the reduction of the at-risk-of-poverty rate by social transfers is estimated to be at 9.16 %, significantly lower than the EU average (33.2 % in 2016). According to the HBS 2015 estimate, only 36 % of all social transfers are directed towards people at risk of poverty, while only about 34 % of those that receive social transfers are lifted above the poverty threshold by the transfers. Unemployment benefits are received by only a small share (2.8 %) of those registered as unemployed at the public employment services.

**Enrolment in early childhood education and care is particularly low.** According to the Agency for Statistic of Bosnia and Herzegovina, in the school year 2017-2018, 25,889 children aged 0-6 were enrolled in 321 pre-school care or education institutions, which is a 3.9 % increase compared to the school year 2016-2017. Due to a lack of capacity, 2 790 children who applied could not be enrolled. Comparing the number of enrolled children in 2017-2018 to the number of children aged 0-6 based on data from the last population census of 2013 (245 149), the gross enrolment ratio (GER) would be very low, at around 10.5 %. For children aged 3-6 the GER would be at around 14.5 % which is very low compared to 93.2 % of children between 3 years old and the starting age of compulsory education who attend pre-school education in the EU. Using the same sources, for children below 3 years the GER in child care is particularly low at around 5 % only. Children from rural areas make up just 0.5 % of children attending pre-school education and care, and children from families with unemployed parents account only 2 %. However, children from urban areas with two working parents represent 75.5 % of children attending pre-school education and care (UNICEF, VBJK 2016). Despite being subsidised by local

governments, the cost of attendance in public pre-school education and care represents a substantial burden for lower income families.

**Access to health care is a challenge for a significant part of the population.** According to Bosnia and Herzegovina's Agency for Statistics (2018), only two thirds of all households have easy or very easy access to primary health care services. More than a half of households living in non-urban areas have difficult or very difficult access to primary health care. Households in the Federation entity have better access to primary health services compared to households in the Republika Srpska entity (70.1 % and 61.4 %, respectively). Other important challenges related to the health protection pertain to unequal provision of services in different entities and cantons, non-portability of insurance, significant out of pocket payments that affect the access to and affordability of health protection for the poor.

### Education and skills

**There is only limited country-wide information on the overall quality and outcomes of the education system.** In 2019, PISA results for the country will be reported for the first time. This will establish quantitative and qualitative benchmarks for assessing the education system. A country-wide dialogue promoting inter-institutional cooperation in education is not in place. This limits the cooperation among institutions and stakeholders, restricting opportunities for discussions on the effectiveness of education policies and programmes. The system in the Federation entity is particularly fragmented: power lies with the 10 cantons, while the federal level has limited powers. However, Bosnia and Herzegovina has traditionally had a very low share of early school leavers (4.9 % in 2018), which is less than half the EU average (10.6 % in 2018).

**Enrolment policies are inefficient in channelling students to fields of study which are on demand on the labour market.** There is a rigid allocation of resources to schools as a function of historical planning, including enrolment, as opposed to ensuring finance is prioritised and targeted at those schools/training programmes that prepare graduates in professions that are on demand on the labour market. This results in a restricted choice for students and a continued weak availability of skilled labour to meet the needs of employers.

**There has been no comprehensive countrywide strategy for vocational education since 2015.** There have been various attempts to create such a strategy, involving support from international donors. However, these have not been successful. The existing country-wide framework curriculum provides the basis for secondary education (including VET). The curriculum is reported to have been rolled-out across the country. However, there is no reliable information about its effective implementation.

**Efforts to consolidate some policy frameworks are under way.** In 2018, policymakers and practitioners from both entities worked together on a set of countrywide priorities in entrepreneurship and digital competences. A next step is to have these priorities agreed at the state level. Secondly, plans are in place to update a countrywide Strategy for Entrepreneurial Learning which expired in 2015. It will take on board more recent EU policy recommendations, including entrepreneurship promotion across all levels of education and development of entrepreneurial experience for young people. Thirdly, a proposal was developed in 2018 for a countrywide VET quality assurance framework for initial and continuing VET that was based on the EU's EQAVET. Agreement between the entities has not yet been achieved and discussions are ongoing to secure agreement between all the education authorities.

**Adult education remains weak.** The implementation of the Strategic Platform for the Development of Adult Education in 2014-2020 suffers from a lack of resources and the absence of a countrywide qualifications system. This inhibits the development of up-skilling pathways for adults seeking to improve their opportunities on the labour market. Participation of adults in education and training remains very low, and has even fallen in recent years. Depending on the measurement method, the percentage of adults (25-64) engaged in education and training stands at between 1.8 % (LFS 2017) and 8.7 % (Adult Education Survey 2016). This is very low compared to the EU average of 10.9 % (LFS 2017) and 45.1 % (Adult Education Survey 2016). Those most likely to take up formal or non-formal education and training are young people (25-34), highly educated people or people already in employment.



### 6.4.3. Competitiveness and sectoral issues

#### Business environment

**The business environment is adversely affected by a number of factors, including political instability; the weak rule of law; a fragmented, overly complex and non-harmonised regulatory framework translating in high compliance costs; a large and inefficient public sector<sup>(19)</sup>; widespread informality and corruption; and a significant tax burden on labour<sup>(20)</sup>.** Progress with improving the business environment have been limited during last year, as indicated in the 2019 World Bank's Doing business report, where Bosnia and Herzegovina is on the 89<sup>th</sup> place out of 190 countries, and has the lowest ranking in the Western Balkans region. Compared to the previous year, the country's ranking even deteriorated by three positions. Particular challenges include 'starting a business', 'dealing with construction permits', 'paying taxes' and 'getting electricity'. There are also issues with property rights ('registering property'). The ERP partially recognises these challenges by referring primarily to 'distortion' of the internal market and the single economic space. Nevertheless, the ERP generally takes a patchy approach to the reform priorities for the business environment. This patchy approach reflects the complex and fragmented character of the business environment itself. The lack of support for private and export-led growth is evidenced by the 'missing middle', with small-scale businesses and large state owned enterprises (SOEs) dominating the economy. While bank lending to the private sector has gained pace, access to finance continues to be a problem, particularly for micro and small companies. Programmes linking domestic businesses with foreign investors should be improved.

**The effective application of the rule of law is key for improving the business environment.** Effective and independent judicial systems are a prerequisite for creating an environment that is friendly to investment and businesses, as they instil confidence throughout the entire business cycle. Moreover, if not forcefully addressed, corruption will make Bosnia and Herzegovina a less attractive place to do business. Effective measures to further strengthen the rule of law, ensure appropriate and timely contract enforcement, and reduce the backlog in court cases could positively impact the business environment. This could in turn lead to an improvement in productivity and competitiveness in Bosnia and Herzegovina.

#### Informal economy

**The widespread informal economy poses another burden on business in Bosnia and Herzegovina.** Despite some limited progress in addressing informality (such as improving the degree of registration in the labour market), the share of informal employment in total employment is relatively high (around 30 % according to the ILO). The informal economy impedes the creation of jobs in the formal sector, as it created unfair competition to those companies which are registering their labour force. SMEs are more likely to be involved in the informal economy due to the higher costs of regulatory compliance for smaller firms (OECD, 2018). Public perceptions of government corruption and misuse of taxpayer money motivate many people to remain in the large informal economy (2019 Index of Economic Freedom). The ERP diagnostic is weak. It does not dedicate a specific section to this challenge, and refers to the issue primarily in the context of employment and labour markets (high share of undeclared work). Current efforts to address this issue focus on combining taxpayer information of the four tax agencies and enhanced regularly exchange of information. The combined database is now used for risk analysis and assessment to improve audit selection.

#### Research, development and innovation

**Bosnia and Herzegovina still has limited capacity for technological absorption and for research, development and innovation.** This is mainly due to its fragmented national research landscape. The institutional set-up for innovation policy is highly decentralised. The entity level deals with research and

<sup>(19)</sup> Providing for 39 % of formal jobs with private firms having difficulties to compete with public salaries according to LFS 2017.

<sup>(20)</sup> High social security contributions, fiscal and para-fiscal fees.

development (R&D) and innovation policy, and coordination is poor. Key obstacles include low investment in R&D; a very low number of researchers per head of population; very few innovation-related policies or strategies and very limited cooperation between academia and the private sector. The country is estimated to have spent around 0.24 % of GDP on research in 2016 (the lowest gross expenditure on R&D in the region). The revised strategy for scientific development sets the goal of having 0.8 % of GDP investment in research and development by 2022, which would still be far from the EU's 2020 target of 3 %. The lack of funding for R&D limits the potential for innovation and promotes brain drain. 43 % of highly educated people have already left abroad (OECD, 2019; Landesmann, 2016). The legislative framework regulating science and research development, based on a 2009 Framework Law, is fragmented and needs to be improved throughout the country. A smart specialisation strategy is part of Bosnia and Herzegovina's commitments under the REA MAP but has not yet been developed.

**The process by which scientific knowledge is fed into policy-making is rather weak, not comprehensive and not inclusive.** The Global Competitiveness Index (2018 edition) ranks Bosnia and Herzegovina 114<sup>th</sup> (out of 140 countries with regard to their innovation capability). The country participates in the Horizon 2020 programme, which links its research community to European Partners. However, with the exception of a recently initiated donor programme, there are no public funds available to promote innovative projects of SMEs when those projects carry financial risks. Current efforts to boost the country's innovation capability include strengthening participation in Horizon 2020, developing a national roadmap for research infrastructures, and developing a smart specialisation strategy. The Republika Srpska entity is aiming to establish a science and innovation fund. The country should significantly boost the role of private sector innovation in its overall economic policy. It should also improve the formulation, coordination and implementation of policy. An innovation voucher scheme could be considered.

### Digital economy

**The country's digitalisation is still at a very low level<sup>(21)</sup> and falls well below the average performance of south east Europe (SEE) economies on the use and access of information communication technologies.** The Global Competitiveness Report (2018 edition) ranks Bosnia and Herzegovina 86<sup>th</sup> out of 140 countries for adoption of information and communication technologies (ICT). Legislation which would enable the liberalisation of the telecommunications and electronic media sector is not yet in place. Further obstacles to competitiveness and growth of this sector include the absence of a broadband strategy and 4G network. 66 % of households have internet access at home (EUROSTAT, 2017). The penetration of broadband internet is 19.83 %. The policy of the electronic communication sectors of Bosnia and Herzegovina for 2017-2021 and the accompanying implementation action plan are in place. This policy is a prerequisite for the further development of the regulatory framework on radio frequency.

**Bosnia and Herzegovina is lagging behind in the implementation of its policy for the information society until 2020 (adopted in May 2017).** The fragmentation of responsibilities among different levels of authorities has a direct impact in the area of e-government services. This leads to a dual barrier in the implementation of e-services. The first barrier is that there is no centralised portal providing e-services. The second barrier is that there is no central co-ordination body to oversee services provided in the entire territory. This means that the many benefits of e-government solutions and ICT-enabled services are not currently available (ITU, 2018). Digitalisation of government services for enterprises therefore needs to continue (OECD, 2019). Some conditions for the implementation of electronic signature in open systems are in place (such as the establishment of the Office for Supervision and Accreditation of Certifiers at the state level Ministry of Communications and Transport). However, electronic signature is still not implemented in practice. The country needs to adopt legislation on electronic identification and trust services for electronic transactions compliant with the relevant EU *acquis*. Non implementation of the digital switchover (issues of jurisdiction and equipment ownership still cause significant delays) prevents

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<sup>(21)</sup> 1.6 out of 5 according to the OECD Competitiveness Outlook (2018).

the country from reaping the benefits of the digital dividend (OECD, 2018) and disturb the operation of certain radio frequency transmitters locally and regionally. The country is currently focusing on adopting a broadband access strategy; a strategy for information society development; and the adoption of a law on electronic communications and electronic media.

### Investment activity

**Domestic and foreign investment has remained subdued, reflecting a poor business environment and high political uncertainty.** The country's physical capital stock is suffering from decades of underinvestment. Public and private investment has remained low during the last 10 years with private gross fixed capital formation dropping from 24.5 % of GDP in 2008 down to 17 % in 2017. This drop in private investment reflects the poor business environment and the low degree of certainty due to frequent political gridlock. Public investment accounted for 3 % of GDP on average in 2008-2017. Given the country's need to modernise its infrastructure, this investment rate appears low. It also reflects a public spending policy that prioritises spending on public sector employment and on transfers, while neglecting infrastructure investment. This makes it difficult to improve growth potential and labour productivity, impeding efforts to raise income levels and living standards.

**At around 2 % of GDP, net FDI inflows are by far the lowest in the region, in spite of some regulatory improvements.** The five year average flow of inward FDI is 2.2 % of GDP according to the Global competitiveness index 2018 edition. The main countries of origin for the FDI in 2017 were Austria (24.1 %), Croatia (13.1 %) Slovenia (13 %) and Switzerland (7.6 %).<sup>(22)</sup> Inflows increasingly consisted of reinvested earnings. In principle, the legal framework provides favourable treatment and protection guarantees for FDI. Bosnia and Herzegovina is among the most open economies to FDI<sup>(23)</sup>. There are no restrictions on FDI inflows and few limitations on foreign ownership. Nearly 63 % of the country's stock of FDI originates from EU countries; it is concentrated in the financial sector, retail and tourism. The low level of FDI clearly reflects the reality of the country's poor and fragmented business environment. Bosnia and Herzegovina faces a challenge to promote FDI in a uniform way and with the cooperation of all levels of government. There is no country-wide strategic framework to encourage FDI. There are also no comprehensive programmes to better connect foreign investors and domestic firms to enhance the impact of FDI. Another issue is "aftercare" support: once a commitment has been made to invest in the country, investors also need help to ensure their project is implemented in the way they planned. This aftercare support is insufficient at present.

**Bosnia and Herzegovina is encouraged to implement all the aspects of the Regional Economic Area Multi-Annual Action Plan (REA MAP).** The REA MAP is based on EU standards and will facilitate Bosnia and Herzegovina's integration in regional and European value chains and will also help increase the attractiveness of the economy for FDIs in tradable sectors. Further connectivity with neighbouring countries in transport and energy will further strengthen Bosnia and Herzegovina's access to, and integration in, the regional market. The creation of a regional digital space and of more integrated labour markets with neighbouring economies will offer new possibilities for the country's youth, which is important in light of the high youth unemployment.

### Trade performance

**The country's openness to trade is relatively low given the small size of its economy, with the sum of exports and imports accounting for about 90 % of GDP.** In 2017, exports of goods and services accounted for 38.9 % of GDP, while imports of goods and services accounted for 54.8 % of GDP. The range of exported goods is very limited and the highest shares are as follows: "Base metals and articles of base metals (18 %), machinery and electrical equipment (12 %), miscellaneous manufactured articles" (11

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<sup>(22)</sup> Bosnia and Herzegovina Central Bank statistics.

<sup>(23)</sup> According to the OECD FDI Regulatory Restrictiveness Index (2016), the country scores 0.029 compared to an OECD average 0.067 (0=open, 1=closed).

%), “textile and footwear” (11 %), “mineral products” (9 %), and “chemical products” (9 %) <sup>(24)</sup>. The country’s trade performance still lags behind its neighbours due to burdensome administrative procedures for trading and limited export promotion capacities. The main problems holding back trade are: (i) a fragmented domestic market, (ii) complex export procedures, (iii) the absence of coordinated border checks and (iv) the absence of a comprehensive approach to EU food-safety and sanitary and phytosanitary standards. Despite some recent successes by the country in meeting required standards for exporting to EU markets, non-tariff barriers to trade with the EU, in particular as regards sanitary and phytosanitary standards, remain a problem (OECD, 2018).

**In international rankings, the country has the lowest scores in the region for the quality of its border administration, transport and communication technologies (WEF, 2016).** There is a need to foster mutual recognition of (i) certificates, (ii) testing facilities, (iii) risk management systems and (iv) pre-arrival processing of documents. There is also a need to make progress in the implementation of the customs policy law, including by introducing the concept of authorised economic operators.

**Nevertheless, the share of the goods export market accounted for by the EU-27 rose from 45 % in 2008 (when the EU-Bosnia and Herzegovina Stabilisation and Association Agreement/interim agreement entered into force) to 71.8 % in 2017.** This rise was only partly accounted for by Croatia joining the EU and demonstrates the potential of trade integration with the EU. 96.3 % of Bosnian products can access the EU market without customs duties. In recent years, trade with neighbouring countries, such as Croatia, Slovenia, Serbia and Turkey, has increased markedly. Given the different exporting product specialisation among Western Balkan countries, there are significant potential opportunities for increasing trade integration in the form of regional value chains that could link up with global value chains, especially in sectors such as food and car manufacturing (World Bank, 2018).

## Energy

**The energy sector is hampered by political interference and by a fragmented, inconsistent and uneven legislative framework between different levels of governance.** This results in an unfavourable investment climate and insufficient regulatory independence. The creation of an internal energy market is being hindered, because Bosnia and Herzegovina has not fully aligned its legislative frameworks for gas and electricity with the third energy package. Bosnia and Herzegovina needs to adopt state-level legislation aligned with third energy package in the field of both electricity and gas and then followed by compliant entity-level legislation. The lack of a legislative framework significantly impedes the effective integration of the country in regional energy markets. It also acts as an obstacle to further reforms and economic development. The markets for electricity and gas remain fragmented and dominated by key incumbent companies. The current model for the legal and functional unbundling of the company for transmission of electricity from generation and supply is not in line with any of the unbundling models under the EU *acquis*. Bosnia and Herzegovina also lacks a single or harmonised legal and regulatory framework for tendering for new generation capacity. Energy tariffs are too low to foster private sector financing of many new power plants (World Bank, 2015). The problem of cross-subsidies in the electricity sector has not been adequately addressed.

**However, a countrywide strategic framework for energy is in place.** In 2018, Bosnia and Herzegovina adopted a framework energy strategy up to 2035. This strategy sets out objectives and implementation priorities to be reached in the years to come. The adoption of the strategy is an important step towards setting a vision for the future development of the energy sector in the country. The strategy will help tap into the country’s potential, drive sustainable economic growth, and set up a framework for viable investments. A national renewable energy action plan is also in place. This action plan has set a national target of ensuring that (i) 40 % of final energy consumption comes from renewable energy sources and (ii) 10 % of energy used in transport comes from renewable energy sources by 2020. However, there is a lack of transparency in the operation of the responsible authorities tasked with implementing this plan. It is also unclear if enough funds have been collected for its implementation and no information has yet

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<sup>(24)</sup> WIIW database collected from Agency of Statistics of Bosnia and Herzegovina, 2017 latest available.

been made public on designated incentives for renewable energy. Bosnia and Herzegovina is still one of the most energy inefficient and carbon intensive countries in Europe. This harms its competitiveness and exposes it to increasing pollution. In spite of this, a national energy efficiency action plan was adopted in line with requirements of the Energy Community Treaty. This action plan is currently being updated because financing of the planned activities is proving problematic. Improving the connectivity of energy infrastructures will accelerate the integration of Bosnia and Herzegovina into pan European networks and will help increase the competitiveness of the country's energy market over time.

## Transport

**The transport infrastructure in Bosnia and Herzegovina is insufficiently developed, and improving only slowly.** The highway network is limited, making it more difficult for companies to export, and increasing their costs and transport time. The transport sector is dominated by poorly managed and often inefficient SOEs. The legislative framework on concessions and public-private-partnerships remains highly fragmented, and private-sector involvement in public infrastructure is limited (World Bank, 2015). The necessary investment is delayed by (i) a lack of coordination between government levels, (ii) a lack of external financing, and (iii) the absence of a single or harmonised legal and regulatory framework. Implementation of the connectivity reform measures, which would be a significant driver of economic growth (with much less costs), is not progressing. Improving the connectivity of transport infrastructures will accelerate the integration of Bosnia and Herzegovina into pan European networks and will help further develop economic corridors over the region, which would benefit the country.

**The authorities are very reluctant to open the railway market.** This is due to unsafe, outdated and unreliable railway infrastructure. The two railway companies of the entities need to complete the process of separating infrastructure management from transport services to ensure their full independence. Competitiveness is affected by overemployment in the main rail transport operators. There has been no major increase in the volume of goods transported by railway since 2008, with 1.1 billion tonne km transported in 2016 (Eurostat). Economic cost of road crashes and the environmental costs of transport activity are very high (OECD, 2018).

## Agriculture

**Bosnia and Herzegovina faces many obstacles to increasing agricultural productivity and opportunities for its agriculture.** These obstacles include low overall investment and administrative capacities, land fragmentation, the large proportion of small farms in the sector, low productivity, and outdated facilities for manufacturing and processing. Forests are underexploited, partly due to the absence of a harmonised legal framework across the country. Due to the structure of farms, there is little specialised agricultural production. The average farm holding size is approximately 2 ha. Agriculture, forestry and fisheries continue to play a significant role in economic growth, job creation and social stability. These sectors account for 7,5 % of gross value added (2016) and 18,9 % of employment (2017), although an estimated 60 % of Bosnia and Herzegovina's population live in rural areas (UNDP), which is very high compared to the OECD average of 20 %. However, these figures are all estimates, since the last agricultural census was conducted in 1960. The absence of up-to-date data on agriculture is a stumbling block in itself, to policy making in this sector.

**To improve competitiveness and growth prospects in agriculture, alignment with the EU *acquis* must be pursued, and state support to the sector must be reviewed.** The EU remains Bosnia and Herzegovina's main trading partner for agricultural goods. In 2017, exports of agricultural products to the EU made up 35 % of total agricultural exports. There is a need for *acquis*-compliant state-level legislation on food, veterinary medicine, wine, organic farming, and harmonisation of agricultural information systems. The most widespread type of producer support in the country at present is based on output and variable input–use. This distorts the market, and does not promote long-term competitiveness<sup>(25)</sup>. The

<sup>(25)</sup> According to the OECD Competitiveness Outlook 2018, the composition of budgetary support to producers as percentage of gross farm receipts is as follows: 2,9 % of “most distorting support” and 2,1 % of “other support”.

country should instead increase the share of producer support dedicated to general services for the sector, balanced across key areas such as infrastructure, knowledge, and inspection. This would strengthen the foundation for long-term productivity growth. The country has adopted a strategic plan for rural development 2018–2021, which has the potential to create more synergies between sectors of food-safety policy, veterinary policy, phyto-sanitary policy, agricultural policy and rural development policy, needed for the overall sustainable economic growth of Bosnia and Herzegovina.

### Industry

**The industrial sector still suffers from the lack of a single economic area.** Industry's contribution to GDP has been around 20 % over the past five years, and the sector was the main contributor to the country's exports over that period. Manufacturing accounts for over 60 % to industrial production, while the most significant increases in production in 2017 were recorded in textiles and leather (17.2 %) and machines and devices (15.1 %). Industry's share of employment stands at 26 %. Bosnia and Herzegovina does not have a unified approach to enterprise and industrial policy, as this is an exclusive competence of the entities, the Brčko District and the cantons in the Federation entity. There is no state-level body promoting consistency between industrial strategies and other policies affecting industrial competitiveness. The fragmented institutional framework is not conducive to business creation, investment, entrepreneurship, innovation, the promotion of SMEs. The ERP fails to provide a specific diagnostic of this sector.

### Services

**The service sector, including public administration, health and education, is the largest in terms of employment and value generation, accounting for nearly two-thirds of the gross value added (65.4 % in 2017).** Most of the active labour force being employed in this sector (51.6 % in 2017). Tourism has an important growth potential with high growth in visitor rates. According to 2016 figures, direct contribution to GDP amounts to 2.5 %, and total tourism contribution to GDP amounted to 9.2 %. Direct tourism employment contribution amounted to 3 %, and the total tourism employment contribution amounted to 10.6 % (OECD, 2018). Bosnia and Herzegovina usually achieves a surplus in the services trade balance, largely driven by the provision of construction services abroad, and substantial net earnings from tourism. Services exports represent a significant part of the country's international trade. The ERP fails to provide a specific diagnostic of this sector.

6.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2018

Overall: Limited implementation (34.1 %) <sup>(26)</sup>	
2018 policy guidance	Summary assessment
<p><b>PG 1:</b></p> <p>Improve the current medium-term fiscal planning framework to become an effective policy planning tool for public finance.</p> <p>Strengthen the analytical capacities of the various stakeholders producing macro-fiscal analysis and forecasts.</p> <p>In order to better support policy analysis, improve the provision of timely and exhaustive statistics, in particular government finance, national accounts and labour market statistics.</p> <p>Strengthen the country-wide public debt management capacities, at all levels, in particular the cooperation and flow of adequate and full information from all data providers.</p>	<p>There was <b>limited implementation</b> of PG 1:</p> <p>1) <b>Limited implementation:</b> There have been some limited improvements in the ERP, but there are no signs of any strengthening in policy planning.</p> <p>2) <b>Limited implementation:</b> The World Bank provided training on macro-fiscal forecasting, and the IMF and EU organised a training session to improve macro-fiscal programming.</p> <p>3) <b>Limited implementation:</b> The central bank undertook efforts to improve the reporting of general government data and submitting a fiscal notification to Eurostat. Eurostat provided trainings on government finance statistics and National Accounts within IPA15. Labour market statistics still lack a new Master Sample Frame; its implementation is expected in the first half of 2019.</p> <p>4) <b>Limited implementation:</b> The debt management strategy has been updated but no significant progress has been achieved in improving cooperation and the flow of information.</p>
<p><b>PG 2:</b></p> <p>Create fiscal space for public investment by containing spending on public consumption and improving the targeting of social spending.</p> <p>Furthermore, take steps to reduce public-sector payment arrears.</p> <p>Lower the tax burden on labour, including social security contributions while ensuring sustainable public finances.</p>	<p>There was <b>limited implementation</b> of PG 2:</p> <p>1) <b>Limited implementation:</b> Spending on public consumption has been contained, but no progress has been achieved in improving the targeting of social spending.</p> <p>2) <b>Limited implementation:</b> First steps have been taken to register existing payment arrears and to develop plans on how to reduce them.</p> <p>3) <b>Limited implementation:</b> One entity has started in some areas to lower the tax burden.</p>
<p><b>PG 3:</b></p> <p>Safeguard the integrity of the currency board arrangement as the anchor of monetary stability.</p>	<p>There was <b>partial implementation</b> of PG 3:</p> <p>1) <b>Full implementation:</b> The currency board continues to enjoy a high level of credibility with the general public. The central bank continued to</p>

<sup>(26)</sup> For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission's Overview and Country Assessments of the 2017 Economic Reform Programmes available at [https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments\\_en](https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en).

<p>Enhance further the analytical and forecasting capacity of the CBBH, and develop its toolkit by establishing a bank lending and inflation expectations survey.</p> <p>Follow up on ongoing legislative changes and develop a comprehensive strategy fostering the resolution of NPLs to help remove supply-side bottlenecks to credit extension.</p> <p>Strengthen the bank resolution framework by ensuring sufficient coordination among the bodies entrusted with resolution.</p> <p>Develop a macroprudential framework so as to mitigate systemic risk in the financial system.</p>	<p>ensure the full convertibility of the domestic currency by backing net monetary liabilities with foreign exchange reserves. The currency board's coverage of monetary liabilities remained broadly unchanged over past years, standing at 105.8 % in December 2018, which is adequate.</p> <p>2) <b>No implementation:</b> There has been no concrete progress on the part of the CBBH in developing further its analytical and forecasting capacity yet.</p> <p>3) <b>Partial implementation:</b> New laws have been introduced to facilitate NPL resolution (for example only specialised companies can buy NPLs). Nevertheless, the framework of recovering and resolving NPLs needs to be improved by facilitating out-of-court restructurings and amending the tax treatment of NPL sales to specialised companies.</p> <p>4) <b>Partial implementation:</b> Although, new laws and by-laws have been introduced which improve cooperation and coordination among financial sector regulators and supervisors, the Law on Deposit Insurance is still pending, rendering the reform incomplete.</p> <p>5) <b>Limited implementation:</b> Although the two banking supervision agencies have some macroprudential instruments and measures at their disposal, there is no centralised macroprudential framework in place.</p>
<p><b>PG 4:</b></p> <p>Adopt a credible and relevant country-wide Public Financial Management strategic framework with a performance based monitoring and reporting system.</p> <p>Adopt a countrywide energy sector reform strategy and a legal framework in compliance with the Energy Community Treaty.</p>	<p>There was <b>partial implementation</b> of PG 4:</p> <p>1) <b>Limited implementation:</b> The Republika Srpska entity has committed to adopt its entity level strategy in spring 2019. This is a precondition for adoption of a country wide PFM strategy (the other levels of government have adopted PFM reform programmes already).</p> <p>2) <b>Full implementation:</b> A framework energy strategy for Bosnia and Herzegovina was adopted by the country's Council of Minister in August 2018.</p> <p>3) <b>No implementation:</b> No steps were undertaken by relevant authorities at different levels of governance to ensure required compliance with obligations stemming from the Energy Community Treaty</p>
<p><b>PG 5:</b></p> <p>Simplify and harmonise business registration procedures between entities.</p>	<p>There was <b>partial implementation</b> of PG 5:</p> <p>1) <b>Limited implementation:</b> Little progress was made in introducing online registration as a way to simplify and harmonise business registration procedures. The Federation entity has adopted an action plan for introduction of a one-stop shop for</p>



<p>Introduce e-payment services on taxation</p> <p>and fully implement the law on electronic signature.</p>	<p>electronic business registration. However, no progress was made on the creation of a software solution, because adoption of the required legislation is pending in the entity Parliament. The Republika Srpska entity is proceeding with preparations for on-line registration by introducing relevant legislation into the parliamentary adoption procedure. Overall progress is limited, as measures allowing companies to complete formalities fully online in the entire territory are still lacking.</p> <p>2) <b>Substantial implementation:</b> electronic submission of VAT declaration has been introduced and is mandatory since 1 January 2019. The method used is web-based authentication as the Indirect Taxation Authority (ITA) has still not received certification from the Ministry of Communications and Transport (MCT) to start issuing e-signatures.</p> <p>3) <b>Partial implementation:</b> The 2006 Law on electronic signature has not yet been fully implemented. Some conditions for the implementation of electronic signature in open systems are in place (such as the establishment of the Office for Supervision and Accreditation at the MCT), but electronic signature is still not implemented in practice. Institutions which have filed an application (ITA and the Agency for Identification Documents, Registers and Data Exchange) have still not received certification from MTC to start issuing e-signatures. Implementation of e-signature is also hampered by the different legal frameworks across the different administrative levels (OECD, 2019). Finally, legislation on electronic identification and trust services for electronic transactions compliant with the relevant EU <i>acquis</i> has not yet been adopted.</p>
<p><b>PG 6:</b></p> <p>Reduce the tax wedge and disincentives to work.</p> <p>Ensure better coordination between employment activation measures and social benefit schemes.</p>	<p>There was <b>limited implementation</b> of PG 6:</p> <p>1) <b>Partial implementation:</b> The tax wedge remains high especially for low-wage earners, which has a negative impact on the demand for labour, stifling economic growth and promoting the growth of the informal labour market. Some progress can be noted in the Republika Srpska entity which passed changes to labour and income tax legislation. These changes reduced the tax burden on labour and increased worker's take-home pay, while keeping gross salary the same. In the Federation entity, legislative proposals were made to reduce the tax burden on low-wage earners and to reduce contributions.</p> <p>2) <b>No implementation:</b> No real progress was made on better coordination between employment</p>

<p>Increase enrolment in preschool education.</p> <p>Undertake a review of secondary and higher education enrolment policies in order to improve their links with the labour market needs.</p>	<p>activation measures and social benefit schemes.</p> <p>3) <b>Limited implementation:</b> In the school year 2017-2018, the number of preschool institutions decreased, while the number of children enrolled has slightly increased by 3.9 % year-to-year. The 2017-2022 Platform for the Development of Preschool Education in Bosnia and Herzegovina, which was adopted before the reference period, has among its objectives to increase the coverage of pre-school education. According to the information about the implementation of the Platform over the reference period, some of the competent authorities have adopted their own strategic objectives which are being implemented. Further information on the implementation is missing.</p> <p>4) <b>No implementation:</b> No steps have been undertaken to review enrolment policies. The previous practice of annual consultations on the labour market to identify labour market needs before the enrolment of students for the school/academic year did not prove to be effective. There is high enrolment in occupations and study programmes for which there are no employment prospects. Enrolment in medical schools is increasing, with students planning to get employment abroad when they graduate.</p>
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## 6.6. THE 2019 POLICY GUIDANCE

### **JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TURKEY**

The Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

Brussels, 17 May 2019

[...]

In light of this assessment, Participants hereby invite Bosnia and Herzegovina to:

1. Strengthen the ERP's medium-term macro-fiscal planning framework through enhancing the analytical and forecasting capacities at all levels with a view to presenting a consistent and consolidated country-wide analysis and policy document. Enhance public-sector transparency by completing the recording of public sector employment, by addressing payment arrears and by publishing the trend and origins of public guarantees. In order to better support policy analysis, improve the provision of timely, exhaustive and in particular country-wide statistics on government finance, national accounts and labour market statistics, in particular by implementing a quarterly labour force survey.
2. Increase public investment, based on an investment strategy and actual implementation. Contain spending on public sector wages, based on a complete recording of public sector employment. Improve the targeting of social transfers, based on needs.
3. Safeguard the integrity of the currency board arrangement and the independence of the central bank in order to maintain monetary stability. Enhance the analytical and forecasting capacity of the central bank, and develop its toolkit by establishing a bank lending survey and by developing a macroprudential framework. Address remaining obstacles hindering the resolution of non-performing loans, and closely monitor the emergence of potential financial stability risks related to the consumer loan segment, deploying appropriate micro- and macroprudential policy tools if needed. Strengthen the bank resolution framework by adopting the law on deposit insurance.
4. As a step to improve governance and transparency, create publicly available registers of public enterprises providing up to date information on ownership, employees and comprehensive financial statements, including the companies' debt situation, and adopt and implement a credible and relevant country-wide Public Financial Management strategic framework with a performance based monitoring and reporting system. Advance restructuring and/or privatisation of public enterprises and improve their efficiency and corporate governance, including the two telecom companies in the Federation entity.
5. With a view to creating a single economic space, simplify and harmonise business registration, licensing and permit procedures between entities. Fully implement the law on electronic signature. With a view to reducing para-fiscal fees and charges, put legislation in place giving legal force to the developed registers of fees and charges.
6. Undertake a review of secondary and higher education enrolment policies in order to improve their links to the current and prospective needs of the domestic labour market. Reduce the tax wedge, especially for low-income workers, and disincentives to work in order to incentivise formal employment. Disburden public employment services from administrative duties related to health insurance for registered unemployed in order to free their capacities for more active support to jobseekers.

## ANNEX A: ASSESSMENT OF THE STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP

Most measures presented in the ERP are not country-wide and only include entity-specific activities in a fragmented way. There are only six reform measures in the programme that have the potential to cover the country as a whole and only these have been assessed. The Commission's recommendation to identify a list of 15-20 measures that address common country-wide obstacles to competitiveness and growth has been ignored.

### **Measure 1: Improving agricultural production and establishing an efficient system for food safety and quality**

The measure has mostly been rolled over. It is relevant and has the potential to enhance agricultural productivity and increase exports of a number of commodities to the EU. However, in spite of the adoption in early 2018 of a Strategic Plan of Rural Development of Bosnia and Herzegovina, the measure is too ambitious. This is because there is no agreement on competencies, more specifically on the establishment of IPARD (IPA Rural Development) Paying Agency at state level. The planned activities are highly relevant, but there are too many of them. The activities are also mostly scattered between the two entities and they lack a harmonised approach within the country. To have a more significant impact on the competitiveness of the economy as a whole, the country will have to improve its institutional arrangements to avoid overlapping competences and strengthen its control and coordination chain. On the promotion of start ups and the modernisation of family farm businesses, these plans are relevant. However, there is too much focus on a protectionist approach to this sector, which is not conducive to enhancing competitiveness. Overall, there is insufficient information on timelines and budgeting.

### **Measure 2: Enhancing the quality infrastructure system according to the EU model**

This rolled over measure on harmonisation of the quality infrastructure is highly relevant in raising the country's competitiveness and long-term growth potential. If implemented, it will contribute to creating a single economic space and to facilitating trade. As rightly mentioned in the ERP, this measure is also in line with the country's commitments under the SAA (Article 75). Cross-cutting coordination between the relevant institutions at different levels of government has not yet been ensured. The measure continues to contain several of the deficiencies mentioned in last year's assessment, which explains the absence of real progress in the activities that have been planned for 2018. The lack of real commitment to this measure is reflected in the absence of timelines, expected results, key performance indicators, concrete activities or impact. The implementation of this measure will require proper cooperation between all levels of government. No budget allocations are indicated and there is only a vague reference to the possibility of allocation of the Instrument for Pre-Accession (IPA) funds following the adoption of the strategy.

### **Measure 3: Improving the communication and information society along with the alignment of the regulatory framework with EU standards**

This measure is indeed very relevant for economic growth and increased productivity. Various activities planned under this measure, such as the adoption of the broadband Internet access strategy and the Law on electronic communication and electronic media are consistent with commitments undertaken under the Multiannual Action Plan on the Regional Economic Area. The adoption of a new law on electronic communications and electronic media aligned with the EU *acquis* in this sector is long overdue. This is because the Stabilisation and Association Agreement stipulated that Bosnia and Herzegovina should have adopted such a law one year after the Agreement entered-into-force. Implementation of this measure could benefit from including references to the introduction of the 4G network, full implementation of electronic signature (including adoption of planned legislation on electronic identification and trust services for electronic transactions) and completion of the digital switchover. The lack of progress in implementing this measure is compounded by vague indications of budgetary appropriations and no indication of key performance indicators.

#### **Measure 4: Reform in the area of research and innovation**

The measure aims at improving the overall functioning of the research and innovation at the state level. The measure also mainly includes activities contributing to better governance and strategic planning. While the measure to some extent aims at increasing expenditure on R&D, there are no clear work plans, budgetary commitments or key performance indicators. The measure thus risks not having a significant impact on the competitiveness of the economy. Some of the planned activities aim at addressing the fragmented framework in this sector, but more efforts could be made. For example, it would be very helpful if the country drafted an Action Plan for the revised strategy for scientific development for 2017-2022.

Given the implementation of the Multiannual Action Plan for the Regional Economic Area, Bosnia and Herzegovina is encouraged to propose a country-wide/state-level framework for the digital economy. This framework should encompass various ERP reform measures on research, development, innovation and the digital economy.

#### **Measure 5: Improving the labour market efficiency**

The areas targeted by this measure are relevant. The overall aim is to reform labour market legislation to improve the functioning of the labour market. Employment service reforms are also planned to promote the client-based approach. No concrete steps have been developed overall for 2019-2021 and indicators are missing or inadequate. Given the delays in the past, the implementation has many risks. Costs for the reform measure are not mentioned. The Republika Srpska entity plans to adopt amendments to legislation to reform and redefine the role of the Public Employment Service (PES). However, these amendments depend on the adoption of the Law on health insurance, which is necessary to decrease the burden on the public employment services caused by the servicing of health care insurance. The ERP only outlines steps for 2019. For the Federation entity, the measure is underdeveloped and seems restricted to the adoption of an Employment Strategy and amendments in the area of occupational safety and health, peaceful resolution of disputes and work of private employment agencies.

#### **Measure 6: Improving the social protection system**

There is a relevant focus in all parts of the country on better targeting social benefits and better covering the poorest through 'mapping' and the creation of registers of benefit recipients. The Republika Srpska entity is planning a comprehensive 'mapping' (i.e. an inventory of all social benefits that are available), and developing its register of benefit recipients. It also plans to make a transition from statutory benefits to benefits disbursed based on needs. The activities planned for this measure are relevant and ambitious and have yet to be implemented. The Federation entity is currently setting up a register of cash benefit users, and is aiming at improving the targeting model to ensure better coverage of the poorest and most vulnerable categories of people. However, it is not well explained if war-related benefit recipients will be included in this exercise. The reform measure for the Federation entity also includes other current activities in the social protection field thus diluting the focus of the reform measure.

#### **ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM ERP 2018-2020**

Reporting on implementation of structural reform measures of the ERP 2018-2020 did not follow the guidance note: this reporting is inadequate and partly incomplete. It also focuses mostly on non-country-wide measures and only partially reflects the current state of play. In many places, the reporting on the stage of implementation is overstated. There is no reporting at state level.

## ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Council of Ministers adopted the 2019-2021 ERP on 30 January 2019. The ERP was officially submitted to the Commission on 31 January. The programme is largely in line with medium-term budgetary frameworks, while at the time of the finalisation of the programme the adoption of the country's 2019 budgets had not been completed yet.

### *Inter-ministerial coordination*

The preparation of the ERP was centrally coordinated by the Directorate for Economic Planning (DEP). Contributions to the ERP were prepared and endorsed at entity level. No single country-wide programme was presented.

### *Stakeholder consultation*

The draft ERP was published on the DEP website on 23 January; a week before the deadline for submission to the Commission. Invitations to comment were sent out to relevant stakeholders, but no comments were received due to the very short deadline. The ERP was not discussed with the social partners.

### *Macroeconomic framework*

The programme still does not provide the full set of required data. Recent macroeconomic performance is adequately described. The macroeconomic framework is sufficiently comprehensive. However, key features, such as labour-market developments, should have been explained in greater detail. Consistency with other parts of the programme, particularly with the fiscal framework, is still limited. The reasoning behind the chosen policy approach and the link to the overarching policy strategy are not sufficiently elaborated upon.

### *Fiscal framework*

The fiscal framework is still not sufficiently integrated with the other parts of the programme. Public investment plans are not consistent with the macroeconomic framework. The fiscal section still remains largely silent on the links with structural reforms. The rationale and underlying measures of the chosen policy approach of significantly reducing the revenue and spending ratios are not sufficiently elaborated upon. There are hardly any references to the Commission's assessment in the 2018 Country Report. The ERP provides hardly any quantitative analysis of measures briefly mentioned. The compilation and presentation of fiscal data is not in line with ESA 2010. In particular, there is a lack of country-wide fiscal data.

### *Structural reforms*

Sections 4, 5 and 6 do not follow the programme requirements, and do not present one consistent country-wide reform programme. This reflects the absence of proper coordination between the entities on country-wide challenges and reform priorities. Measures are often formulated too broadly, and the cost of activities (as well as source of financing) is insufficient. Key performance indicators are not always present and potential risks indicate frequently political obstacles. The reporting on the implementation of the policy guidance is largely missing. Tables 10 and 11 do not follow the guidance note. Table 10 hardly provides any information on budgetary implications. Table 11 is not complete. There are 15 reform measures listed, but only six measures can qualify as being country-wide.

# 7. KOSOVO\*

## 7.1. EXECUTIVE SUMMARY

**Kosovo's economic reform programme (ERP) expects economic growth to remain robust, supported by public spending initiatives and private consumption.** The ERP baseline scenario is on the optimistic side, forecasting average annual GDP growth of 4.5 % in 2019-2021, which is above the historical trend. Private consumption should remain the main growth driver, supported by growing remittances, higher social transfers and easier access to credit. A very ambitious public investment plan is set to drive overall investment growth. Public consumption is set to increase sharply in 2019, due to higher allocations for infrastructure maintenance and priority areas, but to stagnate afterwards. Shortcomings in the execution of public investment and higher import growth than assumed in the ERP remain the main downside risks to the economy. Moreover, political decisions such as the 100 % tariffs on imports from Serbia and Bosnia and Herzegovina have a negative impact on trade and undermine regional economic integration. The possible construction of a major new power plant (Kosova e Re) constitutes an upside risk for growth, but could have significant repercussions for public debt.

**The budget deficit is set to widen, while recurrent pressure for higher wages and social transfers create fiscal risks.** The 2019 budget deficit is projected to reach the upper limit of 2 % of GDP fixed by the fiscal rule. The expected high revenue growth relies on ambitious gains from tax compliance. The projected rise in expenditure is driven by a steep rise in current and capital spending, the latter due to the expected start of several infrastructure projects financed by privatisation revenues and international financial institutions (IFIs). The overall deficit is projected at 5.2 % of GDP on average in 2019-2021 (1.8 % when adjusted for capital spending excluded under the fiscal rule), and public debt is set to rise to 25.1 % of GDP by 2021. Immediate fiscal risks stem from the recently adopted Law on salaries for public employees (which risks breaching the wage bill rule), overspending on the war veterans pension scheme and persistent pressure from large interest groups for increases in entitlements and transfers, as shown by the recent adoption of the Law on teachers' pensions.

The main challenges facing Kosovo include the following:

- **Given numerous development challenges, Kosovo needs to prioritise public expenditure within the limited fiscal space and in compliance with the fiscal rule.** Preserving high rates of capital spending, as envisaged in the budget, and ensuring funding for priority areas such as health, education and the judiciary remain key. Prioritisation, planning and coordination between policies are essential, while new initiatives should be properly evaluated and costed before adoption. While Kosovo has taken some steps to improve capacities for policy evaluation, macro-fiscal forecasting, budget planning and fiscal oversight, further efforts are needed to improve fiscal governance and efficiency of public spending while reducing fiscal risks. Improved revenue administration should create more space for priority spending.
- **Capital projects are regularly delayed due to weak capacities for project implementation.** Around 25 % of the capital budget remained unused in 2018. The costs of social spending are systematically underestimated in the budget, leading to regular fund reallocations at the expense of capital spending. Further improvement of multiannual investment planning and administrative capacities for project management is important if Kosovo is to achieve the ambitious public investment growth envisaged in the ERP.

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(\*) This designation is without prejudice to positions on status, and is in line with UNSCR 1244/1999 and the ICJ Opinion on the Kosovo Declaration of Independence.



- **The informal economy represents around a third of GDP, leads to unfair competition and reduces job security and safety at work.** Institutional weaknesses in the updating and exchange of business information and weak inspections and tax audits contribute to the level of informality. The perception of poor quality in public services such as healthcare and education may also create a disincentive to pay taxes. The government has developed a revised Strategy and Action Plan for combatting informality, which is expected to be adopted in April 2019.
- **Kosovo's competitiveness continues to be hampered by an unreliable and undiversified energy supply.** Access to electricity remains one of the main problems, creating large costs for businesses. The problem is exacerbated by the unresolved dispute between the transmission system operators of Kosovo and Serbia. Kosovo is investing in renewables, but the current system of feed-in tariffs needs to be reviewed. Despite positive developments, energy inefficiency continues to pose a major problem that warrants close attention. The investment in the Kosova e Re is expected to put upward pressure on prices and this will require appropriate planning and policy response.
- **Very low activity and employment levels and the marginal presence of women in the labour market are the most striking challenges in Kosovo.** No improvement has been achieved in recent years, despite steady economic growth. Very high numbers of young people are out of education or employment, which is not conducive to developing the future workforce. Private-sector employment is of poor quality, with high levels of informality. A comprehensive approach to economic development creating new jobs is not yet in place, and strong skills mismatches persist. Measures for alleviating widespread poverty are very limited, and social expenditure is largely concentrated on categorical benefits and pensions.

**The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2018 has been partially implemented.** Capacities for macroeconomic forecasting and budget planning have increased, but there has been little progress with regard to the options paper on establishing a fiscal oversight body. Investment project management at local level has improved slightly. There has been no progress on reclassifying the war veterans pension beneficiaries. The Law on energy efficiency was adopted in November 2018 and the Energy Efficiency (EE) Fund was established in January 2019. There has been steady progress in the deregulation of energy prices. However, no study was conducted on the gradual adjustment of tariffs to reflect future costs. The new strategy and action plan on combatting the informal economy has been drafted and is undergoing consultation but is not yet adopted. Response to the 2018 policy guidance has been mixed in the areas of employment, social and education policies, reflecting budgetary and administrative capacity constraints on the one hand, but also a complex political environment. Positive developments can be noted in the work of the Employment Agency, but reforms in the education and social sphere are lagging behind.

**The ERP sets out reform plans that are broadly in line with the key challenges and priorities identified by the Commission.** It reflects the government's commitment to stable public finances and supporting economic growth through ambitious capital investment. It also refers to the need to support private sector and promote inclusive growth. However, recently adopted fiscal policy measures could jeopardise achievement of these goals. Weaknesses in electricity supply, access to finance and contract enforcement as well as the large informal economy are also recognised as major impediments. The proposed education, employment and social policy measures are mostly rolled over from previous ERPs. While this is justified to the extent that the measures are still ongoing, there is a lack of structural reforms fostering job creation and addressing structural bottlenecks.

## 7.2. ECONOMIC OUTLOOK AND RISKS

**Robust economic growth continued in 2018**, with real GDP increasing by 3.9 % year on year (y-o-y) in the first 9 months and the ERP estimating it to have reached 4.3 % for the year as a whole. Growth was mainly driven by strong expansion of investment and private consumption, supported by public infrastructure projects, large inflows of remittances, and robust wage and credit growth. The net contribution of trade was negative.

**The ERP assumes a more realistic pace and profile of GDP growth than the linear acceleration envisaged in 2018.** GDP growth is set to accelerate to 4.7 % in 2019 (rather than 4.9 %, as projected in the previous ERP) and slow to 4.2 % in 2020 (previously 5.1 %), before picking up again, to 4.8 %, in 2021. It is expected to be driven by a double-digit average annual surge in public investment, in particular in 2019, financed by the liquidation proceeds of the Privatisation Agency, IFI lending and, strong growth in private consumption amid rising remittances, household credit, higher social transfers and assumed rise in employment. Public consumption is expected to increase by 6.5 % in real terms in 2019 due to higher spending on infrastructure maintenance and in priority sectors such as healthcare and the judiciary, but to adjust downwards in 2020 and grow moderately thereafter. Export growth is set to average 5.5 % in 2019-2021 due to the expected robust expansion of services exports and diversification of merchandise exports. Import growth is projected to average 4.3 % over that period, resulting in a negative contribution of net exports to growth. The ERP assumes that economic output will remain broadly at its potential level.

*Table II.7.1:*

### **Kosovo - Macroeconomic developments**

	2017	2018	2019	2020	2021
<b>Real GDP (% change)</b>	<b>4.2</b>	<b>4.3</b>	<b>4.7</b>	<b>4.2</b>	<b>4.8</b>
<i>Contributions:</i>					
- Final domestic demand	3.0	7.7	6.1	4.9	5.3
- Change in inventories	0.1	0.1	0.1	0.1	0.1
- External balance of goods and services	1.2	-3.5	-1.4	-0.8	-0.6
<b>Employment (% change)</b>	<b>7.6</b>	:	:	:	:
<b>Unemployment rate (%)</b>	<b>30.5</b>	:	:	:	:
<b>GDP deflator (% change)</b>	<b>1.4</b>	<b>1.1</b>	<b>0.6</b>	<b>1.4</b>	<b>0.8</b>
<b>CPI inflation (%)</b>	<b>1.5</b>	<b>1.1</b>	<b>1.3</b>	<b>1.3</b>	<b>1.3</b>
<b>Current account balance (% of GDP)</b>	<b>-6.8</b>	<b>-8.1</b>	<b>-9.6</b>	<b>-9.0</b>	<b>-9.1</b>
<b>General government balance (% of GDP)</b>	<b>-1.3</b>	<b>-2.8</b>	<b>-6.0</b>	<b>-5.3</b>	<b>-4.4</b>
<b>Government gross debt (% of GDP)</b>	<b>15.5</b>	<b>16.2</b>	<b>19.4</b>	<b>22.9</b>	<b>25.1</b>

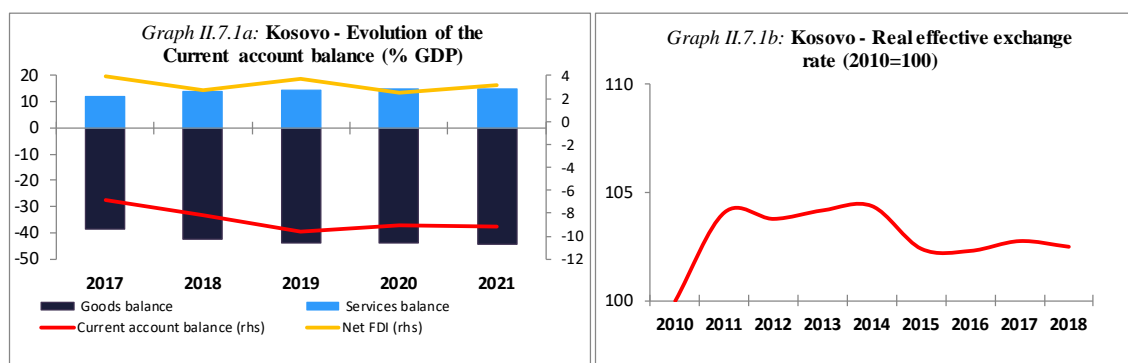
*Sources: Economic Reform Programme (ERP) 2019.*

**The baseline scenario of average growth of 4.5 % in 2019-2021 looks optimistic.** Despite the downward revision from the ERP of 2018, it is still above the 4 % average annual expansion projected by the IMF. One domestic risk is the under-execution of public investment, which is a recurrent issue due to overoptimistic planning and weak capacity for implementation. Moreover, import growth could turn out to be higher than expected given the historical trend and the substantial import component of investment. Political instability, new untargeted social transfers and minimum wage increases could further

undermine the business environment, which is already struggling with widespread informality and high reservation wages. Another downside risk to GDP growth stems from lower-than-projected growth in the EU and its spillovers through slower growth in remittances and moderating demand for Kosovo's goods and services exports. The ERP's 'low growth' scenario takes account of some of these potential downside risks, resulting in 3.5 % average annual growth in 2019-2021. The 'high growth' scenario assumes that the construction of Kosova e Re will start in 2019 and that public investment will be higher than in the baseline, resulting in average growth rate of 5.7 % over the period.

**Price developments are expected to remain benign.** In Kosovo's small euro-ised economy, prices are determined largely by global commodity prices and inflation in the main trading partners. Average annual inflation reached 1.1 % in 2018, as prices rose throughout the year in line with recovering commodity prices, from -0.2 % year on year in January to 2.9 % year on year in December. The key driver, however, was food prices, which rose steadily from July and hit 5.5 % year on year in December following the introduction of 100 % import tariffs on goods imported from Serbia, and Bosnia and Herzegovina (BiH). The ERP expects inflation to remain at 1.3 % on average in 2019-2021, but does not provide further details, e.g. on the expected impact of the import tariffs. The ERP projection is rather benign while the CBK forecasts an annual inflation rate of 2.0 % in 2019. Monthly inflation rates observed in January and February were over 3 % y-o-y, mainly driven by food prices which rose over 6 % y-o-y in each month.

**High trade and current account deficits reflect Kosovo's low production and export base.** Despite robust growth in services exports, the trade deficit is estimated to have deteriorated to 28.5 % of GDP in 2018, from 25.9 % a year earlier. It is projected to widen further, to 29.3 % of GDP on average over 2019-2021, in line with expectations of higher investment and domestic consumption growth. Kosovo's exports of goods still consist mostly of metals, minerals and low added value products, although the improving Herfindahl-Hirschman index points to some export diversification. Service exports are dominated by tourism services to the diaspora. Net transfers (mainly remittances) are the main offsetting factor, at 12 % of GDP in 2018. Remittances are projected to grow by an average of 5 % a year in 2019-2021, which is in line with the historical trend. The current account deficit is expected to deteriorate from 8.1 % of GDP in 2018 to an average of 9.3 % in 2019-2021, which appears broadly plausible.



**While expected to pick up, net foreign direct investment (FDI) continues to cover only a third of the current account deficit.** It fell substantially, to 2.7 % of GDP in 2018, from 3.9 % the previous year. The drop was due to weaker performance by foreign firms and higher repatriation of profits for debt repayments, which reduced the scope for reinvesting earnings. The sectoral FDI structure is still dominated by real estate and renting, which made up 86 % of the total in January-October 2018. FDI inflows are projected to recover to 3.7 % of GDP in 2019, followed by another dip to 2.5 % in 2020, falling below one third of the current account deficit. In the third quarter of 2018, Kosovo's net international investment position stood at -1.7 % of GDP, practically unchanged from 2017. Reserve assets are on a declining trend, from 3.8 months of imports in 2017 to 3.5 in 2018, and are expected to fall further, to around 3 months, in 2019-2021 <sup>(27)</sup>.

<sup>(27)</sup> IMF 2018 Article IV Consultation.

Table II.7.2:

**Kosovo - Financial sector indicators**

	2014	2015	2016	2017	2018
<b>Total assets of the banking system (EUR million)</b>	3 187	3 385	3 637	3 870	4 184
<b>Foreign ownership of banking system (%)</b>	90.4	90.1	88.9	88.1	86.8
<b>Credit growth</b>	4.2	7.3	10.4	11.5	10.9
<b>Deposit growth</b>	3.6	6.5	7.2	6.8	8.7
<b>Loan-to-deposit ratio</b>	74.2	74.7	77.0	80.3	81.9
<b>Financial soundness indicators</b>					
- non-performing loans	8.3	6.2	4.9	3.1	2.7
- net capital to risk-weighted assets	17.8	19.0	17.8	18.1	17.0
- liquid assets to total assets	43.6	44.9	41.5	37.9	39.1
- return on equity	22.5	29.1	19.7	21.3	20.2
- forex loans to total loans (%)	0.3	0.3	0.2	0.2	0.1

Sources: National Central Bank, Macrobond.

**The banking sector accounts for the bulk of financial assets and remains stable, liquid and profitable, but fast-rising consumer and real estate loans require close monitoring.** In January-October 2018, bank lending expanded by 11.6 % from a year before, supported by low interest rates, guarantees extended by the Credit Guarantee Fund for lending to SMEs, and strengthened contract enforcement. Lending to firms and households registered similar rates of growth (11.8 % and 11.4 % respectively). While the level of financial intermediation remains low and there is ample scope for credit deepening, the ERP rightly highlights the need to monitor high loan growth in certain segments, e.g. consumer loans, which strongly outpaced growth in nominal GDP and wages. While its policy toolkit remains limited mainly to minimum reserve requirements, the central bank (CBK) regularly monitors systemic risks and implements macro-prudential policy under a recently adopted framework. Banks have continued to be financed predominantly by deposits; the loan-to-deposit ratio was 83.9 % in October 2018. The proportion of non-performing loans (NPLs) reached a record low of 2.8 % <sup>(28)</sup> and the NPLs are fully provisioned. Risks in the banking sector remain contained and profitability is high, with an average return-on-equity ratio of 18.8 % in October. While insurance and micro-finance companies have become more active, they still account for only 7 % of total financial system assets. <sup>(29)</sup> The ERP does not provide quantified forecasts for the financial sector, but the underlying assumption is of continuing credit growth, with private consumption and investment expected to remain the main drivers of growth.

### 7.3. PUBLIC FINANCE

**Despite the failure to implement the reform of the war veterans pension scheme, the deficit target for 2018 was comfortably met, as capital spending underperformed significantly.** The ERP estimates the 2018 budget deficit at 1.1 % of GDP; while the IMF estimate is higher (1.5 %), both are still comfortably within the fiscal rule ceiling of 2 % <sup>(30)</sup>. The ERP and the IMF estimated the overall headline

<sup>(28)</sup> Improved asset quality, favourable economic conditions and accelerated lending activity partially drove the NPL reduction. However, the bulk of the decline appears to stem from accelerated write-offs, following amendments to the Regulation on credit risk management, which reduced the overall stock of NPLs.

<sup>(29)</sup> The remaining 23 % of financial assets are held by the pension funds.

<sup>(30)</sup> The fiscal rule places a cap on the fiscal deficit of 2 % of forecast GDP, excluding capital projects financed by privatisation proceeds and donors ('investment clause'). This exemption for donor-financed investments can be invoked until 2025, provided

budget deficit at 2.8 % and 3 % of GDP, respectively. Revenues performed largely as expected, although growth in indirect tax revenues slowed to 2.1 % (from 7.2 % in 2017), due to weaker excise and VAT collection, and shortfalls in collection at municipal level. There were more significant deviations on the expenditure side. The failure to reclassify beneficiaries of the war veterans pension scheme in line with earlier plans resulted in spending in that category exceeding projections by some 0.3 % of GDP. Due to weak administrative capacities in capital project planning and management, the capital budget was significantly underspent (by 2.4 % of GDP), even though capital expenditure increased 14 % year on year.

**The 2019 budget targets a fiscal deficit of 2 % of GDP, which is the upper limit allowed by the fiscal rule.** It complies with the fiscal rules by keeping the wage bill constant as a share of GDP and the government's bank balance at 4.5 % of GDP. At the same time, the fiscal stance is expansionary, as the budget envisages a significant increase in both the headline deficit, which is projected to rise by around 3 percentage points (pps), to 6 % of GDP, and as measured according to the fiscal rule definition. The budget provides for a considerable increase in total spending (by around 4.5 % of GDP), driven by an acceleration in infrastructure investment financed by IFIs and privatisation receipts under the 'investment clause', which should raise capital spending by some 3 % of GDP. It also accommodates higher government consumption, social spending and public transfers, in particular higher (permanent) spending on pensions following sizeable increases in basic (20 %) and contributory (15 %) pensions. There are increased allocations to priority sectors such as healthcare, education and the judiciary. The budget relies on savings equivalent to 0.25 % of GDP from the reform of the war veterans pension scheme, for which it allocates EUR 57.9 million, or 0.8 % of GDP (i.e. slightly above the 0.7 % cap) on the basis of a reclassification of recipients. A projected significant increase in total revenues (1.2 % of GDP) is to be driven by indirect taxes, VAT and excise, which account for 76.5 % of total public revenues, reflecting higher total consumption. Substantial revenue gains of around 1 % of GDP should come from initiatives to improve tax debt collection and tax compliance, and from excise rises. Total public revenue and expenditure are set to grow by 7.2 % and 13 % respectively as compared with the 2018 budget, but by 10.2 % and 21.5 % as compared with the estimated 2018 outcome.

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the public debt ratio remains below 30 % of GDP. As a part of the fiscal rule, the wage bill rule provides that the increase in the public wage bill cannot exceed nominal GDP growth. The government deposits used as fiscal buffers are legally required to stay at 4.5 % of GDP as long as the government is using privatisation proceeds. The debt rule provides that public and publicly guaranteed debt cannot exceed 40 % of GDP.

*Box II.7.1: The 2019 budget*

- \* The 2019 budget was presented in October 2018 and adopted in early February 2019.
- \* It targets a deficit of 2 % of GDP in line with the fiscal rule definition.
- \* Revenue: increase of excise on tobacco, improved collection of tax debt, increase in tax base due to economic growth and large imports of diesel cars.
- \* Expenditure: increase in maintenance expenditure, primarily driven by the reclassification of existing spending, increase in subsidies and transfers due to higher pensions and higher number of beneficiaries in other schemes, higher capital spending financed by IFIs and privatisation proceeds.

## Main measures in the 2019 budget

Revenue measures*	Expenditure measures**
<ul style="list-style-type: none"> <li>• Excise tax revenue: increase of EUR 19 million (0.3 % of GDP)</li> <li>• Tax debt collection: increase of EUR 27 million (0.4 % of GDP)</li> <li>• Tax compliance: gains of EUR 14 million (0.2 % of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>• Maintenance expenditure: increase of EUR 71 million (1 % of GDP)</li> <li>• Subsidies and transfers: increase of EUR 74 million (1 % of GDP)</li> <li>• Capital spending: increase of EUR 255 million (3.2 % of GDP)</li> </ul>

\* Estimated impact on general government revenues.

\*\* Estimated impact on general government expenditure.

Source: ERP

**The main objective in 2019-2021 is to maintain fiscal sustainability and compliance with the fiscal rule while addressing significant public infrastructure gaps.** The fiscal strategy is frontloaded. Public revenue should rise by 1.2 pps to 27.4 % of GDP in 2019 and stay stable at 26.9 % in the 2 subsequent years. Non-tax revenue is projected to stay at roughly the same level (around 3 % of GDP). Like revenue, public expenditure is expected to surge in 2019 and grow moderately (by 2 %) in nominal terms on average thereafter. As a ratio to GDP, public spending is projected to increase by 4.5 pps to 33.4 % of GDP in 2019 and decline gradually to 32.2 % and 31.3 % in the 2 subsequent years. The resulting budget deficit, using the methodology of the fiscal rule, will be 2.0 % of GDP in 2019, 1.4 % in 2020 and 1.9 % in 2021, while the overall deficit is projected at 6 %, 5.3 % and 4.4 % respectively.

Table II.7.3:

**Kosovo - Composition of the budgetary adjustment (% of GDP)**

	2017	2018	2019	2020	2021	Change: 2018-21
<b>Revenues</b>	26.3	26.2	27.4	26.9	26.9	0.7
- Taxes and social security contributions	23.3	23.2	24.3	23.9	24.0	0.8
- Other (residual)	2.9	3.0	3.1	3.0	2.9	-0.1
<b>Expenditure</b>	27.5	28.9	33.4	32.2	31.3	2.3
- Primary expenditure	27.3	28.7	33.0	31.8	30.9	2.2
<i>of which:</i>						
Gross fixed capital formation	7.3	7.9	11.1	10.8	10.6	2.7
Consumption	12.1	12.5	13.4	12.8	12.5	0.0
Transfers & subsidies	7.9	8.3	8.4	8.1	7.7	-0.5
Other (residual)	0.0	0.0	0.1	0.1	0.1	0.1
- Interest payments	0.3	0.3	0.4	0.4	0.4	0.1
<b>Budget balance</b>	-1.3	-2.8	-6.0	-5.3	-4.4	-1.6
- Cyclically adjusted	-1.2	-2.5	n.a.	n.a.	n.a.	n.a.
<b>Primary balance</b>	-1.0	-2.5	-5.6	-4.9	-4.0	-1.5
- Cyclically adjusted	-0.9	-2.2	n.a.	n.a.	n.a.	n.a.
<b>Gross debt level</b>	15.5	16.2	19.4	22.9	25.1	8.9

Sources: *Economic Reform Programme (ERP) 2019.*

**Public debt is increasing gradually and is mainly held by domestic public institutions.** While at end 2018 Kosovo's public debt stood at 16.2 % of GDP, which is moderate by regional comparison, high primary deficits are expected to drive a rise in the debt ratio to 25.1 % of GDP by 2021. The 2020 debt-to-GDP ratio will probably be 2.9 pps higher than projected in the 2018 ERP. Around 62 % of the debt is issued domestically and held by a narrow investor base consisting of Kosovo public institutions and banks, with the Kosovo Pension Security Trust and the CBK holding around 29 % and 30 % of domestic debt stock respectively. The international debt is held mainly by IFIs. The share of international debt is expected to increase, to 46 % of the total by 2021. The average weighted interest rate is set to decline gradually, from 2.4 % in 2019 to 1.7 % in 2021. The average maturity of domestic debt rose to 27 months at the end of 2018, from 20 months in 2017, as Kosovo has issued debt with longer maturities more regularly, including bonds with 7 and 10 years' maturity in 2018. Kosovo still does not have access to international debt markets due to the lack of an international credit rating, but the government is reviewing the debt law, which would include provisions regulating the access to international markets. Government deposits should remain at the legally required level of 4.5 % of GDP in 2019-2020 and decline to 3.4 % in 2021, which is technically in compliance with the rule but still implies a reduction of fiscal buffers <sup>(31)</sup>.

<sup>(31)</sup> The underlying assumption for 2021 is that the liquidation funds of the privatisation agency (PAK) will have been spent by then.

## Box II.7.2: Debt dynamics

Table:

Kosovo - Composition of changes in the debt ratio (% of GDP)

	2017	2018	2019	2020	2021
<b>Gross debt ratio [1]</b>	<b>15.5</b>	<b>16.2</b>	<b>19.4</b>	<b>22.9</b>	<b>25.1</b>
Change in the ratio	1.5	0.6	3.2	3.6	2.2
<i>Contributions [2]:</i>					
<b>1. Primary balance</b>	<b>1.0</b>	<b>2.5</b>	<b>5.6</b>	<b>4.9</b>	<b>4.0</b>
<b>2. "Snowball" effect</b>	<b>-0.5</b>	<b>-0.5</b>	<b>-0.4</b>	<b>-0.7</b>	<b>-0.9</b>
<i>Of which:</i>					
Interest expenditure	0.3	0.3	0.4	0.4	0.4
Growth effect	-0.6	-0.6	-0.7	-0.8	-1.0
Inflation effect	-0.2	-0.2	-0.1	-0.3	-0.2
<b>3. Stock-flow adjustment</b>	<b>1.0</b>	<b>-1.3</b>	<b>-2.0</b>	<b>-0.6</b>	<b>-0.9</b>

[1] End of period.

[2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).

The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other effects.

Source: Economic Reform Programme (ERP) 2019, ECFIN calculations.

In line with sizeable budget deficits in 2019-2021, public debt is forecast to rise steadily to 25.1 % in 2021. Robust economic growth is expected to mitigate the increase in the debt-to-GDP ratio. The impact of interest rate payments and inflation are set to be marginal. In contrast, a substantial downward impact on public debt is projected from stock-flow adjustment for 2019 (not explained in the ERP).

**Underestimating current expenditure and overestimating capital spending and revenue growth are the main fiscal risks in 2019-2021.** The projected rise in the revenue ratio relies mainly on a narrowing of the tax compliance gap and collection of the tax debt. While clear targets have been set and measures have been taken to improve tax administration, the risk of missing the ambitious targets is significant. This risk is mitigated somewhat, as the 2019 budget includes contingency measures to adjust spending in the event of revenue shortfalls. On the expenditure side, the allocation for the war veterans pension scheme assumes that the reclassification of beneficiaries takes place, which is far from certain. If it does not, there will be a repeat of the budget overrun seen in 2018. Various additional social benefits for specific groups, such as the recently adopted pension supplement for Albanian teachers active in the 1990s, generous maternity benefits (currently under debate) and an early retirement scheme for the police add further uncertainty and potentially sizeable fiscal risks. On the other hand, the projected major increase in capital spending in 2019 (48 % more than the 2018 outcome) seems overly ambitious given the track record of implementation in previous years. Overall, the budget composition could turn out much less favourable to growth than envisaged, with higher current spending, including social transfers not targeting poverty reduction, and lower capital expenditure. Additional fiscal risks stem from the poor management and financial performance of publicly owned enterprises.

**While the ERP rightly acknowledges fiscal risks relating to new social transfers and revenue underperformance, it is silent on the Law on salaries for public employees (adopted in February 2019).** The ERP projects the public wage bill to grow by 4.2 % on average in 2019-2021, which is in line with the rule capping its growth at the rate of nominal GDP growth. As the overly generous new Law on salaries will only take effect towards the end of 2019, the fiscal impact this year will be manageable. However, the full implementation in 2020 could result in the rule being breached unless mitigating measures are taken <sup>(32)</sup>. To address this risk, the Ministry of Finance is working on secondary legislation to limit allowances and cancel vacant positions in order to comply with the wage bill rule. Containing public wage growth is all the more important as public-sector salaries already significantly exceed private-sector wages and are detrimental to the competitiveness of the economy.

<sup>(32)</sup> A further repercussion is that a higher basic wage in primary education will also raise teachers' pensions, so that the allocations for 2019-2021 will be exceeded.



**The arrangements for financing Kosova e Re, the costs of which are estimated at over EUR 1 billion, give rise to further fiscal risk.** Kosovo has signed a commercial agreement with a US private investor, which is currently conducting the tendering process for engineering, construction and long-term maintenance works. The World Bank has decided not to go ahead with a planned partial loan guarantee. If the government supports Kosova e Re with financing or a guarantee, including a purchase price guarantee, this would have a significant impact on public debt, which was EUR 1.1 billion in 2018 (16.2 % of GDP). A large increase in public debt would also have repercussions for the ‘investment clause’, which can be invoked only if debt remains below 30 % of GDP. Therefore, public support for Kosova e Re would significantly reduce the fiscal space available for other projects.

**The existing system of fiscal rules provides the main anchor for fiscal policy while safeguarding high out-of-budget capital spending.** The adjusted deficit rule caps the fiscal deficit at 2 % of forecast GDP, excluding capital projects financed by privatisation proceeds and donors. This exemption for donor-financed investments can be invoked until 2025, provided public debt remains below 30 % of GDP. The overall debt-to-GDP ratio is capped at 40 % of GDP. As part of the fiscal rules, the wage rule limits wage bill growth to the nominal GDP growth rate from 2018. A further constraint on current spending is a limit on war veterans pension expenditure corresponding to 0.7 % of GDP annually; this has yet to be implemented due to the failure to reclassify recipients. While the authorities remain committed to adhering to the fiscal rules, recurrent pressure from various interest groups for more entitlements and transfers, and the tendency to yield to such pressure to win political support create risks and uncertainty on a regular basis.

#### 7.4. STRUCTURAL CHALLENGES AND REFORM PRIORITIES

**Kosovo has been improving its business environment in recent years and slowly diversifying exports.** However, its manufacturing base continues to be limited, resulting in a persistent trade deficit. Attracting more investment to reach higher growth rates will be needed to improve living standards towards EU levels. This will require continuous implementation of structural reforms across many sectors. The Commission has conducted an independent analysis of Kosovo’s economy and identified the main structural challenges to competitiveness and inclusive growth, drawing on Kosovo’s own ERP and other sources. The analysis highlights a number of structural challenges across many sectors. The three most important ones are: (i) increasing activity and employment levels; (ii) tapping renewable and energy saving potentials and fully opening the energy market and (iii) formalisation of the economy - the energy sector suffers from outdated production capacity, low energy efficiency and a not fully liberalised energy market and a tariff system that does not yet reflect real costs.

##### 7.4.1. Key challenges

###### ***Key challenge #1: Increasing activity and employment levels***

**Kosovo's socioeconomic development is not advancing, since the labour market is not expanding.** Very low activity and employment levels and the marginal presence of women in the labour market are some of the most striking challenges, next to pervasive informal employment and poor job quality in the private sector. Despite steady economic growth, the situation has not changed in recent years and will not do so unless a more comprehensive approach to economic development with creation of new jobs is considered. Skills mismatch also hinders a more sustained labour market expansion, while at the same time increasing numbers of young people are trained for taking up employment abroad. Social expenditure is largely concentrated on categorical benefits and pensions, with limited investments in human capital.

###### ***Key challenge #2: Formalisation of the economy***

**The widespread informal economy represents a major structural weakness.** The most recent EU-supported assessment (2017) showed that it represents around 31.7 % of Kosovo’s GDP with an estimated breakdown of 23.5 % of GDP for the ‘grey economy’ (legal but undeclared activities) and 8.2

% for the ‘black economy’ (illegal activities). A 2014 study estimated that the informal economy constituted 32.7 % of GDP, so it shrank only marginally in those three years. The reduction was bigger in the grey economy, which indicates that more progress was made in public financial management than in law enforcement, especially since most informality consists of undeclared revenue and work rather than unregistered businesses. The reduction in the grey economy was a result of more effective tax administration by both tax and customs authorities. In contrast, the black economy grew in absolute terms (by EUR 35 million) thus outweighing the shrinking of the grey economy. Informality is also a significant problem in terms of employment. Estimations on informal employment range between 30 and 40 %. Agriculture is the economic sector that relies most on informal employment, followed by real estate, construction and wholesale trade.

**A wide range of factors contribute to informality.** The tax burden in Kosovo is low compared with other countries’ (in order to attract FDI dividends are tax-exempted), and is not seen as a major contributor to informality. Similarly, Kosovo ranks 44th in the world for ease of paying taxes, better than both BiH (139th) and Albania (122nd), for example. Instead, factors that contribute to informality seem rather to be institutional weaknesses in the updating and exchange of business information, the burden inspections place on formal companies and the large number of licenses and permits that businesses face. Also, the low trust in government and the perception of poor quality in public services such as healthcare and education discourage tax compliance.

**Informality has many adverse effects.** It creates unfair competition for formal businesses, limiting their opportunities for expansion and further investments in their development, innovation and productivity. It also reduces the opportunities associated with formal employment, including job security and safety at work. According to the latest *Business environment and enterprise performance survey* (BEEPS V) survey, competitors’ informal activity is seen as the major obstacle to doing business in Kosovo. In all, 66 % of firms reported that having to compete against firms in the informal sector was as a major issue, the highest among all 30 countries covered in BEEPS V (the average was 39 %).

**Government efforts to combat informality have focused on the revision of the strategy and action plan, expected to be adopted in April 2019.** Kosovo adopted its first strategy and action plan for preventing and combating the informal economy in 2014; it focused on the development of a legal framework, in particular in the area of anti-money laundering. The more precise qualitative and quantitative indicators in the revised (2019-2022) strategy action plan should improve the monitoring of progress. In particular, regular assessments of the ‘tax gap’ should guide efforts to combat the informal economy. The latest (2017) assessment found that the biggest part of the effective tax gap was in personal income tax (56.2 %) followed by corporate income tax (32.2 %) and VAT (11.6 %). The Kosovo Statistics Agency (ASK) is studying informal activities in four sensitive sectors: transport, retail trade, construction and accommodation. This should further help the government formulate the most effective policy response.

***Key challenge #3: Tapping renewable and energy saving potentials and fully opening the energy market***

**Kosovo’s competitiveness continues to be hampered by the unreliable and undiversified energy supply.** The outdated power system essentially relies on two old, inefficient and highly polluting lignite thermal power plants with total installed capacity of 1 560 MW,<sup>(33)</sup> and covering around 92 % of electricity production. Electricity demand and consumption have grown steadily over the years. This, together with the ageing of the power plants and insufficient flexibility to adapt to consumption in peak periods, means that electricity has to be imported and exported to balance the system<sup>(34)</sup>. While net imports were only 366 GWh in 2018, imports (1 242.2 GWh) and exports (876.2 GWh) were both quite sizeable.

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<sup>(33)</sup> The operational capacity is nevertheless only around 1,038 MW (Kosovo Energy Corporation -KEK).

<sup>(34)</sup> Total production of electricity in 2017 was 5,300 GWh, with an electricity balance of around 90.96 %.

**The duration and frequency of power outages have been reduced** <sup>(35)</sup>, **but the reliability of the energy supply is still well below average for Europe and Central Asia.** Kosovo ranks 113th in the world for ease of getting electricity (World Bank, 2019). The lack of energy security gives rise to significant costs for business and represents the biggest obstacle to attracting high-quality FDI. According to the last BEEPS V, firms perceive the unreliable electricity supply as the second biggest obstacle to doing business in Kosovo. The resultant fiscal burden is higher for micro-enterprises (44.5 % of average annual turnover) and small businesses (21 %) than for medium enterprises (3.9 %) and large businesses (1.8 %).

**Kosovo has not diversified its energy production mix and new generation capacities continue to rely on coal.** The planned construction of Kosova e Re (450 MW), at a total estimated cost of over EUR 1 billion will mean that the 50-year-old, highly polluting Kosovo A power plant can be closed. Kosovo is on track to meet the mandatory target set by the Energy Community of 25 % of renewable energy sources (RES) in gross final energy consumption by 2020 (ASK): the RES share was 23.59 % in 2017. However, this has been achieved mainly by revising the definition of RES to include biomass for heating, which is widely used by household customers, rather than any substantial investment in renewable energy. The Energy Community is expected to adopt new renewable energy targets for 2030, in line with the EU's targets and this will require substantial additional efforts from Kosovo.

**The government is investing in renewables, but its support should be made more cost effective.** The revised measure in the ERP involves building 28 new small hydro power plants (with total capacity of 99.6 MW) and implementing five new wind energy projects (137.4 MW) and two solar energy projects (3.4 MW). This is certainly welcome, but considering the declining costs of renewable energy, Kosovo could advance much further in its RES targets by adopting competitive selection processes for its renewable energy support.

**Another key to overcoming the challenges relating to the energy supply is further investment in energy efficiency.** Distribution losses remain high if compared by regional standards (technical losses of 12.75 % and commercial losses of 8.82 % produced total losses of 21.57 % in 2017). Moreover, investment in and maintenance of the distribution network remain low. The Law on energy efficiency and the EE Fund respond to the policy guidance jointly adopted by Kosovo and the EU in May 2018 and should improve the situation. However, Kosovo would benefit from further energy efficiency incentives to households and private sector (which account for 39 % of the final electricity consumption). It would also benefit from a comprehensive action plan to address inefficient (and highly polluting) heating based on solid fuels (coal and firewood), which do significant harm to public health and the economy, and would also benefit from better energy efficiency statistics.

**There is no open trading in the electricity market and energy tariffs do not yet fully reflect costs.** While Kosovo has made some progress in phasing out cross-subsidies between different categories of customers, the retail market is still only partly deregulated (for the supply of high voltage customers). The contractual framework for the construction of Kosova e Re, whereby a single buyer will purchase the electricity produced by the plant, could be detrimental to market opening. Kosovo has the lowest electricity prices for households in the Western Balkans: EUR 5.9 per 100 kWh in the first half of 2018, as compared with a regional average of EUR 8 and an EU average of EUR 20.4 (Eurostat). In order to mitigate the expected upward pressure on prices from the significant investments required in the sector, Kosovo needs to develop a programme for protecting vulnerable customers in line with Energy Community requirements.

**Regional integration in the energy sector is prevented by the unresolved dispute between the transmission system operators of Kosovo and Serbia.** This is blocking the entry into force of the connection agreement reached in the Dialogue between Pristina and Belgrade and the use of the 400 kV connection between Kosovo and Albania completed in June 2016 (with an investment of EUR 35

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<sup>(35)</sup> The system average interruption duration index (SAIDI) was 13.9 in the *World doing business report* (WDB) 2019, as compared with 62.1 in WDB 2018; the system average interruption frequency index (SAIFI) was 8.9, as compared with 34.7 in 2018.

million). This imposes significant losses on the Kosovo operator (KOSTT) and threatens the security of regional transmission networks.

#### 7.4.2. Labour market, education and social policies

##### Labour market developments

**Labour market performance lags considerably behind the region and the EU, with no sign of a positive trend.** Economic growth has not contributed to employment; the continued growth of the working age population is putting pressure on the labour market and is only partly absorbed by emigration. In 2018 the labour force participation rate fell to 40.9 % from 42.8 % a year before. Participation by women stood at only 18.4 %, and a third of economically active women are unemployed (33.4 %). The overall employment rate stood at 28.8 %, as compared with 29.8 % in 2017, while the wide gap between male and female employment rates (45.3 % and 12.3 % respectively) persisted. The unemployment rate slightly fell to 29.6 % in 2018, from 30.5 % in 2017. High youth unemployment increased further and reached 55.4 % from 52.7 % in 2017. The ERP does not provide forecasts for employment growth or the unemployment and activity rates; however, with large annual inflow of young people to the labour force and so far modest employment growth, large changes in the labour market outcomes are unlikely.

**Further consolidation of Kosovo's labour force survey (LFS) may be necessary.** A survey conducted by the Millenium Challenge Corporation (MCC) in 2017 using the same EU labour force survey as Kosovo (but on age group 15-74) resulted in showing a significantly higher labour market performance (which may even be higher if calculated for age group 15-64). MCC calculated the activity rate at 49.6 % (+7 pps vs LFS), the employment rate at 41.1 % (+11 pps.) and overall unemployment at 16.3 % (-13 pps). The difference between MCC and LFS results is particularly marked for youth, at 29.2 % it is calculated over 20 pps lower than LFS.

**The labour market is characterised by strong gender segregation.** Only a small percentage of women have jobs (2018: 12.3 %), the gender employment gap over 32 pps is among the widest in Europe. Female employment is highest among women aged 35-45 (2018: 16.7 %), while male employment is highest in the age group 45-54 (2018: 65.9 %). Work on a strategic approach to encouraging the entry of women into the labour market is at an early stage. The proportion of young people not in education, training or employment (NEET) is exceptionally high at 30.1 % (2018), well above the regional (2017: 23.5 %) and nearly three times higher than the EU average. There is a strong correlation between employment and education level. Around 66 % of tertiary graduates are employed and they account for 60 % of public sector employees. Secondary graduates are the largest group (43.7 %) in private sector employment.

**The establishment of the Employment Agency (EARK) has been an important step in rebuilding the public employment service.** Counselling services for jobseekers have been in place since 2017 and have reached around 100,000 a year. The provision of training measures is limited due to budget constraints, but around 6,000 mostly medium qualified jobseekers received training at vocational training centers. The EARK budget for active labour market policies will amount to EUR 6.6 million in 2019, including the reintegration fund for citizens returning to Kosovo. No consolidated information is available on the overall amount of active labour market measures provided in Kosovo in multiple donors' projects, few of which are coordinated with EARK. First steps have been taken to develop a specific support for young people with the youth employment action plan.

**Low economic development and a lack of growing firms impede the creation of quality jobs.** Most formal employment is based on temporary contracts (2018: 74.5 %), only 25.5 % of all workers in the labour market have a permanent contract, primarily in the public sector. Informality is a defining labour market feature; estimates of its scale range between 30 % and 40 %, depending on the definition used. The problem is complex and includes work without a contract and/or without social security coverage, but also a substantial proportion of underdeclared work.

**Social dialogue is poorly developed, in particular in the private sector.** Workers' fundamental rights are well established in the public sector only. Private-sector workers are *de facto* not represented by trade unions. A number of business confederations represent mostly the interests of larger (foreign) employers, while over 90 % of registered companies are micro-enterprises with fewer than 10 employees. The general collective agreement negotiated in 2014 is not being implemented, but negotiations for a new agreement have started. A protracted conflict over the composition of the Economic and Social Council (ESC) is to be solved by amending the law governing the ESC, but there have been no concrete developments to date.

*Box II.7.3: Monitoring performance in light of the European Pillar of Social Rights*

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights on equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion to benefit citizens in the EU. Since the 20 principles are essential for countries if they are to achieve fair and well-functioning labour markets and welfare systems, they are equally relevant for candidate countries and potential candidates. The new reinforced social dimension for the Western Balkans includes an increased focus on employment and social reforms through greater monitoring of relevant policies (EC, 2018). The Western Balkans Ministers' Declaration on improving social policy in the Western Balkans (6 November 2018) confirms that they will use the Pillar to guide the aligning of their labour markets and welfare systems with the EU's.

**On most of the principles of Pillar, Kosovo performs considerably below the EU average according to the indicators of the Social Scoreboard<sup>(1)</sup>.** To some extent this is inevitable, since Kosovo is poorer than the EU Member States and the other countries in the region, but points to an urgent need for more effective and substantial policy reforms to improve socioeconomic conditions for the population.

Kosovo		
<b>Equal opportunities and access to the labour market</b>	Early leavers from education and training (% of population aged 18-24)	N/A
	Gender employment gap	Worse than EU average, deteriorating
	Income quintile ratio (S80/S20)	N/A
	At risk of poverty or social exclusion (in %)	N/A
	Youth NEET (% of total population aged 15-24)	Worse than EU average, improving
<b>Dynamic labour markets and fair working conditions</b>	Employment rate (% of population aged 20-64)	Worse than EU average, improving
	Unemployment rate (% of population aged 15-74)	Worse than EU average, improving
	GDHI per capita growth	N/A
<b>Social protection and inclusion</b>	Impact of social transfers (other than pensions) on poverty reduction	N/A
	Children aged less than 3 years in formal childcare	Worse than EU average, trend N/A
	Self-reported unmet need for medical care	N/A
	Individuals' level of digital skills	N/A

**Women and young people have a very marginal presence on the labour market.** The potential of a large young population to boost growth and employment is not utilised; rather, the high pressure on the labour market is absorbed by emigration.

**Investments in the education system, in particular the early stages, is very limited.** The vast majority of children under 5 receive no formal early childhood education. However, the situation has improved considerably for 5-6-year-olds, most of whom have access to pre-school education, albeit only a few hours of curricular activities per week.

**Kosovo's performance on social inclusion, social protection and poverty alleviation is mixed.** Social expenditure is largely concentrated on administering a wide and increasing range of categorical benefits. Financial and other social assistance to the poorest segments of the population is still limited. There is no comprehensive strategy for poverty reduction.

**The statistical system is at an early stage of development.** KAS conducts a quarterly Labour Force Survey based on EU methodology. The quality of the data needs to be improved. Statistics on the social situation are not yet developed in line with EU surveys.

Specific challenges exist with regard to establishing indicators based on population data, e.g. in the area of education.

<sup>(1)</sup> The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance (<https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators>). The 12 indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-28 average (performing worse/better/around EU-28 average) and a review of the trend for the indicator based on the latest available 3-year period for the country (improving/deteriorating/no change). Data from 2014-2017 are used.

## Social Protection System

**Kosovo has very high poverty rates by EU and regional standards.** Data based on EU methodology will become available when the results of the EU survey on Income and Living Conditions (EU-SILC) conducted by KAS for the first time in 2018 are released. Poverty levels measured on the basis of income are high and growing, while consumption-based numbers indicate lower and declining poverty thanks in no small parts to remittances. Overall, international surveys show higher poverty rates than domestic figures. The most recent MCC survey (2017) established an at-risk-of-poverty rate of 36.5 % (around 10 pps above the level for the regional as a whole). Kosovo's Household Budget Survey (2015) indicated a rate of 27.9 %. These are rates before social transfers and tend to drop slightly when social transfers are included. Poverty is more widespread among the rural population, families headed by women, individuals with low education levels and smaller ethnic minorities.

**The level and structure of social spending is not addressing the needs of the poorest.** In 2018, spending on social transfers (6.1 % of GDP) was well below regional levels, but the scale was less problematic than its structure. The biggest proportion of domestic social spending (90 %) is on complex categorical pension schemes, while only 10 % is available for social services and social assistance benefits. In 2018, the government started work to reform the system of pensions and benefits, but did not focus on limiting the further expansion of categorical pensions. The impact of cash social assistance on lowering the number of individuals at risk of poverty and social exclusion is marginal (latest available data: 0.9 % in 2015), while the impact of pensions (11.8 % in 2015) and other categorical social benefits (13.6 %) was considerably higher.

**The provision of early childhood education and care is scarce.** Estimates for all types of public and private pre-school education for children under 5 vary between 1 % and 13 %. Almost no free public childcare is available; this has a significant impact on access for children from vulnerable backgrounds and is also reflected in a clear rural-urban divide.

**Work started in 2018 on improving the framework legislation on early childhood education.** New legislation is planned to improve the regulatory framework for public and private education providers and the inclusion of vulnerable groups (ethnic minorities, disabled children). However, it is not backed by sufficient investment in infrastructure, which is currently very low. Education and training for specialised pre-primary staff have been introduced slowly since 2017-18.

## Education and skills

**The links between education and the labour market are weak.** Basic education outcomes are low as demonstrated by PISA 2015 results ranking Kosovo in the bottom zone of student performance. Enrolment in basic education has generally improved, but there are still significant gaps in completion rates. Ethnic segregation, disability, economic conditions and traditions constitute barriers to access to education for children. Educational institutions at both secondary and tertiary level are not yet in a position to provide the labour market with a skilled workforce matching labour market needs. Skills needs for fostering private sector development are not yet clearly defined. The fact that young people tend to seek employment abroad hampers Kosovo's long-term development and perpetuates its dependency on remittances.

**Insufficient financial and institutional capacities are delaying implementation of Kosovo's strategic plan for education.** Kosovo's national qualifications framework was established in 2011 and formally referenced to the European Qualifications Framework (EQF) in 2016. To date, the managing authority has validated 94 medium-level qualifications offered by 37 accredited providers. However, the practical impact of validations remains limited, as the education and training system is insufficiently prepared to deliver the qualifications.

**The quality of teaching is low in most vocational schools.** Suitable teaching and learning materials are available for only a fraction of training profiles. Discussions in the past 2 years on developing a new core curriculum have remained inconclusive. Local companies have very limited capacity to offer students placements for practical training. Numerous initiatives have been taken in recent years to modernise vocational education and training (VET), but their scope, results and systemic impact remain unclear. As yet, there is no proper diagnosis of what needs to be done to reform and develop the VET sector. Doing so would ensure that domestic efforts and donor support are strategically geared towards commonly established objectives.

**Adult participation in life-long learning is very low and decreasing.** In 2017, it amounted to about 4 %. Measures for the upskilling and reskilling of adults are limited to a small number of active labour market measures and donor initiatives. There is a lack of robust initiatives that would contribute to socioeconomic development, given the low level of skills in the adult population.

#### 7.4.3. Competitiveness and sectoral issues

##### Business environment

**Despite recent improvements in access to finance and the ease of doing business, Kosovo continues to be the least sustainable market economy<sup>(36)</sup> in south east Europe (SEE); in particular it is less competitive than the SEE average (EBRD, 2018).** Key weaknesses in the business environment continue to be unfair competition from the informal sector, unreliable access to electricity, weak rule of law and corruption. Firms are particularly concerned about competition from the informal sector and access to electricity (BEEPS V, 2015). The ERP acknowledges these obstacles and in the past few years Kosovo has adopted more best practices in business regulation and recorded good progress in the World Bank *Doing Business Report*, moving from 117th (out of 190) in 2012 to 44th in 2019 (in spite of a small drop from the 40th place in 2018). It ranks particularly high in ‘easiness of securing a loan’ (12th) and ‘starting a business’ (13th). However, other aspects of the operational environment for businesses, such as the cumbersome inspections and the high number of licences and permits, remain a challenge.

**The effective application of the rule of law is key to improve the business environment.** Effective and independent judicial systems are a prerequisite for an investment- and business-friendly environment as they instil confidence throughout the business cycle. Effective measures to strengthen the rule of law, ensure adequate and timely contract enforcement and increase the transparency of legal changes could improve the business environment in Kosovo and thus enhance productivity and competitiveness. Corruption is an issue of concern and should be addressed as a priority to make Kosovo a more attractive place to do business.

**Micro, small and medium-sized Enterprises (MSMEs) dominate the real sector and still face some challenges in terms of access to finance despite recent improvements.** MSMEs account for 65 % of employment (micro-enterprises alone provide 36 % of total employment), but upscaling of existing firms is needed to create jobs in the private sector. However, upscaling efforts are hampered by the relatively low credit penetration given the income level (with a private-sector credit-to-GDP ratio of 40 % in 2018).

##### Research, development and innovation (RDI)

**Kosovo’s capacity in the research, development and innovation (RDI) sector continues to be very limited.** This is linked to a weak RDI policy governance, limited involvement of the private sector and poor cooperation between business and academia. In spite of the creation of a Ministry of Innovation and Entrepreneurship in Kosovo in 2017, the limited coordination with other Ministries and the very low level of public expenditure (0.1 % of GDP compared to an average of 2 % in the EU) reflect weak political commitment to RDI. While there are no statistical data on private business spending on R&D, MSMEs’ ability to create new competitive products and services is limited. The ERP recognises these weaknesses

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<sup>(36)</sup> Defined by six qualities: competitive, well-governed, green, inclusive, resilient and integrated.



and proposes improving the legal environment for RDI and providing more funding. This is welcome. Kosovo is not yet participating in Horizon 2020, but in 2018 it committed itself to developing a smart specialisation strategy, which could help to focus RDI efforts on the areas of Kosovo's economy that offer the greatest potential for growth.

### Digital economy

**The Government is making efforts to move to a digital economy.** The 2013-2020 Digital Agenda for Kosovo is being implemented and targets are being met. Mobile telephone penetration has reached over 112 % and fixed broadband penetration increased from 48.5 % in 2012 to 93.90 % in the second quarter of 2018. The challenge is now to extend coverage in rural areas. However, the wider use of e-signatures and the digitalisation of the economy in general require an updated enabling legislation. Cybersecurity remains a problem with the Regulatory Authority of Electronic and Postal Communications (RAEPC) clearly lacking adequate financial and human resources. To meet the Digital Agenda for Europe 2020 targets, Kosovo will receive private investment and a EUR 21.1 million loan from the World Bank to upgrade its digital economy. The recent agreement on the gradual removal of roaming prices in public mobile communication networks for all end users is a positive step towards the creation of a regional digital space in the Western Balkans region. This will offer new possibilities for Kosovo's youth, which is also important in light of the high youth unemployment.

### Investment activity

**FDI in Kosovo has fluctuated over the past 10 years, but the long-term trend is down.** Initially (2007-2011) the privatisation process of socially-owned enterprises attracted significant investment, but since 2012 FDI has shifted to less productive sectors such as real estate and construction (95 % of the total FDI inflows in 2018). This has been driven mainly by the purchase of real estate by Kosovo's diaspora, and by public investments. FDI fell further in 2018, by 16 % as compared with the same period in 2017. The reasons include higher repatriation of profits and debt repayments as well as net FDI outflows in construction and manufacturing. The main sources of FDI in 2018 were Switzerland (33 %), Germany (28 %), Albania (11 %) and the US and the UK (6 % respectively).

**Net FDI inflows in Kosovo (estimated at 2.7 % of GDP in 2018) is lower than the regional average (5.5 % of GDP).** There is potential to attract more FDI: Kosovo has a good strategic location, a young population and relatively low labour costs. However, the recent imposition of a 100 % tariff on all imports from Serbia and BiH puts in question Kosovo's commitments to international agreements and may have long-term consequences for the investment climate. Among other key issues affecting FDI are a lack of basic infrastructure and of stable electricity supply, poor education skills, a weak rule of law, corruption and the slowdown in the privatisation process.

## Trade performance

**Kosovo is highly reliant on imports with a persistently high trade deficit** (28.5 % of GDP in 2018 when exports accounted for only 26.4 % of GDP). The trade deficit is particularly high in commodities, where it continues to grow, reflecting a weak production base and a lack of international competitiveness. Kosovo exports crude materials and low-added-value products, and imports a wide range of consumer and capital goods. In 2017, its goods exports represented just 5.9 % of GDP, while goods imports amounted to 44.3 %. Its exports face a number of obstacles including non-tariff barriers in the region (some linked to its status), and high administrative costs. It takes a Kosovan exporter over 2 days (59 hours) to comply with border and documentary formalities at a cost of EUR 232, as compared with an average of 10 hours and EUR 127 in the other five Western Balkan economies (World Bank, 2019). Exports are also hindered by an underdeveloped quality infrastructure.

**Exports are nevertheless slowly diversifying: in particular, exports of services (which produced a positive balance of EUR 770 million in 2018) helped to partly offset the persistent goods trade deficit.** Base metals and mineral products accounted for 48 % of Kosovo's total exports. As in previous years, imports are dominated by mineral products (15 %), processed industrial foodstuffs, beverages and tobacco (12 %), transporting means and vehicles, and equipment. The EU and Central European Free Trade Agreement (CEFTA) parties are Kosovo's main trade partners. The EU accounts for 49 % of imports and 30 % of exports, and 99,6 % of Kosovan products can access the EU market without customs duties. CEFTA parties account for 25 % of imports and 47 % of exports. In 2018, the main export destinations were Albania, North Macedonia and India while the main sources of imports were Serbia, Germany and Turkey.

**Kosovo is encouraged to implement all the aspects of the Regional Economic Area Multi-Annual Action Plan (REA MAP).** The REA MAP is based on EU standards and will facilitate Kosovo's integration in regional and European value chains and will also help increase the attractiveness of the economy for FDIs in tradable sectors.

## Transport

**While underdeveloped, the transport links are less of a constraint to Kosovo's competitiveness than other sectors.** Although the transport and storage sector makes only a small contribution to employment (2.7 %), it contributes 6 % of gross added value (GVA). Kosovo's 2015-2025 sectoral and multimodal strategy and action plan analyses each mode of transport and proposes investments in roads, railways and multimodal transport. In the past years investment has been primarily focused on road infrastructure rather than other modes of transport, without a proper balance of resources devoted to the maintenance of roads and railway networks.

**However, there are early signs of modal diversification into railway.** The maintenance of rail infrastructure has long suffered from low revenues and declining passenger demand (although freight transport by rail has increased in the past 2 years). As a result, only one private operator is licensed in addition to the public one even though a legislative basis has been adopted for opening the railway market. Further connectivity with neighbouring countries in transport and energy would further strengthen the access to, and integration in, the regional market. In February 2019, Kosovo signed a contract for the rehabilitation of Route 10 (a 146 km track linking southern and northern Kosovo), which will be the biggest investment in Kosovo's railway in four decades (around EUR 200 million). When refurbished, Route 10, which is part of the core network, will facilitate internal and regional transport. Aviation is hampered by Kosovo's status and its limited participation in international civil aviation bodies (International Civil Aviation Organisation, Eurocontrol etc.).

## Agriculture

**Kosovo's agriculture suffers from low productivity, even by regional standards.** The sector's contribution to GVA is shrinking (from 14 % in 2009 to 9 % in 2017). Combined with its increasing share of employment in recent years (from 2.3 % in 2015 to 4.4 % in 2017) this suggests a decrease in productivity, although this could also be linked to reduced informality. The low productivity is related to a lack of investments in modernising production and to continued land fragmentation (almost 95 % of farms are smaller than 5 ha and only 1.6 % exceed 10 ha). Poor irrigation infrastructure is another major issue, as are the dysfunctional links between primary producers, processors and the market. There is also a lack of specialisation, as most farms are engaged in subsistence farming, producing several crops, vegetables and animal products at the same time.

**The government seems to lack a clear vision for land consolidation.** The underlying problems hampering the proper use and consolidation of agricultural land include its continued use of agricultural land for construction, property issues, and a reluctance to join agricultural cooperatives. However, most government intervention ignores these issues and consists instead of direct subsidies for agricultural production and food processing facilities. The support schemes would benefit from a more holistic approach to developing value chains and integrating them in export markets.

## Industry

**Kosovo's industry is characterised by low added-value and low diversification.** The sector is dominated by MSMEs with low levels of integration in global value chains, innovation and FDI. In 2017, the manufacturing sector represented 10.9 % of Kosovo's GVA (slightly below the regional average of 12 %). Food processing represented the highest share in terms of employment (21.8 %), number of enterprises (26.2 %) and turnover (21.8 %), followed by the production of non-metallic mineral products. However, basic raw materials and mineral products still account for 55 % of Kosovo's exports followed at some distance by prepared foods, beverages, alcoholic beverages and tobacco (9.7 %).

**Many structural problems are hindering industrial development.** There is no comprehensive policy framework and only weak support services for SMEs. Inter-ministerial coordination in this policy area is very weak and responsible institutions such as Kosovo investment and enterprise support agency (KIESA), lack capacity. The emergence of industrial clusters is hampered by the lack of an overall vision based on a solid needs assessment. A number of business parks and economic zones have been identified and are promoted as industrial clusters, but many suffer from under-use and under-investment. Poor cooperation between companies and educational and research institutions and the generally low level of skills in the labour force lead to low production capacities and a lack of product quality and innovation.

## Services

**The services sector is the largest in the economy and an even larger contributor to employment; it also accounts for an increasing share of Kosovo's trade.** It contributes 71.9 % to GDP, 81.2 % to employment and 39 % to total trade. 86 % of registered firms are active in the services sector and they generate 87.3 % of firms' total turnover in the economy. Employment in services is concentrated in wholesale and retail trade, construction, accommodation and food services, education and health services, and public administration. Services are also the fastest growing export sector, with a trade surplus (14 % of GDP in 2018) which has partly offset the trade in goods deficit. Around 80 % of services exports are 'travel services', mostly linked to Kosovo's diaspora, and 8 % are 'other business services'. Unfortunately, the ERP fails to provide any proper analysis of the services sector as a whole and merely refers to some general obstacles as regards tourism.

**Information and communication technology (ICT) has started to play an increasing role in Kosovo's economic growth.** According to the 2018 Kosovo IT barometer, 74 % of IT companies export their services and products (16 % increase from 2017). However, the ICT sector still ended 2018 with a negative trade balance. However, it is not the growth of exports in the ICT sector itself that will lead to

sustainable economic growth, but the application of digital solutions in the wider economy (e.g. energy supply, finance, agriculture). An organic growth of the ICT export sector could also help create an additional edge in the business model of Kosovo's economy, and contribute to economic growth. The World Bank's 'KODE' (Kosovo digital economy) project is one of the initiatives tackling the issue of how to apply digital solutions in the wider economy, which it is addressing through support for internet connectivity and skills. There is also a shortage of skilled and qualified workers (78 % of IT companies complain about this and 92 % claim that their businesses are affected by brain drain).

**A major limitation for the services sector are the inadequate arrangements with neighbouring countries for the mutual recognition of professional qualifications.** To make things worse, Kosovo suffers from discriminatory requirements based directly or indirectly on the nationality of providers or their staff or, in the case of companies, the location of the registered office. There are regional efforts to create a regional economic area that could stimulate growth by facilitating further specialisation in each economy and access to economies of scale. However, Kosovo is currently not playing a constructive role in this effort with its imposition of 100 % tariffs on goods from Serbia and BiH.

7.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2018

Overall: Partial implementation (41.7 %) <sup>(37)</sup>	
2018 policy guidance	Summary assessment
<p><b>PG 1:</b></p> <p>Enhance the institutional capacities and ensure appropriate staffing at the Ministry of Finance in order to improve macro-fiscal planning, forecasting and fiscal impact assessments.</p> <p>Prepare an options paper on the establishment of an independent body for fiscal oversight for further consultations with stakeholders, including the EU.</p>	<p>There was <b>partial implementation</b> of PG1:</p> <p>1) <b>Partial implementation:</b> In 2018, the Ministry of Finance (MoF) recruited three additional staff members, bringing the total to five economists in the macro unit (excluding the director), and it plans to recruit two more in 2019. They have attended a number of training courses.</p> <p>2) <b>Limited implementation:</b> The MoF has set up a working group to work on the options paper. It consists of representatives of various institutions (including ministries, the CBK and the statistics office) and civil society; it has held several meetings to discuss practices in neighbouring and EU countries. However, the paper has yet to be produced.</p>
<p><b>PG 2:</b></p> <p>Complete the war veteran certification and reclassification processes with a view of decreasing costs of the war veteran pension scheme in line with the current legislation.</p> <p>Strengthen institutional capacities at central and local government levels for multiannual investment planning, and investment project preparation and management in order to improve the execution of capital spending.</p>	<p>There was <b>limited implementation</b> of PG2:</p> <p>1) <b>Not implemented:</b> The reclassification has not been done and is long overdue. The 2019 budget plans for this scheme to cost around 0.7 % of GDP in 2019, which is the ceiling laid down in the Law on war veterans. However, the ceiling only enters into force after the reclassification is finalised. Without it, the allocated funds will not be sufficient and budget overruns are set to continue.</p> <p>2) <b>Limited implementation:</b> The MoF has prepared two administrative instructions (AIs) that will help authorities improve the planning, selection, execution and monitoring of capital projects; the AIs on ‘the definition of capital projects’ and ‘selection criteria for capital projects’ apply at both central and local government levels. They are currently undergoing public consultation. The 2019-2021 ERP does not report on the implementation of this measure.</p>

<sup>(37)</sup> For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission’s Overview and Country Assessments of the 2017 Economic Reform Programmes available at [https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments\\_en](https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en).

<p><b>PG 3:</b></p> <p>Continue expanding the central bank’s analytical toolkit by developing an inflation expectations survey.</p> <p>Ensure that central bank purchases of government bonds and bills on the secondary market do not amount to de facto central bank financing of the government.</p> <p>Further address the underlying legal and institutional factors hampering access to finance for SMEs, while monitoring carefully high lending growth to households.</p> <p>Finalise the bank resolution and the crisis management frameworks to strengthen the overall resilience of the banking sector.</p>	<p>There was <b>partial implementation</b> of PG3:</p> <p>1) <b>Limited implementation:</b> A survey has not been established and the CBK is still investigating its design.</p> <p>2) <b>Limited implementation:</b> In the ERP, the CBK states that ‘CBK investment is guided by the Law on the Central Bank and its internal investment policy’. More transparency on any thresholds or directives indicated in the CBK’s investment guidance would help.</p> <p>3) <b>Partial implementation:</b> The Kosovo Credit Guarantee Fund is used extensively by commercial banks, but regulatory and judicial bottlenecks continue to hamper SMEs’ access to finance.</p> <p>4) <b>Partial implementation:</b> The CBK has finalised the bank resolution and liquidation manual, and is currently working on the crisis management framework.</p>
<p><b>PG 4:</b></p> <p>Adopt the Energy Efficiency Law and establish the Energy Efficiency Fund.</p> <p>Adopt energy efficiency incentives to the private sector and households.</p> <p>Advance in the deregulation of electricity supply prices and</p> <p>Conclude a study with the aim of adopting a plan for the gradual adjustment of energy tariffs to reflect actual costs.</p>	<p>There was <b>partial implementation</b> of PG4:</p> <p>1) <b>Full implementation:</b> The new Law on energy Efficiency (EE) was adopted in November 2018. The EE Fund was established in January 2019 and is expected to become fully operational in June 2019.</p> <p>2) <b>Limited implementation:</b> Some limited support schemes for the private sector and households exist/are planned with support from the European Bank for Reconstruction and Development (EBRD) and the Millennium Challenge Corporation (MCC).</p> <p>3) <b>Full implementation:</b> Power generators have been selling electricity at deregulated prices since April 2017 and sales to industrial (110kV) customers have been deregulated since April 2018. For households and commercial consumers up to voltage levels of 35kV prices are also deregulated since April 2019 and for 10kV they will be deregulated from April 2020.</p> <p>4) <b>Limited implementation:</b> No such study has been conducted, but work has started (with World Bank support) to assess the possible impact on the most vulnerable consumers.</p>
<p><b>PG 5:</b></p> <p>Adopt the new Strategy and Action Plan 2019-2022 to fight the informal economy that should include qualitative and quantitative targets.</p>	<p>There was <b>partial implementation</b> of PG5:</p> <p><b>Partial implementation:</b> the new strategy that includes qualitative and quantitative targets has been drafted, but still needs to be finalised. Currently the new strategy is in the consultation process and it is expected to be adopted in May 2019.</p>
<p><b>PG 6:</b></p> <p>Monitor the implementation of the youth employment action plan</p>	<p>There was <b>partial implementation</b> of PG6:</p> <p>1) <b>Substantial implementation:</b> The government adopted the action plan on youth employment on 04 January 2018. Detailed tools were developed to monitor its implementation. The first 6-monthly monitoring report focused on whether activities had started, and what</p>

<p>and increase the scope of active labour market measures in particular for women.</p> <p>Conduct a skills needs analysis for identification of priority sectors to inform the review of occupational profiles and curricula.</p> <p>Complete the necessary steps for the introduction of the general health insurance scheme.</p> <p>Increase enrolment in pre-school education.</p>	<p>remedial action was needed. The first mid-term assessment will be carried out in mid-2019.</p> <p>2) <b>Limited implementation:</b> Progress has been made as regards the participation of women in active labour market measures (ALMMs), but overall there are significantly fewer female than male participants. The Employment Agency is nearing completion of an in-depth evaluation of all ALMMs, which will also evaluate the gender gap in participation.</p> <p>3) <b>Partial implementation:</b> With support of GIZ, an overview of current vocational education and training (VET) provision in VET schools, the vocational training centers and other private providers has been established, which could support a skills needs analysis that has not yet been conducted.</p> <p>4) <b>No implementation:</b> The start of premium collection has been further postponed.</p> <p>5) <b>Partial implementation:</b> The achievement of 100 % enrolment in pre-school education is hindered by lack of facilities in some areas of the country. Licensing of pre-school education establishments continued.</p>
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## 7.6. THE 2019 POLICY GUIDANCE

### **JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TURKEY**

The Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

Brussels, 17 May 2019

[...]

In light of this assessment, Participants hereby invite Kosovo\* to:

1. Complete the war veteran certification and reclassification processes in order to decrease the costs of the war veteran pension scheme in line with the current legislation. Ensure, if necessary through secondary legislation to the Law on Public Salaries, that the 2020 budget complies with the existing fiscal rules, in particular with the wage bill rule. Improve the collection of tax revenues so that the ambitious revenue projections for 2019 are fully met.
2. Improve financial oversight and accountability of publicly owned enterprises. Strengthen institutional capacities at central and local government levels for multiannual investment planning and investment project management in order to improve the execution of capital spending. Prepare an options paper on the establishment of an independent body for fiscal oversight for further consultations with stakeholders, including the EU.
3. Continue improving the central bank's analytical toolkit, including by establishing an inflation expectations survey. Further identify and address the underlying legal and institutional factors hampering access to finance for SMEs. Closely monitor the emergence of potential financial stability risks related to the consumer loan segment, deploying appropriate micro- and macroprudential policy tools if needed. Continue to base decisions concerning the central bank's holdings of government securities on a transparent investment policy, and gradually reduce their level to avoid crowding out private sector activity on the secondary market.
4. Increase energy efficiency incentives for the private sector and households; adopt a plan that includes the gradual adjustment of energy tariffs reflecting expected increases in costs and mitigation measures for vulnerable consumers; improve the support schemes for renewable energy projects with the introduction of competitive bidding/auctions for renewables support.
5. Ensure the implementation of the new Strategy and Action Plan 2019-2023 to fight the informal economy in accordance with the prescribed timetable, integrating appropriate actions to address undeclared work.
6. Develop active measures for increasing female labour market participation and employment. Increase the provision of vocational education and training for professions in demand. Increase investments in education with particular focus on expanding early childhood education.



## ANNEX A: ASSESSMENT OF STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP

### **Measure 1: Reducing energy consumption through energy efficiency measures**

This measure is highly relevant. While carried over from last year, it has been substantially improved and its scope has been extended to activities targeting the residential sector (the largest consumer of energy in Kosovo), in line with the policy guidance recommendation issued in May 2018. It also involves capital investment to reduce technical and commercial losses in the network. The inclusion of activities relating to the EE Fund (another milestone development in addressing last year's policy guidance) shows policy planning consistency.

However, the proposed indicators relate to the overall targets and do not reflect the impact of the proposed measures. Two of them (energy intensity of GDP and energy consumption per employee) also lack specific intermediary targets for 2019 and 2020. Moreover, for the measure to have a significant impact on Kosovo's economy, the planned investments should be combined with other policies to incentivise energy saving and 'soft reforms' such as secondary legislation on energy performance and enforcing capacities.

### **Measure 2: Further development of energy generation capacities**

This measure is rolled over from last year's ERP and implementation of some of last years' activities is proving slower than expected (investments in new hydropower and solar projects have been only partly implemented). If fully implemented, its effects on Kosovo's economy would be sizeable. However, the planned activities are over-ambitious. The core project of the measure is the construction of Kosova e Re. While preparations have progressed since last year, procurement and construction tendering are at the stage of technical and financial proposals. The ERP understates the risks associated with this measure. These include political, financial (funding, potential impact on tariffs and the budget, state aid), social and environmental risks. The new investments will also require a plan to adjust energy tariffs gradually to reflect actual costs and to assess potential mitigation mechanisms to minimise the impact on the poor and vulnerable in a fiscally sustainable manner.

Moreover, the measure is overly focused on infrastructure projects and lacks attention to 'soft reforms', such as the introduction of a market-based mechanism for the further development of RES. The costs that are described (EUR 6 million) reflect only the allocations from the budget and not the real cost. The indicator on the share of energy generated from RES is directly linked to the objective of developing new energy generation capacities and improving energy security, but it lacks intermediate targets for 2019 and 2020.

### **Measure 3: Structural change in the agro-processing sector**

This reform measure is very important to improving Kosovo's competitiveness and long-term growth potential. Some of the activities, are quite relevant and suggest a genuine intention to reform, e.g. the development of a master plan on irrigation (examining the possible expansion and rehabilitation of irrigation canals) and the introduction of alternative irrigation measures. This is likely to pave the way for significant donor support in this area. On the other hand, the other activities seem to continue to relate to the Ministry of Agriculture's regular grant and subsidy schemes (over EUR 145 million allocated). No justification is provided for including such schemes in the ERP, which should focus on structural reforms. The ERP does not describe what, if any, impact assessment is to be done to determine the allocation of these subsidies. One of the suggested indicators (increase in added value per year) could be pertinent to assessing improvements in competitiveness, but the link between the proposed activities and the indicator is not evident. A good indicator would have been progress in addressing Kosovo's considerable structural trade deficit in agro-processing products. It is also difficult to determine progress in the previous year's activities, as for most the only information provided is the number of applications approved, which gives no indication of results achieved. Also, advances in irrigation are not given in terms of percentage of irrigated land, so it is impossible to estimate the real impact.

**Measure 4: Consolidation and inventory of agricultural land**

The fragmented structure of agricultural land is one of the key issues affecting the productivity of the sector, so this measure is highly relevant. Nevertheless, many of the weaknesses mentioned in last year's assessment remain: there are neither baseline data nor data on the expected results (i.e. increased percentage of consolidated arable land). Moreover, very limited progress was on the implementing activities planned for 2018.

Some activities included this year are welcome and could be the starting point for a proper consolidation of agricultural land. However, considering the importance of this reform, it lacks ambition and is limited to the drafting of concept documents (on the inventory and the regulation of agricultural land) and support for a few municipalities in the preparation of municipal zoning maps. In terms of actual consolidation, the measure aims to consolidate only 75 ha in one municipality in 3 years, which shows the absence of a strategic vision and a real commitment to meaningful reform.

**Measure 5: Increase competitiveness in the manufacturing industry**

This measure is an adapted version of last year's measure supporting industrial SMEs. Closer cooperation between SMEs, enhanced networking, improved public-private dialogue, and better production quality are central to competitiveness in the industrial manufacturing sector. However, there appears to be no comprehensive strategy or action plan behind the measure. While sectors with greater industrial potential are mentioned, there is a failure to identify the main obstacles to their competitiveness.

The study of the value chain for high-potential sectors is certainly welcome and can help guide investment to areas of greater impact. However, the level of ambition is very low (only one sector to be studied per year) and the sequencing of some of the activities is unclear (e.g. construction of physical infrastructure in three economic zones in 2019 before amending the Law on economic zones in 2020) and their purpose not explained. In order for action in the industrial sectors to create new opportunities, it needs to be backed by proper policy analysis. Key performance indicators are quantified and meaningful, but it is not clear how they relate to the proposed activities. Moreover, they lack targets for 2019 and 2020.

**Measure 6: Enhancing competitiveness in the Tourism and Hospitality Sector**

This measure is rolled over from the past two ERPs and its main weakness continues to be the lack of vision and political will to implement even the most basic element: developing a policy framework. This was to have been done in 2017. Two years on, the ERP continues to propose the drafting of a strategy and a law on tourism. Although some of the proposed activities seem relevant, in the absence of a policy framework, it is difficult to assess their relative importance and, as a result, they appear rather ad hoc and scattered. The measure is linked to the draft private-sector strategy, but it involves drafting a separate strategy on tourism. The budget for its implementation is rather low, especially as it envisages investments in rural and farm tourism and involves several institutions.

**Measure 7: Adoption of evidence-based policies and addressing administrative burdens**

This measure, rolled over from previous years, has now become more clearly centred around the simplification, merging and repealing of licenses and permits for businesses. It is realistic given the capacities in the sector and its cross-ministerial nature. It is also among the indicators agreed for the EU's public administration reform (PAR) sector budget support. The impact on the private sector will probably take time to materialise as the activities are initially focused on setting up the administrative procedures for the actual burden reduction. However, this is being done in a systematic way with the aim of institutionalising the initiative.

**Measure 8: Securing property rights by addressing informality in the immovable property sector**

This measure is very relevant and could have a significant important impact on the business environment by securing property rights, unlocking access to finance and facilitating dispute settlement, which are all essential to providing legal certainty and attracting local and foreign investment. The measure, rolled over

from the past 2 years, is well planned. While its scope is ambitious, there seems to be sufficient political will, donor support and local stakeholder engagement, which have enabled implementation to advance well. Most activities planned for 2018 have been carried out or are in the final stage of implementation. The measure could also have a positive gender dimension in helping women to enjoy equal property rights and facilitating their economic independence. The proposed indicators are relevant, but two of them (increase of requests at the notarial office for settlement of old inheritance; requests for formalisation of informal transactions per year) do not seem ambitious enough to make a significant impact.

#### **Measure 9: Increase the efficiency of the judiciary in resolving cases**

This measure aims to improve the efficiency of the judiciary in addressing economic disputes by implementing a case-management information system so as to reduce backlog. The reform, rolled over from the past two ERPs, continues to be highly relevant. Implementation advanced well in 2018, notably with the drafting of legislation and the recruitment of judges and professional associates.

The measure focuses on the case-management information system, a technical tool to allocate and assign cases. However, it would have a greater impact if equal, if not more, attention were given to reducing the length of proceedings, introducing fines for unnecessary adjourned hearings, enhancing judge's performance and supporting the use of alternative dispute resolution mechanisms. The proposed indicators are pertinent, but there is no indication of the current backlog to be able to assess progress.

#### **Measure 10: General inspection reform**

This measure was introduced last year and seems pertinent to easing the unnecessary burden for businesses of frequent, uncoordinated and costly inspections. However, the diagnosis of the business environment provides no information as to the magnitude of the problem and its effect on businesses, so the relevance of the measure is difficult to assess. While some steps were taken in 2018, the process has suffered delays and the harmonised law on inspections still awaits finalisation and adoption.

The reform requires solid administrative capacity and an ability to overcome resistance to changes. Both risks are identified in the measure. The proposed timeline and activities for 2019-2020 are in principle reasonable and achievable. The measure has strengthened with the inclusion of the screening of sectoral laws and secondary legislation to align them with the new law on inspection, with implementation of the electronic data management system and with equipment for the market inspectors. However, the expected impact is analysed only very broadly and the proposed indicator (increase in the number of complaints handled) does not really measure the impact of reducing the burden for businesses.

#### **Measure 11: Reduction of informal economy**

The introduction of this new measure is very welcome as it addresses one of the key obstacles to doing business in Kosovo. It is also in line with the policy guidance provided in May 2018. The proposed activities are ambitious, but at the same time focused and practicable. The proposed indicators are relevant but they refer to *ex ante* assessments, which should be carried out as a matter of priority in order to be able to monitor progress. Overall, and considering the limited cost and high potential impact, this measure (if fully implemented) could be the most cost-effective in the ERP.

#### **Measure 12: Improvement of innovation and entrepreneurship environment**

This measure has continued to suffer from slow implementation, in particular a delay in adopting the new law and strategy. However, progress was made with the functionalisation of the Council for Innovation and Entrepreneurship and the launching of the programme for direct financial support. The measure involves an important focus on financial support for innovative businesses, start-ups and NGOs. As a result, the only proposed indicator is the number of such entities supported which does not give a sense of reform. While the measure could have an immediate impact on the competitiveness of a limited number of companies, it will not lead to overall improvement in the innovation and entrepreneurship environment, which still requires an overarching long-term strategy. The development of a smart specialisation strategy in Kosovo would contribute to the achievement of the objective.

The measure involves support for several innovation and entrepreneurship centres. Considering the obstacles that existing incubators face in Kosovo, these activities would probably have greater impact if accompanied by the improvement and expansion of the services these centres provide, so that they can support businesses at various stages of their development.

#### **Measure 13: Expansion of relevant ICT infrastructure network for socio-economic development**

This measure is carried over from past ERPs and remains fully relevant considering the relatively low broadband penetration in Kosovo. Implementation advanced in 2018, notably with 14 pilot projects to extend the ICT network infrastructure in rural areas and agreement on a EUR 20.7 million World Bank loan that will allow investment as from 2019. The measure includes activities aimed at developing infrastructure, supporting the digitalisation of businesses and enhancing e-skills among young people. However, this latter activity appears limited and could be developed further and at different levels, from primary schools to vocational training, to achieve impact.

To increase the potential impact, the measure could also include investment in the infrastructure needed for connection to GEANT (the pan-European data network for the research and education community). Another important aspect, which is not mentioned in the measure, is fostering links between education, research innovation and the economy by establishing national research and education networks. Moreover, in the past 3 years the ERP assessments have highlighted the need to complement infrastructure investments with competition between operators and regulator independence; this has still not been addressed.

The ambition of the proposed indicators, which involve an increase in the number of cadastral zones and public institutions covered, is also difficult to estimate. A more meaningful indicator would have been the increase in the percentage of the population covered by broadband infrastructure (penetration rate).

#### **Measure 14: Trade facilitation — increasing the cost-effectiveness of international trade transactions**

This measure has been rolled over from the previous ERP, but the planned activities have been changed substantially. The measure is now much broader in scope and ambition. Several activities include EU-supported processes, such as the laws on internal and external trade, and the system for exchange of excise data (SEED+). However, some activities (e.g. the draft legislation for digital signature) have been dropped without a justification. The implementation of some activities e.g. WTO membership negotiations, entails political risks and depends on external factors. The proposed indicators are pertinent, but the targets do not seem very ambitious. Some recent measures adopted by Kosovo, such as the 100 % tariffs on imports from Serbia and BiH and the introduction of barriers to 'protect' domestic businesses may undermine the efforts and impact of this measure.

#### **Measure 15: Further development of quality infrastructure and empowerment of market surveillance authorities, with focus on construction products**

This measure remains highly relevant for competitiveness and central to implementing the Stabilisation and Association Agreement. Overall, there was good progress in implementing the activities planned for 2018, in particular with the adoption of important legislation. Activities for the upcoming period (2019-2021) focus on the construction sector and, while well defined, may prove to be too ambitious. The continued lack of qualified staff and financial resources in the responsible agencies is recognised as a risk, but no mitigating measures have been considered.

#### **Measure 16: Improve the quality of VET on the basis of labour market requirements**

The reform, which involves drafting and reviewing occupational standards, is already lagging behind as regards previous ERPs, according to which a good proportion of standards should have been completed in 2017 and 2018. There is no mention of the 25 new standards to be defined and verified. Only three were drafted last year (on interior design, wood workers and wood processors), while another four are being drafted (on technical engineering, plumbing and pipe installers, mechanics, and electrical and heating installers). The budgetary impact of the reform is still unclear, especially as it relies to a great extent on

donations from external stakeholders that have not even been identified. There is no clear breakdown of the total cost of the action.

#### **Measure 17: Better and more inclusive pre-university education**

The proposed reform concerns only pre-school (not pre-university) education. The reforms are primarily aimed at increasing the enrolment of pre-school children rather than achieving greater inclusion. The ERP target of 100 % by the 2021/2022 academic year seems reasonable. Reaching 44 % for 3-5 year-olds in the same period will be more challenging, as the current rate is just over 33 %. The inclusion aspect of the reform is less developed.

#### **Measure 18: Reform in higher education**

The proposed reform is very broad and vague, mixing legislative objectives with infrastructure construction and student assessment. The full implementation of the reform depends on the adoption of the revised draft law on higher education. The government approved the draft law in November 2018. The process of drafting and adopting the Law on the Kosovo Accreditation Agency is advancing and will probably be completed. The new Board of the Agency ensures transparency and is currently working for its readmission to the European Quality Assurance Register (EQAR). The key performance indicators of the measure depend not only on the adoption of legislation in the upcoming period, but also on the allocation of additional funds. The costs of improving the teacher/student ratio and establishing further quality assurance mechanisms have been underestimated. As a result, the budgetary impact of the reform is still unclear, especially as it relies to a great extent on donations from external stakeholders, which have not even been listed. The 2017-2021 education strategy adopted in 2016 has an accumulated deficit of around EUR 44 million (against the EUR 176 million initially earmarked).

#### **Measure 19: Improving young people's and women's access to the labour market by providing quality employment services, active employment measures and entrepreneurship**

The initiatives are appropriate and a continuation of established policy priorities. The focus on training and labour market programmes is valid. The targets relating to women and young people are good, but there is scope to incorporate targets relating to rural areas and perhaps also to the long-term unemployed. Kosovo aims to make greater use of the validation of prior learning and career guidance in the mix of labour market programmes. This could be made more explicit. It intends to include career and validation measures in the learning packages, so these could more accurately be called 'learning and assessment packages'. This will be particularly important for women returning to the labour force and young people who have acquired skills in the informal sector. To maximise the use of existing materials and capacities, the Employment Agency should seek to take advantage of any relevant experience of staff in the Ministry of Education. As with the education measures, there is scope to emphasise cooperation with employers to capture information on vacancies and anticipated skills needs, and to use the experience gained from the use of tracer studies.

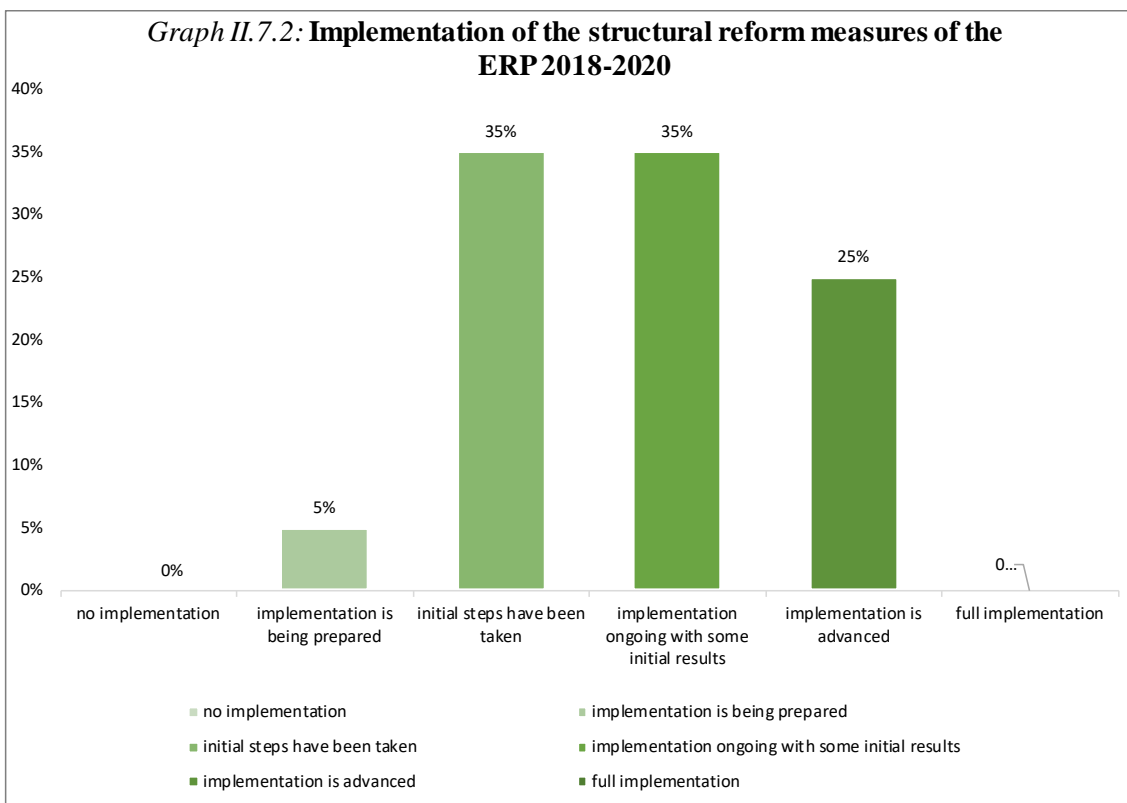
#### **Measure 20: Improvement of social and health services**

This measure is again rolled over from the previous ERP and its effective implementation requires a more resolute approach.

**ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM ERP 2018-2020**

There was a relatively good progress in the implementation of the measures in 2018, with an average score of 3.2 out of 5. The reporting on the planned activities is thorough and while in some activities the scoring provided is slightly high, overall, it provides a fair description of the level of implementation.

Implementation is higher in some measures, such as measure 8 on the adoption of evidence-based policies and reducing administrative burden, measure 10 on increasing judicial efficiency through reduction of court case backlog and measure 13 on the expansion of ICT infrastructure. At the same time, implementation is weaker in other measures, such as measure 12 on improving entrepreneurship and the innovation environment and measure 17 on reforming pre-university education and particularly weak on measure 5 on expanding farms through consolidation and regulation of agricultural land.



## ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Economic Reform Programme 2019-2021 was adopted by the Government on 29 January 2018 and submitted to the Commission on 30 January 2019 within the deadline. It is in line with the previously approved medium-term fiscal strategy and national development strategy. No components of the ERP are missing.

### *Inter-ministerial coordination*

The preparation of the ERP was centrally coordinated by the Ministry of Finance with the support of the Office for Strategic Planning in the Office of the Prime Minister (OPM). All relevant line ministries contributed to the drafting of the programme and were fully consulted.

### *Stakeholder consultation*

Section 6 of the ERP provides information on the public consultation of the ERP. A draft ERP was made available to the public on the OPM website in December 2018 and January 2019. Written comments from stakeholders were annexed to the ERP with an explanation of which comments have been accepted and integrated. No consultation of the Economic and Social Council took place.

### *Macroeconomic framework*

While somewhat optimistic, the macro-fiscal framework presented in the ERP is broadly plausible and coherent, and provides an adequate basis for assessment. External assumptions have been taken from the IMF's October 2018 *World economic outlook* and the Commission's autumn 2018 forecast. The alternative 'low growth' and 'high growth' scenarios are useful for showcasing the likely impact of some expected and unexpected developments in Kosovo's economy. Forecasts for the labour market and the financial sector are still lacking. The ERP fails to discuss the expected economic impact of the recent decision to impose 100 % tariffs on imports from Serbia and BiH. The cyclical analysis is of limited usefulness, given the short time series available.

### *Fiscal framework*

The fiscal framework was prepared on the basis of the 2019 budget. It envisages relatively high revenue and expenditure projections as compared with the 2018 outcome; these are subject to a number of risks that are partly acknowledged in the ERP. There is no discussion of fiscal risks relating to the new Law on salaries for public employees. Structural measures in the ERP have been included in the 2018 budget. No projection is provided for the cyclically adjusted budget balance. Intended changes in debt management could have been explained better. The fiscal tables in the annex to the ERP are not fully consistent with the main text.

### *Structural reforms*

The structural reforms sections (4, 5 and 6) follow the guidance note. The reporting of the implementation of the policy guidance and the structural reform measures from the 2018-2020 ERP (table 11 in annex) is largely sufficient, but miss some important information (e.g. no reference to adoption of the plan for the gradual adjustment of the tariffs). The number of reform measures is limited to 20 and the page limit (40) for section 4 is respected. The structure of the reform measures is good, in terms of scope and clarity of timeline and budget for activities planned in the three years of the programme. However, activities could be more precise and indicators defined for the estimated impact. Tables 9-11 of the annex are filled in appropriately.





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