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2016 Economic Reform Programmes of Albania, the former Yugoslav Republic of Macedonia, Montenegro, Serbia, Turkey, Bosnia and Herzegovina and Kosovo*

The Commission's Overview and Country Assessments

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EUROPEAN ECONOMY

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INTRODUCTION

Economic governance has become one of the three fundamental pillars in the enlargement process over the past years, mirroring moves in the EU to strengthen economic policy monitoring and multilateral surveillance under the European Semester. In its 2013 and 2014 enlargement strategies, the Commission outlined a new approach to economic governance. This new approach implies an important change in the economic policy dialogue with enlargement partners with a view to giving clearer guidance on the reforms needed to foster macroeconomic stability, ensure fiscal sustainability, and support long-term growth and competitiveness. In this spirit, the 2015 Economic and Financial Dialogue between the EU and the Western Balkans and Turkey included, for the first time, all enlargement countries, and provided targeted policy guidance for each of them. The dialogue was based on a revamped set of medium-term Economic Reform Programmes (ERP) submitted by enlargement countries, containing their 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.

In September 2015 the Commission once again invited enlargement countries to submit their ERPs by 31 January 2016. This paper brings together into a single document the Commission staff's assessment of the ERPs for 2016-2018 submitted by Albania, Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia, Kosovo(*), Montenegro, Serbia and Turkey ([1]). The country assessments also take stock of the extent to which the country-specific policy guidance adopted last year has been implemented. The cut-off date for the analysis was 15 April 2016.

The country assessments reflect 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.

The ERPs of the six Western Balkan countries have been made public ([2]).

The programmes and the Commission staff's assessment were discussed at experts' level in multilateral meetings held in Brussels on 22 April, 26 April, 4 May and 12 May 2016 as well as at the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey held in the margins of the ECOFIN Council on 25 May 2016. Representatives from EU Member States, enlargement countries, the European Central Bank and the Commission attended these meetings.

The Joint Conclusions discussed and adopted at the Economic and Financial Dialogue contain country-specific policy guidance. The conclusions are available online ([3]). In addition, the relevant parts of the country-specific policy guidance are also reproduced in this paper at the end of each country assessment chapter.

Comments would be gratefully received and should be sent to:

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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.

([1]) Turkey transmitted its programme with a substantial delay, allowing only for a reduced assessment.

([2]) Albania: http://www.ekonomia.gov.al/files/userfiles/Albania_s_Economic_Reform_Programme_2016-2018.pdf;
Bosnia and Herzegovina: www.dep.gov.ba/naslovna/?id=1723;
the former Yugoslav Republic of Macedonia: www.finance.gov.mk/files/ERP_2016_en.pdf;
Montenegro: http://www.gov.me/en/News/157668/Montenegro-Economic-Reform-Programme-2016-2018.html;
Kosovo: http://plan-rks.org/en/download/Kosovo%20economic%20reform%20programme%202016;
Serbia: http://www.mfin.gov.rs/UserFiles/File/dokumenti/2016/Economic%20Reform%20Program%202016%202018.pdf

([3]) http://data.consilium.europa.eu/doc/document/ST-9500-2016-INIT/en/pdf

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Part I

Horizontal Overview of the 2016 Programmes

1. HORIZONTAL OVERVIEW OF THE 2016 PROGRAMMES

1.1. MACROECONOMIC AND FISCAL POLICY FRAMEWORKS

Economic growth prospects of the Western Balkans are improving mainly as a result of strengthening domestic demand. Economic activity in the region improved in 2015, thanks partly to the recovery from flood-related damages incurred a year earlier by Serbia and Bosnia and Herzegovina. The economic reform programmes expect a further steady acceleration of growth in the medium term. In the region as a whole, GDP on a PPP-weighted basis is forecast to rise by 2.8 % in 2016, 3.2% in 2017 and 3.9% in 2018. Encouragingly, there are signs of an emerging new investment cycle: most countries expect gross fixed capital formation to become an important growth driver. Increasing FDI is projected to support investment across the region. This reflects efforts to improve the business climate; the impact of some large projects already in the pipeline; and an expected slow but steady improvement in the external environment. In Montenegro and the former Yugoslav Republic of Macedonia, ambitious agendas of public infrastructure works are also set to boost growth in the years to come. Gains in employment, coupled with rising wages and remittances and low inflationary pressures, are expected to underpin a steady growth in private consumption. In some countries, such as Montenegro and the former Yugoslav Republic of Macedonia, recent increases in public wages and social transfers are also projected to support household spending. Due to the import content of rising domestic absorption, foreign trade is generally expected to be a drag on growth, even if exports are set to increase on the back of strengthening demand from the region's main trade partners in the EU. The only exception is Serbia, where net exports are expected to contribute positively to growth thanks to a projected robust increase in foreign sales.

Table I.1.1:

Economic Reform Programmes 2016
Key indicators

	2012	2013	2014	2015e	2016	2017	2018
Real GDP growth (% change)							
Albania	1.4	1.1	2.0	2.6	3.4	3.9	4.2
The former Yugoslav Republic of Macedonia	-0.5	2.7	3.5	3.5	4.0	4.3	4.5
Montenegro	-2.7	3.5	1.8	4.3	4.1	4.0	3.0
Serbia	-1.0	2.6	-1.8	0.8	1.8	2.2	3.5
Turkey	2.1	4.2	2.9	4.0	4.5	5.0	5.0
Bosnia and Herzegovina	-0.9	2.4	0.3	2.5	3.0	3.2	4.0
Kosovo	2.8	3.4	1.2	3.8	4.0	4.3	4.3
Unemployment rate (%, LFS)							
Albania	13.8	16.4	17.9	17.3	15.9	14.4	13.1
The former Yugoslav Republic of Macedonia	31.0	29.0	28.0	26.9	25.7	24.3	22.8
Montenegro	19.7	19.5	18.0	17.0	16.6	16.2	16.1
Serbia	23.9	22.1	20.1	18.5	17.0	16.1	14.6
Turkey	8.3	8.9	9.9	10.2	10.2	9.9	9.6
Bosnia and Herzegovina	28.0	27.5	27.5	27.7	27.1	26.4	25.6
Kosovo	30.9	30.0	35.3	:	:	:	:
Current account balance (% of GDP)							
Albania	-10.2	-10.9	-12.9	-10.1	-10.7	-11.2	-11.0
The former Yugoslav Republic of Macedonia	-3.2	-1.6	-0.8	-0.5	-1.9	-2.4	-2.4
Montenegro	-18.5	-14.5	-15.2	-12.6	-13.8	-13.8	-12.2
Serbia	-11.6	-6.1	-6.0	-4.6	-4.5	-4.1	-4.1
Turkey	-6.1	-7.8	-5.5	-4.5	-3.9	-3.7	-3.5
Bosnia and Herzegovina	-8.8	-5.5	-7.3	-7.0	-7.6	-8.2	-9.0
Kosovo	-7.5	-6.4	-7.9	-9.6	-8.6	-9.1	-9.3
Inflation (CPI, annual % change)							
Albania	2.0	1.9	1.6	1.8	2.3	2.7	3.0
The former Yugoslav Republic of Macedonia	3.3	2.8	-0.3	-0.3	2.0	2.0	2.0
Montenegro	4.0	1.8	-0.5	1.5	1.5	2.0	2.0
Serbia	12.2	2.2	2.1	1.9	2.8	4.0	4.0
Turkey	8.9	7.5	8.9	7.7	8.0	6.3	5.8
Bosnia and Herzegovina	2.0	-0.1	-0.9	-0.8	1.0	1.2	1.5
Kosovo	2.5	1.8	0.4	-0.2	0.4	0.4	0.6

Sources: Economic Reform Program (ERP) 2016 for 2014-2018, CCEQ for 2012 and 2013.

Notwithstanding the signs of recovery, growth expectations are subject to downside risks. Forecasts from authorities across the region often reflect an optimism bias. Most countries have already revised downwards their medium-term growth expectations compared to the previous year's ERPs, partly reflecting the fact that the outturn for 2015 is forecast to have been lower than expected in all countries except Serbia([1]). Still, risks surrounding the ERPs' baseline growth trajectory remain generally tilted to the downside. In particular, a generally cumbersome investment environment as well as capacity constraints and delays in executing public investment continue to hamper gross fixed capital formation. Furthermore, expected increases in household spending often rely on overoptimistic assumptions about employment and wage growth. In addition, crisis legacies and unfinished balance sheet repair by banks still constrain financial intermediation in a number of countries (such as Albania, Bosnia and Herzegovina, Montenegro and Serbia). Political uncertainties and upcoming elections could also weigh on investor and consumer sentiment. On the external side, weaker-than-anticipated demand from the EU, renewed concerns about macroeconomic and growth potential, and a rise in global risk perception would be detrimental to growth in the Western Balkans in the context of persistent current account deficits and the resulting reliance on capital inflows across the region.

Table I.1.2:

Economic Reform Programmes 2016
Fiscal indicators

	2012	2013	2014	2015e	2016	2017	2018
Total revenue* (% of GDP)							
Albania	24.9	24.0	26.2	26.4	27.4	27.3	27.3
The former Yugoslav Republic of Macedonia	31.9	30.2	29.8	32.2	32.3	32.0	31.2
Montenegro	41.3	43.4	44.8	41.9	42.9	40.7	39.6
Serbia	41.5	39.7	41.5	41.9	41.0	40.1	39.0
Turkey	37.8	40.0	39.6	40.7	41.0	40.0	39.5
Bosnia and Herzegovina	41.7	40.8	41.2	41.3	39.7	38.2	36.4
Kosovo	n.a.	24.7	23.9	25.0	26.2	25.2	24.5
Total expenditure* (% of GDP)							
Albania	28.4	28.9	31.3	30.2	29.6	28.7	27.8
The former Yugoslav Republic of Macedonia	36.6	34.2	34.0	35.8	35.6	34.9	33.8
Montenegro	47.4	47.7	47.9	48.4	48.9	46.8	42.4
Serbia	47.9	45.0	48.1	45.9	45.0	42.7	40.8
Turkey	38.9	40.7	40.2	40.7	41.6	40.7	39.9
Bosnia and Herzegovina	43.5	42.3	43.1	42.6	40.9	38.2	35.3
Kosovo	n.a.	27.8	26.5	27.1	28.1	27.2	26.6
General government balance (% of GDP)							
Albania	-3.4	-5.0	-5.1	-3.8	-2.2	-1.4	-0.5
The former Yugoslav Republic of Macedonia	-3.8	-3.8	-4.2	-3.6	-3.2	-2.9	-2.6
Montenegro	-6.1	-5.2	-3.1	-6.5	-6.1	-6.1	-2.8
Serbia	-6.8	-5.5	-6.6	-4.1	-3.9	-2.6	-1.8
Turkey	-0.3	-1.6	-0.6	0.0	-0.7	-0.7	-0.4
Bosnia and Herzegovina	-2.0	-2.1	-1.9	-1.3	-1.2	0.0	1.1
Kosovo	-2.6	-3.1	-2.6	-2.0	-1.8	-1.9	-1.9
General government debt (% of GDP)							
Albania	62.1	65.5	71.8	72.2	70.6	67.7	63.6
The former Yugoslav Republic of Macedonia	33.7	34.2	38.2	38.6	39.4	40.7	41.5
Montenegro	55.9	61.6	58.5	65.5	70.7	74.4	77.9
Serbia	55.9	58.8	71.8	76.0	79.1	78.6	75.7
Turkey	36.2	36.2	33.5	32.6	31.7	30.5	29.5
Bosnia and Herzegovina	35.9	38.1	40.8	41.3	41.7	38.3	33.0
Kosovo	8.1	8.9	10.4	13.5	17.3	20.0	22.0

Sources: Economic Reform Programme (ERP) 2016 for 2014-2018, CCEQ for 2012 and 2013.
* 2011 data from PEP/EFP 2013, 2012 data from PEP/EFP 2014. Kosovo data from CCEQ.

The economic upturn supports much-needed fiscal consolidation, but adjustment measures are often unspecified or back-loaded, and debt stabilisation is still to be achieved by countries in the region. The general growth slowdown in the post-2008 period, which in most Western Balkan countries turned to a double-dip recession, has taken a toll on public finances and sent public debt ratios on an upward trajectory, even if the debt burden reflects large cross-country differences. Rigidities associated with an expenditure structure tilted towards unproductive spending, as well as weaknesses in revenue mobilisation, mean that reversing this trend has thus far not taken place.

Policy plans of Serbia and Albania, which have the highest level of public debt in the region, envisage an ambitious expenditure-led fiscal consolidation, but underlying measures could be more specific while fiscal risks, stemming in particular from the pace of reform implementation and from contingent liabilities, persist. Kosovo also intends to rein in current spending following recent increases in social transfers and benefits in order to keep the deficit below 2% of GDP, as required by national law. Bosnia and

([1]) On a PPP-weighted basis, the average reduction in expected GDP growth across the region relative to last year's ERPs is 0.2 pps. for both 2016 and 2017. Had it not been for an upward revision in both years for Serbia, which is emerging from its flood-related recession quicker than expected, the difference would be even greater.

Herzegovina's programme assumes a substantial reduction in both the revenue and expenditure ratio, without however providing a clear rationale, especially as regards the envisaged disproportionate cuts in investment spending. The stated commitment to fiscal consolidation by the former Yugoslav Republic of Macedonia stands in contrast to the planned substantial increase in entitlement spending and capital expenditure, which means that the debt ratio is projected to keep rising even under the authorities' optimistic growth assumptions. Montenegro's major motorway investment, whose costs amount to as much as 20% of GDP over four years, coupled with limited possibilities for discretionary cuts in current spending, will result in a further rise in public debt from its already high level.

In all countries, fiscal credibility and sustainability would greatly benefit from more transparent budgeting, stronger medium-term fiscal frameworks and the introduction or consistent application of well-defined fiscal rules capable of firmly anchoring expectations. Several countries have plans to improve budgetary processes and institutions. For instance, Serbia aims to further develop programme budgeting and enhance impact analysis and monitoring of state-owned enterprises. Albania has established a dedicated revenue unit within the Ministry of Finance to produce better bottom-up revenue forecasts, and it is considering the introduction of a new fiscal rule following the repeal of the previous debt ceiling in 2012. Montenegro envisages support for municipalities on restructuring their debt in exchange for streamlining their workforce and limiting their expenditure. On the whole, however, more effort is needed to address substantial weaknesses in fiscal governance.

Turkey's economy is also projected to accelerate, but continues to face significant macroeconomic challenges. The authorities optimistically expect GDP growth to increase to 4.5% in 2016 and still further to 5% in the subsequent two years. Contrary to recent years, growth is forecast to be supported by strong investment activity and positive contributions from net exports. The ERP's projections are explained by an acceleration of Turkey's structural reform programme which will serve to promote investments, particularly in the tradable sector, and increase international competitiveness and hence exports. In view of the slow pace in implementing structural reforms in recent years and the time-lag between reform implementation and macroeconomic results, these assumptions appear too sanguine. The ERP also projects a reduction in the two main imbalances characterising the Turkish economy: on the external side, a persistent current account deficit whose financing relies, to a large extent, on volatile forms of capital flows; and on the internal side, entrenched inflation in the high single digits which is costly in terms of macroeconomic stability, resource allocation and redistributive effects. It lacks, however, a coherent description of how the macroeconomic policy mix will be adjusted to achieve the anticipated reduction of these imbalances. Although the sustainability of public debt is not in question, a more restrictive fiscal policy stance would be appropriate given in particular the need to increase national saving.

1.2. STRUCTURAL REFORMS

The structural reform plans of the Western Balkans vary in terms of ambition, scope and analytical foundation. All countries engaged in the enlargement process are undertaking substantial rule of law related reforms under the political Copenhagen criteria, including in the areas of public administration, public financial management, and the fight against organised crime and corruption. In parallel to the areas addressed in the ERPs, progress in these reforms is essential to improve the business and investment climate. The ERPs prepared by Albania, Kosovo, Montenegro and Serbia have a solid analytical basis from which policy measures are derived, while the programmes of the former Yugoslav Republic of Macedonia and of Bosnia and Herzegovina do not include sufficient diagnostics.

The Western Balkans share many structural obstacles for the creation of fully functioning and competitive market economies. Poor access to finance has an important negative effect on private sector development. Excessive interference by the state is still a problem in Serbia, Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia where non-transparent state aid schemes and para-fiscal charges and interference in economic operators' choices affect private sector development. Related to this is an excessive regulatory burden, in particular in Albania and Bosnia and Herzegovina, and legislative uncertainty with frequent and non-transparent legal changes, such as in the former Yugoslav Republic of Macedonia. The informal economy is widespread in all Western Balkan countries and most pronounced in Kosovo. Agriculture has a significant potential in all the countries of the region. However, land fragmentation, unclear property rights and underdeveloped irrigation systems remain significant barriers. The use of outdated technologies lowers the productivity of the sector in the whole region. In all these countries, the level of public and private sector investment in research, development and innovation (RDI) is very low and far below the level needed to enable the economies to move up the ladder of the value chains.

Some of the Economic Reform Programmes overemphasise the need for large-scale infrastructure projects, in particular on transport, while paying too little attention to market reforms to overcome structural weaknesses. This bias towards infrastructure is reflected in budget allocations as well. While a functioning infrastructure is important to boost competitiveness and attract investment, any large-scale public investment should be subject to prioritisation based on cost-benefit analyses and should consider the opportunity cost of not implementing other necessary reforms. This is especially true when faced with limited fiscal space, which is the prevalent situation in all the Western Balkan countries. Prioritisation based on an analysis of outcomes is missing or weak in most of the countries even when they plan large-scale and expensive public investments. Such a prioritisation process should take into account the impact on competitiveness, growth and job creation, be transparent and subject to scrutiny by stakeholders. The National Investment Committees and the single project pipelines are significant steps in this direction. It is important that investments in infrastructure are accompanied with meaningful soft measures, such as those the Western Balkan countries have committed themselves to implement as part of the connectivity agenda agreed in the Berlin process.

Liberalisation of energy markets and unbundling of networks remains a key challenge and an obligation under the Energy Community Treaty. It is particularly important in Albania, Serbia and Bosnia and Herzegovina. Together with poor energy security and significant distribution losses, the lack of market opening keeps energy prices high. Investments in energy infrastructure are important and should be complemented with measures to increase energy efficiency.

Certain challenges shared by all enlargement countries are mutually reinforcing, such as a weak rule of law and corruption. These can have a negative effect on the investment climate and the ability to attract foreign direct investment, with economic consequences. Combatting corruption and improving the rule of law require sustained political commitment and a coordinated approach; and the ERPs show this is a priority in all countries.

Poor labour market performance, reflected in particularly low activity and employment rates and high levels of unemployment, is a common denominator in all Western Balkan countries, with levels particularly alarming in Kosovo and Bosnia and Herzegovina. Employment trends in the region vary; Serbia shows slight but still fragile improvements, whereas the situation is further deteriorating in Kosovo. The very low female participation requires more robust action, as well as the labour market integration of young people. Employment services and active labour market policies are often not robust enough to respond sufficiently to the challenge of supporting the long-term unemployed. Some countries (Serbia, the former Yugoslav Republic of Macedonia) have initiated reforms in this area.

Certain critical factors hamper labour market improvements, including widespread informal work, inadequate linkages between social assistance and activation towards employment, particularly in Bosnia and Herzegovina, Albania and Montenegro, and remittances discouraging human capital formation and take-up of work, which is most pronounced in Kosovo. In sum, poor labour market outcomes strongly affect the social situation of the population.

Strong labour market imbalances also point to the need to improve quality and outcomes of education systems in the Western Balkans, in particular to better align skills with labour market needs. This requires further reforms of the education system at all levels, beyond the current focus on vocational education and training and higher education. Poor quality and outcomes of basic education do not only put at risk future employment prospects, but have wider effects on the economic and social situation of the population.

The social protection systems in the Western Balkan countries are also in need of reform to improve sustainability and better target assistance given the limited fiscal space, and as regards the quality and provision of care services, notably when it comes to pension and healthcare systems. Some actions have been initiated to improve the provision of social benefits in Albania and Serbia, but a lot remains to be done. Social assistance is often not targeted enough to reach the most vulnerable persons facing poverty and social exclusion.

Rekindling Turkey's stalled reform process is key to increasing productivity and diversifying the economy. The country has seen remarkable development since 2001 when the government began important economic and political reforms. However, in recent years the reform process has stalled and even reversed in some areas that are important for the investment climate, such as the rule of law. Turkey also faces substantial labour market challenges, reflected in low female participation and employment rates; a high number of young people not in employment, education and training; a high level of informal work; and a low qualification level of the workforce. Spending on research and development has been increasing but is still rather low and the cooperation between research institutions and economic operators is often weak, hampering innovation and productivity.

Part II

Country analysis

1. ALBANIA

1.1. EXECUTIVE SUMMARY

Albania is experiencing a gradual economic upturn that is expected to continue in 2016-2018. GDP growth is driven by private investment, mainly in the form of foreign direct investment in the energy sector, and is projected to average well above 3%. Consumption spending is also expected to pick up on the back of rising disposable income and employment gains. Nevertheless, the recovery is facing downside risks, notably due to sluggish bank lending amid a still high share of impaired loans and because falling commodity prices have weakened the outlook for the extractive industry, which has been an important growth driver in recent years.

Albania's economic reform programme (ERP) reflects an appropriate policy mix, with an accommodative monetary policy and plans for continued fiscal consolidation. The economy is still operating below its potential. This keeps a lid on price rises and allows the central bank to pursue loose monetary policy in an effort to steer persistently low inflation back towards the target. At the same time, the economic upswing provides a good opportunity for fiscal consolidation and the programme sets out an ambitious plan for continued budgetary adjustment. The completion of the wide-ranging exercise to clear accumulated central government arrears and the resulting decline in expenditure will also help reduce the headline deficit.

Lowering vulnerabilities and realising the economy's growth potential are major challenges facing Albania. Tackling macroeconomic imbalances and rebuilding policy buffers would make the country more resilient to adverse external shocks. At the same time, implementing structural reforms is key to achieving high rates of sustained economic growth beyond the current cyclical improvement. The main challenges are:

Debt-related vulnerabilities are high and there is little room for manoeuvre of fiscal policy in the face of shocks. Despite efforts to consolidate the budget since 2014, Albania's public debt remains high at more than 70 % of GDP, and is associated with significant rollover and exchange rate risks. The country's fiscal adjustment plans are ambitious and are based mainly on ensuring better tax compliance and tightly controlling expenditure. However, implementing these plans will likely be challenging. Additional budgetary risks stem from contingent liabilities in the electricity sector, spending commitments in public-private partnerships and potentially significant local government arrears.

Improvements to the fiscal framework would support fiscal credibility and underpin the consolidation process. Multi-annual commitment control has been strengthened to prevent arrears recurring, but there is considerable scope for making medium-term budgeting more binding, eliminating the optimism bias in macroeconomic and revenue forecasts and improving the capacity to plan and manage capital expenditure. A fiscal rule has been under preparation for some time; if well-designed it would greatly support budgetary discipline and help anchor fiscal policy.

Obstacles to resolving non-performing loans still burden banks' balance sheets and impede the functioning of the bank lending channel. Banks are well capitalised and highly liquid, and the banking system withstood well the turbulent period following the introduction of capital controls in Greece. Still, declining but high non-performing loans and loan euroisation continue to be major challenges, both to the stability of the banking system and to the conduct of monetary policy.

Attracting foreign direct investment into tradable sectors would help boost productivity and broaden the export base. A large gap in the trade balance means that the current account deficit exceeds

10 % of GDP and is expected to widen in the coming years. However, financing the current account deficit relies little on debt-generating flows. Foreign direct investment has been relatively high since 2007 and is expected to increase further, but it is concentrated in non-tradable and natural resource intensive industries as significant obstacles in the investment environment have so far undermined Albania's attractiveness to higher value added activities.

Although it has already implemented many reforms, Albania still faces several challenges to improving the business climate. Businesses, which are predominantly SMEs, are burdened by a lack of access to finance, a high level of informality, still unclear land ownership and an excessive regulatory burden. The economic reform programme identifies the main obstacles in these areas, and the measures it proposes, if implemented smoothly and without delays, could bring significant improvements. However, combatting informality and widespread corruption requires sustained political commitment and a coordinated approach.

Further liberalisation of network industries would be beneficial for investment and economic development. Given Albania's limited fiscal space, the need for large-scale investments, especially in the energy and the transport sectors, can only be met by creating favourable conditions for private investment. Steps towards further liberalisation of the energy market are already planned, and the ongoing Trans-Adriatic Pipeline project will help the country to diversify its energy sources.

Increased economic activity has not translated into significant gains on the labour market. High youth unemployment is linked to widespread skills mismatches. Labour market participation of women is particularly low and high informality continues to act as an impediment to growth. The coverage and outreach of employment services and the measures to encourage labour market activity are insufficient. The inadequate overview of social needs hinders the targeting and outreach of social services.

The macroeconomic and fiscal framework of the ERP is coherent, consistent and provides an adequate basis for policy discussions, while the structural reform section has improved compared to last year. The reform measures correspond well to the key obstacles to growth and competitiveness identified in the diagnostics. Moreover, they cover not only public investment projects but also long-term strategies and market economy-oriented adjustments of the legal framework.

Last year's policy guidance has been partially implemented. Budget revenues have not stayed on track and capital spending has been under-executed, but tentative progress has been made towards devising a fiscal rule. Electricity-sector reforms have yielded significant financial improvements and further policy measures have been agreed to facilitate the resolution of non-performing loans. Other positive achievements include the adoption of the laws on higher education and the power sector and the establishment of the National Business Centre to streamline business registration and licencing. Some steps have also been taken to improve the vocational education and training (VET) and higher education systems. However, no real progress has been made on the important issue of the land cadastre strategy.

1.2. ECONOMIC OUTLOOK AND RISKS

Albania's economic reform programme (ERP) projects that economic recovery will gradually strengthen on the back of robust growth in domestic demand. After three consecutive years of contraction, in 2015 the investment cycle started to revive. In the immediate term, investment is expected to remain the main growth driver, supported by strong foreign direct investment (FDI) inflows and a gradual easing of financing conditions for corporates. Private consumption is set to recover from the fall recorded in 2015 thanks to lower precautionary saving by households and a projected steady increase in employment and wages. On the other hand, the envisaged fiscal tightening will mean that growth is not buoyed by public consumption. Foreign trade is predicted to contribute negatively to growth throughout the programme horizon as the projected pick-up in exports is expected to be outweighed by the effect of robust import growth, especially in 2016-17 when some import-intensive large investments will be implemented. On the production side, the ERP projects that all main branches of the economy will contribute positively to growth in 2016-2018, especially agriculture and, in line with growing consumption, the services industry. The extractive industry, which has been an important growth driver in recent years, is set to undergo a mild recession in 2016 as lower prices for oil and other commodities trigger production cuts. However, it is expected to recover quickly in the following years. All in all, the ERP projects that economic growth will accelerate from an expected 2.6 % in 2015 to 4.2 % in 2018.

Table II.1.1:

Macroeconomic developments and forecasts

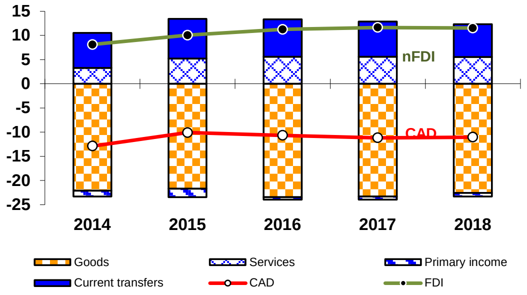
	2014		2015		2016		2017		2018	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	2.0	**2.0**	2.7	**2.6**	3.2	**3.4**	3.5	**3.9**	n.a.	**4.2**
Contributions:										
- Final domestic demand	1.9	**2.7**	1.1	**-0.2**	4.4	**5.5**	4.4	**4.7**	n.a.	**4.5**
- Change in inventories	1.9	**0.8**	0.0	**0.0**	0.0	**0.0**	0.0	**0.0**	n.a.	**0.0**
- External balance of goods and services	-1.8	**-1.5**	1.6	**2.7**	-1.2	**-2.2**	-1.0	**-0.8**	n.a.	**-0.3**
Employment (% change)	1.6	**1.3**	2.0	**2.4**	2.2	**4.1**	2.5	**4.4**	n.a.	**3.4**
Unemployment rate (%)	17.9	**17.9**	17.5	**17.3**	16.9	**15.9**	16.0	**14.4**	n.a.	**13.1**
GDP deflator (% change)	1.6	**1.6**	0.6	**0.6**	2.0	**2.5**	2.4	**3.0**	n.a.	**3.1**
CPI inflation (%)	1.6	**1.6**	1.9	**1.8**	2.3	**2.3**	2.6	**2.7**	n.a.	**3.0**
Current account balance (% of GDP)	-12.9	**-12.9**	-10.9	**-10.1**	-11.9	**-10.7**	-12.3	**-11.2**	n.a.	**-11.0**

Sources: Economic Reform Programme (ERP) 2016, Commission 2016 Winter Forecast (COM)

The assumed growth drivers are plausible, but the ERP's projected growth trajectory appears optimistic and exceeds the Commission's winter forecast. While FDI-financed large investments in the energy sector (into a major gas pipeline and two large hydropower plants) are boosting gross fixed capital formation, tight credit standards for businesses amid lingering challenges to bank loan portfolios may continue to constrain investment financing for some time. Moreover, although the repayment of government arrears over 2014-2015 improved corporate liquidity, its impact will wane over time. The pick-up in household spending is partly based on improving sentiment, but consumer confidence has been volatile lately, pointing to protracted uncertainties. Moreover, the projected employment growth, at 4 % on average and based solely on private sector job creation, appears overly optimistic and would imply declining labour productivity in 2016-17. On the external side, it is realistic to assume that Albania would benefit from the expected gradual recovery of its main trading partners in the EU, even if close links with Greece mean that unfavourable developments there may well spill over to Albania. Furthermore, the oil sector, which is one of the country's major exporters, might suffer a deeper contraction if oil prices stay low for longer than expected. Agriculture and electricity production remain subject to weather-induced volatility. It therefore appears that, even if it has been revised down from last year, the ERP's growth trajectory is still somewhat optimistic and subject to downside risks, as the programme itself acknowledges.

Persistently below-target inflation suggests that monetary policy will remain loose, but its effectiveness continues to face constraints. Annual inflation has remained below the central bank's 3 % target for three consecutive years, reflecting subdued price pressures from still below-potential output and low imported inflation. The central bank cut its policy rate twice in 2015 to a historic low of 1.75 %, but although financial conditions have continued to ease, the bank lending channel is still impaired by a protracted deterioration in the quality of banks' assets. The central bank has signalled its intent to maintain an accommodative monetary stance for an extended period as it now expects the economy to return to its potential output at the beginning of 2017 and inflation to reach the 3 % target in the following year. There might still be some, albeit diminishing, room for further lowering the policy rate if these expectations are not met. Moreover, lower government borrowing should also help improve the pass-through of monetary policy impulse by exerting downward pressure on market interest rates. However, under a free-floating exchange rate regime, further monetary easing might face constraints stemming from the high proportion of foreign-currency loans to unhedged borrowers, even if the lek's exchange rate against the euro has remained stable for years.

Graph II.1.1:
Evolution of the current account balance (% of GDP)



Source: Economic Reform Programme (ERP) 2016 , ECFIN calculations

The current account deficit is expected to widen as a result of strong growth in import-intensive investments. A substantial trade deficit, caused by a narrow production and export base and partly funded by remittances from Albanians living abroad, is the main factor driving Albania's historically large current account shortfall. In 2015, the current account deficit is estimated to have narrowed substantially from 12.9 % of GDP recorded a year earlier because a pick-up in investment was more than offset by increased precautionary saving by households. Going forward, the programme expects that import growth, driven by strong investment and rising private consumption, will outweigh the impact of a steady increase in exports, especially of agricultural and textile products and tourism. Remittances are forecast to stay broadly flat in 2016-2018, while the primary income balance is expected to remain in deficit due to continued profit repatriation by an expanding FDI base. Overall, the programme projects that the current account deficit will widen gradually from an estimated 10.1 % of GDP in 2015 to 11.2 % in 2017, before falling back to 11 % in 2018. This probably underestimates somewhat the magnitude of prospective deficits, partly because the 2015 outturn might be worse than expected in the ERP, and also because the projected real growth in exports, at 6.3 % a year on average, might be overstated in the context of low commodity prices and sluggish overall global trade. In terms of the saving-investment balance, rising investment relative to GDP is projected to outstrip the expected increase in the domestic saving rate. Two-thirds of this increase is to come from the public sector as a result of fiscal consolidation.

Non-debt-creating flows, primarily in the form of FDI, are expected to finance a large and increasing part of the current account deficit. Between 2007 and 2014, almost two-thirds of the current account deficit was financed by FDI and nearly 72 % of it by non-debt-generating flows, including capital transfers. Consequently, external indebtedness, at 73 % of GDP in the third quarter of 2015, does not give rise to immediate concerns. This is also because external debt is composed mainly of government long-term borrowing and intercompany lending between direct investors and subsidiaries. At the same time, foreign reserves covered 6.6 months of imports of goods and services, providing an adequate safeguard against adverse shocks. In the years to come, the ERP expects rising FDI inflows to finance the entire current account deficit and to contribute to a steady increase in foreign reserves. Downside risks to this outlook stem from persistently low commodity prices weighing on FDI into the extractive industry. Moreover, despite Albania's relative recent success in attracting foreign investments, these remain heavily concentrated in non-tradable and natural resource-based industries. Moving into higher value-added activities and better integration into global supply chains would help boost productivity and create more and better jobs, but would require wide-ranging structural reforms to bring about substantial improvements in the investment environment.

Impaired loans still burden bank balance sheets and hamper a revival in lending, even though banks are well capitalised and highly liquid. The non-performing loan (NPL) ratio decreased to 18.2 % at the end of 2015 from 22.8 % a year earlier mainly due to mandatory loan write-offs. High NPLs are a major factor behind tight lending standards, especially for corporates, and contribute to weak lending to the private sector. Private credit in Albania grew by only 2.2 % in the year to December 2015 (adjusting for the impact of the NPL write-off). Supported by international institutions, the government and the central bank agreed on a comprehensive NPL action plan in September 2015 that involves legislative and regulatory measures and is expected to speed up NPL resolution and credit recovery. On the other hand, monetary easing has led to a decrease in the lek-euro interest rate spread and has supported a gradual shift towards lending in lek. However, liability euroisation remains high; foreign currency loans to unhedged borrowers still make up around a third of the total loan stock, making their repayment vulnerable to a sharp depreciation of the lek. The banking system overall maintains adequate buffers to absorb shocks as capital adequacy and liquidity ratios exceed regulatory requirements and profitability has been improving. Banks are also not reliant on foreign-based parents for funding because the ratio of loans to domestic deposits is only 55 %. However, the preponderance of short-term deposits among funding sources leads to maturity mismatches and hinders long-term financing by banks. On the asset side, government securities have a share of around 24 %, exposing banks to sovereign risk.

Table II.1.2:
Financial sector indicators

	2011	**2012**	**2013**	**2014**	**2015**
Total assets of the banking system, mEUR	8,102	8,503	8,803	9,234	9,306
Foreign ownership of banking system by asset, %	90.4	89.8	88.6	87.1	84.1
Private credit growth, %	10.4	1.4	-1.4	2.0	2.2*
Deposit growth, %	13.1	7.3	3.4	4.5	2.6
Loan to deposit ratio	61.6	58.6	55.6	55.5	53.2
Financial soundness indicators, %					
- non-performing loans to total loans	18.8	22.5	23.5	22.8	18.2
- core capital to risk weighted assets	14.3	14.6	14.9	13.8	13.5
- liquid to total assets	26.5	29.4	27.6	31.9	32.3
- return on equity	0.8	3.8	6.4	10.5	13.2
- forex loans to total loans	67.9	64.5	63.0	62.4	60.8

**: Adjusted for loan write-offs*
Sources: Economic Reform Programme (ERP) 2016, Bank of Albania

1.3. PUBLIC FINANCE

In 2015, revenue fell significantly short of target, but due to under-execution of expenditure the budget deficit was somewhat lower than planned. Revenue underperformed by 8 % against the initial target and 4.3 % against the revised plan adopted in July 2015. The shortfall was caused mainly by reliance on a high assumed 2014 revenue base as well as overoptimistic assumptions about nominal GDP growth and collection efficiency gains. Reasons specific to individual taxes, such as lower-than-expected oil prices and deposit interest rates, also played a part. Overall, the ratio of revenue to GDP increased only marginally against an expected rise of 1.9 pps. in the ERP for 2015, of which half was supposed to come from discretionary tax measures. At the same time, expenditure remained 7.7 % below the initial plan mainly due to savings in interest costs and the underspending of capital budgets, which occurs repeatedly and points to weak capacity to manage investments. All in all, the headline budget deficit was lower than the 4 % target in 2015 and declined to 3.8 % of GDP from 5.1 % recorded in 2014. This outcome was supported by a decrease in payments linked to the clearance of government arrears from 2.4 % of GDP in 2014 to 1.2 % in 2015. There was no improvement in the underlying primary balance net of these expenses.

The ERP commits Albania to an ambitious fiscal consolidation path to tackle vulnerabilities stemming from high public debt. This commitment translates into a plan to improve the headline deficit by an annual average of 1.1 pps. to -0.5 % of GDP in 2018. The bulk of the adjustment is anticipated to come initially from raising the revenue-to-GDP ratio by 1 pp. in 2016, following which it would remain stable. In 2017-2018, spending restraint is expected to drive fiscal consolidation as expenditure relative to GDP is projected to decrease by 0.9 pps. annually. As a result, the primary surplus (excluding the arrears clearance that took place in 2014-2015) would improve from 0.1 % of GDP in 2015 to 2.4 % in 2018. If these targets are met, both the headline and the primary balance will record its best performance since Albania's transition to a market economy began 25 years ago. On this basis, the public debt ratio (including state guarantees) will start declining in 2016 and will fall below 64 % in 2018.

Table II.1.3:

Composition of the budgetary adjustment (% of GDP)

	2014	2015	2016	2017	2018	Change: 2015-18
Revenue	26.2	26.4	27.4	27.3	27.3	0.9
- Taxes and social security contributions	21.1	20.9	21.4	21.6	21.6	0.7
- Other (residual)	5.1	5.5	6.0	5.7	5.7	0.2
Expenditure	31.3	30.2	29.6	28.7	27.8	-2.4
- Primary expenditure*	26.1	26.3	26.8	25.8	24.9	-1.4
of which:						
Gross fixed capital formation	5.1	5.4	5.8	5.4	5.1	-0.3
Consumption	8.8	9.1	8.9	8.4	8.1	-1.0
Transfers & subsidies	11.8	11.3	11.6	11.4	11.2	-0.1
Other (residual)	0.4	0.5	0.5	0.6	0.5	0.0
- Interest payments	2.9	2.7	2.8	2.9	2.9	0.2
Budget balance	-5.1	-3.8	-2.2	-1.4	-0.5	3.3
- Cyclically adjusted	-4.9	-3.7	-2.2	-1.5	-0.6	3.1
Primary balance*	0.2	0.1	0.6	1.5	2.4	2.3
Gross debt level	71.8	72.2	70.6	67.7	63.6	-8.6

**: Excluding arrears clearance*

Sources: Economic Reform Programme (ERP) 2016, ECFIN calculations

The 2016 budget optimistically projects strong growth in revenue, relying to a large extent on better tax administration and compliance. Nominal GDP is assumed to grow by 5.9 %, which exceeds the Commission's winter forecast of 5.2 %. However, the increase in revenue is projected to be even higher, as its ratio to GDP is expected to rise by 1 pp. This is only partly explained by discretionary tax measures, which are anticipated to yield about 0.4 % of GDP.([1]) The high assumed tax elasticity should also get some support from expected changes in the composition of GDP, with tax-rich private consumption predicted to return to growth. However, a large part of the planned increase in revenue is attributed to the impact of the government's renewed efforts to curb tax evasion, non-compliance and the informal economy by stepping up checks and penalties and through better tax administration. The first results in terms of growth in the number of social security contributors and registered businesses are encouraging, but it is not clear whether the impact will be large enough to help achieve the expected fiscal result. If revenue again falls short of plan, expenditure will need to be cut to meet the deficit target. A small contingency line of about 0.1 % of GDP and somewhat over-budgeted interest costs may cushion this somewhat. However, in the past capital expenditure bore the brunt of spending cuts. This was not conducive to supporting long-term growth and also contributed to the build-up of arrears. This pattern might repeat itself since capital expenditure continues to provide the main discretionary item to be reduced to compensate for errors in forecasting revenue.

([1]) See box for details on the impact of revenue measures approved in the 2016 budget.

Box: The budget for 2016

The 2016 state budget was approved by the Parliament on 17 December 2015. It assumes real GDP to grow by 3.4 % and the GDP deflator to increase by 2.5%. The budget deficit is expected to fall to 2.2% from 3.6% recorded in 2015.

Table: Main measures in the budget for 2016 and their estimated net savings impact

Changes in local taxes: extension of property tax on urban land; removal of the simplified income tax for small businesses; increase in the infrastructure impact tax; redefinition of the tax on billboard advertising	**(0.1% of GDP)**
Applying VAT to certain inward processing activities	**(0.1% of GDP)**
Introduction of reference wages for self-employed professionals to calculate social security and health insurance contributions	**(0.07% of GDP)**
Increase in the gross written premium tax from 3% to 10%	**(0.04% of GDP)**
Replacing ad valorem royalty on non-metallic minerals with quantity based royalty	**(0.03% of GDP)**
Introduction of a registration fee and an annual circulation tax on luxury cars	**(0.02% of GDP)**
Total tax revenues effect	**(0.4 % of GDP)**

Source: ERP 2016

Beyond 2016, plans for fiscal consolidation rely on spending restraint, but the underlying measures are often unclear. Expenditure relative to GDP is expected to decline by 1.8 pps. between 2016 and 2018, with the main spending categories all sharing the burden of retrenchment as their planned increase stays below that of nominal GDP. The rise in social insurance outlays, the biggest expenditure item, is expected to be linked to the annual rate of inflation, as required by law. Improving the efficiency of public administration and better targeting social assistance schemes may create savings, but the ERP is short on details. Total capital expenditure is projected to stay flat after 2016 and fall back as a share of GDP to 5.1 % in 2018 from 5.8 % in 2016. This is still relatively high, although capital budgets tend to be under-executed. Local government spending is expected to increase in 2016, but to then experience one of the biggest relative declines in 2017-2018. However, this is not consistent with decentralisation plans resulting from recent reforms to territorial administration. All in all, the implementation of the envisaged expenditure-led consolidation faces downside risks, not least because spending pressures might emerge in the run-up to the parliamentary elections expected in 2017, just when Albania's IMF-supported programme, which currently acts as a disciplinary anchor, expires. On the revenue side, risks mainly stem from optimistic projections of nominal GDP growth.

Box: Alternative scenarios

The programme presents alternative scenarios in terms of growth and budget outcomes to take into account some of the risks surrounding the baseline assumptions. In addition to the baseline assumption, the ERP looks in particular at the low growth and favourable growth scenarios and their effect on public finances. In case of feeble growth, the assumptions also include lower tax elasticity. The low growth scenario expects real GDP growth of only 1 % in 2016, 2.2 % in 2017 and 3 % in 2018, with a corresponding negative impact on revenue. Under this scenario, half of the revenue shortfall is offset by spending cuts, exhausting the contingency line for deficit protection and reducing capital spending, while the other half increases the deficit (to 2.9 % in 2016, 2.3 % in 2017 and 1.5 % in 2018). This would still cause the public debt ratio to fall to 69.5 % in 2018. If growth is more robust than planned, half of the extra revenue would be used for public investment, and only the remaining part would be saved and thus used for deficit reduction. Presenting alternative scenarios, even if they are relatively mild, enhances the soundness of the ERP. However, it is not clear whether the scenarios were developed solely for the purpose of the ERP or whether they are also anchored formally in the documents guiding the medium-term budget.

A number of additional fiscal risks linger and are not fully evaluated. Apart from risks inherent in its ambitious plan for fiscal adjustment, Albania's budgetary position may be affected by financial obligations entered into by the public sector for which the government can ultimately be held responsible. Public guarantees represent one such source of risks, even if they are fully accounted for in the public debt and were reported to amount to 3.9 % of GDP at the end of 2015. The financially unviable electricity sector has long been a major beneficiary of public guarantees, but major reforms have started recently and the sector's financial situation has improved. The ERP now expects to completely eliminate power sector subsidies by 2020.

A further long-standing risk to the budget outlook is posed by the obligation, confirmed by international court rulings, to provide compensation to former owners expropriated during Communism. The medium-term budget has increased allocations for this purpose to some 0.3 % of GDP annually, and a recently-approved law aims to adjust the existing scheme to make this compensation financially more affordable. However, there are still legal hurdles to implementing this new law. Moreover, it is not clear to what extent the fiscal bill, previously estimated at as much as 70 % of GDP, would be reduced as a result of these changes.

The ERP also reports on efforts and plans to increase transparency over liabilities linked to public-private partnerships and over non-debt obligations of local governments, both of which may amount to several per cent of GDP. There is also scope to better evaluate the long-term impact on fiscal sustainability of the recently-reformed pension scheme and the health care system.

Box: Debt dynamics

The ERP expects the debt ratio to start decreasing as from 2016, helped by a predicted primary surplus, higher inflation and a pick-up in real GDP growth. These positive factors are projected to have an increasing impact, while the implicit interest rate is expected to rise only moderately. The low level of stock-flow adjustments indicates that the government does not expect significant net flows of guarantees or exchange rate movements. The expected debt trajectory appears to be based on optimistic forecasts of the main macroeconomic and fiscal variables.

Table II.1.4:

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

	2014	2015	2016	2017	2018
Gross debt ratio [1]	**71.8**	**72.5**	**70.9**	**67.9**	**63.9**
Change in the ratio	1.7	0.8	-1.6	-3.0	-4.0
Contributions [2]:					
1. Primary balance	**2.3**	**1.4**	**-0.6**	**-1.5**	**-2.4**
2. “Snowball” effect	**0.4**	**0.5**	**-1.2**	**-1.6**	**-1.8**
Of which:					
Interest expenditure	2.9	2.7	2.8	2.9	2.9
Growth effect	-1.4	-1.8	-2.3	-2.6	-2.7
Inflation effect	-1.1	-0.4	-1.7	-2.0	-2.0
3. Stock-flow	**-1.0**	**-1.1**	**0.1**	**0.2**	**0.1**

Notes:

[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) 2016, ECFIN calculations

High public debt, coupled with considerable short-term refinancing needs and increasing exchange rate risks, remains a cause for concern. Albania’s public debt, including guarantees, exceeds 70 % of GDP. Domestic debt, at almost 40 % of GDP, still has a low average maturity and results in domestic refinancing needs in excess of 20 % of GDP annually. With a narrow investor base composed mainly of domestic banks, Albania is vulnerable to changes in market sentiment or host country regulatory requirements that could influence debt holders’ willingness to hold Albanian securities. Albania stepped up foreign currency borrowing in 2015 to mitigate domestic refinancing risks and help release banking sector liquidity for private-sector lending. Consequently, external debt has risen to 34 % of GDP and increasingly exposes the government to exchange rate risk, especially in terms of a potential depreciation of the lek against the euro. The envisaged fiscal consolidation is therefore essential to mitigate debt-related vulnerabilities and rebuild room for policy manoeuvre.

Plans to improve the fiscal framework are key to supporting budget consolidation. The recent clearance of accumulated government arrears was accompanied by measures to prevent their re-emergence. These measures included improving checks on multi-year commitments and introducing more binding medium-term budgetary ceilings. However, the medium-term budgeting process still needs improvement, not least because over-optimistic macroeconomic and revenue projections and the resulting unrealistic expenditure allocations have undermined its credibility. To tackle this problem, a dedicated revenue unit has been established at the Ministry of Finance and coordination with the taxes and customs administrations will be strengthened to produce better bottom-up revenue forecasts. In addition, a draft fiscal responsibility law has been prepared at technical level and would reintroduce a fiscal rule following the repeal of the previous debt ceiling in 2012. Summoning political commitment to a well-designed fiscal rule that secures debt sustainability, counter-cyclicality and transparency would help greatly in anchoring expectations about budgetary discipline.

1.4. STRUCTURAL REFORMS

Albania's ongoing fiscal consolidation needs to be supported by profound structural reforms in order to bring about sustained growth. The main bottlenecks for a more competitive economy are institutional and regulatory barriers affecting both the overall business environment and foreign trade; access to finance; access to and reliability of the electricity supply; low labour market participation; the mismatch between skills demand and supply in the labour market; and the large share of the informal economy. Widespread corruption is another key obstacle figuring in the top three concerns of businesses according to the Business Environment and Enterprise Performance Survey (BEEPS).

The structural reform policy guidance adopted at the Economic and Financial Dialogue with the EU in May 2015 has been partially addressed. A new law on higher education and scientific research in higher education was adopted in 2015 and the accompanying implementing laws are to follow in 2016. An agreement was signed in 2015 between the Ministry of Education and Sport and the British Quality Assurance Agency for the independent accreditation of higher education institutions and to assist in capacity building of the national accreditation agency, in order to join the European Network of Quality Assurance. Measures to improve vocational education and training (VET) have been embedded in a National Employment and Skills Strategy, adopted in 2014, but much remains to be done to adapt training offers to labour market needs and to improve the quality and effectiveness of VET provision.

To further ease the regulatory and administrative burden on businesses, the National Business Centre was established in November 2015 as a one-stop shop for business registration and licensing. The implementation of the streamlined authorisation system is ongoing. The newly established Investment Council is by-and-large operational and helps to facilitate communication between policymakers and businesses.

Investments in the core transport network will be prioritised by establishing a single project pipeline. The power sector law entered into force in June 2015 and work is progressing on bylaws, especially those aimed at unbundling the energy sector. No real progress has been made on adopting a land cadastre strategy.

The ERP correctly identifies key obstacles for growth and competitiveness in an analysis that underpins the prioritisation of reform measures. A number of the reform measures in the ERP have only a limited budgetary impact as they are of a more strategic, planning and programmatic nature. The overall composition of envisaged measures looks appropriate given the limited fiscal space available to Albania due to its high public debt and commitment to fiscal consolidation. However, implementation and monitoring weaknesses remain and are not sufficiently acknowledged in the ERP. One of the main shortcomings of the programme is the evaluation of the measures' expected outcomes, which are either set too high to be regarded as realistic or are not ambitious enough.

Public finance management

Weaknesses in public finance management (PFM) are well known but get limited attention in the ERP. Albania adopted a PFM reform strategy in 2014, making it the first country in the region to do so. The reform strategy contains measures to address the key systemic weaknesses in PFM. These include poor quality of public spending and no value-for-money reviews; inadequate public procurement and contract management practices; and an inadequate correlation between annual budgeting and medium term budget plans. However, PFM is not linked to a priority measure in the ERP, which fails to mention public investment management, public procurement or external audit as problem areas. The PFM reform strategy, which benefits from EU budgetary support, requires a sustained political commitment to meet the deadlines and achieve the agreed targets.

Infrastructure

Given Albania's high degree of dependency on hydro power resources for power generation, diversifying the energy supply would be beneficial for the country's economic development. The energy sector is far from being a real market as it remains overly concentrated, centralised and regulated. There are significant losses in electricity distribution, which makes it necessary to import additional electricity. The country has not yet fully implemented the Energy Community Treaty nor the soft measures agreed under the Berlin process on regional cooperation in infrastructure development.

The measures to further liberalise the energy market in accordance with the Energy Community Treaty and introduce gas to the energy mix are highly relevant in addressing the above constraints. Liberalising the energy market is essential to increase the competitiveness of the economy; however, risks resulting from it should be considered and mitigated. Large-scale investments are needed to modernise the transmission network and safeguard a reliable and sustainable energy supply. In addition, further progress in controlling illicit energy use will require faster and sustained implementation of the energy sector reform. Liberalising the market should draw the interest of private companies for a long-term engagement in Albania and relieve pressure on the public budget. At the same time, the independence of the regulatory body also needs to be strengthened to ensure a level playing field. Increased competition on the market could also reduce prices for businesses and households, even if this is not considered in the ERP. The reform on the diversification of energy sources focuses on gasification. The actions include adopting a gas master plan and continuing the support to the Trans-Adriatic Pipeline project. These activities seem manageable and should help achieve the aims of the reform.

Albania's external trade is predominantly done by road or maritime transport. Limited public funding opportunities to further develop and implement big infrastructure projects is a key bottleneck for the transport sector. Implementing the soft measures agreed under the Berlin process on regional cooperation in infrastructure development would further support the development of transport infrastructure.

The two transport infrastructure measures concerning a highway and the port of Durrës seem relevant but a lack of analysis makes their final impact on competitiveness difficult to assess. The envisaged feasibility study for the construction and upgrade of the Adriatic-Ionian corridor is an important first step that will have the impact expressed in the ERP once the construction works are finished and the infrastructure is complete. The measure on the upgrade and construction of infrastructure in the port of Durrës will facilitate traffic in and out of the port. Deepening the port basin and rehabilitating two quays will increase the potential number and size of ships that can enter the port, while constructing an internal railway will facilitate work in the port. However, the lack of a quantified assessment makes it difficult to assess the relevance of this measure to the competitiveness of the economy as a whole.

Albania's future competitiveness depends largely on the availability of fixed broadband infrastructure capacity to manage 'big data' volumes. A proper legal and regulatory framework is necessary to ensure an investment-friendly environment for broadband development by the private sector, as broadband penetration remains extremely low at a mere 8%.

The reform involving the adoption of the new law to reduce the cost of broadband infrastructure is welcome. However, if it is to have the intended impact, the law should be implemented in synergy with the measure on the effective implementation of the digital agenda strategy. Moreover, a budget should be made available to improve broadband backbone and backhaul capacity, since there is currently no funding for this. Well-coordinated telecommunication, transport and energy infrastructure projects will allow a sharing of digging costs and attract private investment. Besides the availability of adequate infrastructure, the development of ICT services requires that competition among operators is ensured and the independence of the regulator is safeguarded.

Sector development

Agricultural sector development

Albania's agricultural sector is characterised by small and fragmented holdings. It is hampered by still-unresolved land ownership issues such as inaccurate or overlapping boundaries between properties, unregulated land use, high transaction costs in selling and buying property, and absent or not-functioning registers. Informality is widespread in this sector, safety and quality standards are not enforced, and capital investments are insufficient.

The measure to consolidate and defragment agricultural land should allow farmers to make use of economies of scale. The timeline, costs, budgetary impact and expected impact on competitiveness are all well described in the ERP, although doubts may be raised about the level of ambition and insufficiency of funds. Property and land consolidation will require time. Consequently, in 2016-2018 it may be more feasible to concentrate on solving property rights issues, completing the legislative framework, and starting work on the electronic country-wide cadastre.

Industry sector development

Somewhat surprisingly, no information is provided on industry sector development. The industrial sector in Albania is relatively small, accounting for around 14% of GDP. Main sectors include food processing, textiles and footwear, the extracting of raw materials and the production of cement and chemicals. Industrial exports are concentrated on raw materials and textiles/footwear. There is considerable room for export diversification.

Services sector development

Services constitute the largest sector of the Albanian economy. They contribute about 70% to gross value added. Therefore, their importance and potential for further development should be recognised in future strategies and not be given less attention than the industrial or agriculture sectors. In this context, it is important to underline that the export of services is in surplus and that tourism already has a high economic impact in Albania, even though it performs below potential. The total contribution of travel and tourism to GDP, including indirect effects, is estimated at around 20%. However, the sector faces numerous challenges linked to the lack of skills of tourism professionals, low accessibility of tourism services, the absence of a sustainable natural and cultural offer, and the lack of coordination and planning both within the sector and with other relevant sectors such as vocational education and training.

In this context, the measure to standardise the tourism sector is particularly relevant. If properly implemented, this would address widespread informality and support growth and competitiveness. However, the measure on its own is rather unambitious, lacks specification, and is not explicitly linked to other sector-specific strategies such as the ones on VET, rural development, business environment, RDI, infrastructure, and land ownership.

Business environment, corporate governance and reduction of the informal economy

Despite past efforts, Albania's businesses are constrained by a host of factors in their surrounding environment. One of the main obstacles is the complicated legal and regulatory framework, which is exacerbated by an inconsistent enforcement. A simpler regulatory framework and more business-friendly administrative procedures as well as improved legal certainty brought about by a successful justice reform would increase the country's attractiveness to foreign investors. Tax legislation tends to be enforced in a non-transparent manner allowing for *ad hoc* exemptions for some businesses. Unfair competition from the informal economy is an additional serious challenge. Other bottlenecks include problems with starting a business, obtaining construction permits, enforcing contracts and the high regulatory costs to businesses. Access to finance for SMEs is also constrained and limits the development of the private sector and its integration in regional and European markets.

The creation of a legal cadastre would facilitate investment and it remains a priority for Albania. However, progress is limited. In this context it is important to analyse weak spots and strengthen capacities in order to ensure smooth legal land registration, the full functioning of the cadastre in general and especially the e-cadastre until 2019.

The planned measures to improve the business environment are important, but fighting the informal economy and corruption remains a major task. The measure on reducing the regulatory burden for businesses focuses on making the National Business Centre fully operational as a one-stop-shop business registration and licensing body, while also introducing e-licensing and e-permits and developing IT solutions to ensure their effectiveness. The timeline for the roll-out, cost and budgetary impact are clearly set. However, the expected impact on investments, job creation and competitiveness may be slightly optimistic and may depend on other factors beyond the scope of the measure.

Technological absorption and innovation

Albania's capacity for technological absorption and research, development and innovation (RDI) is low. Key obstacles include low expenditure and investment in research and development (about 0.4% of GDP), weak links between the scientific and private sectors, as well as fragmentation of the national research and innovation system. As a result of this weak innovation policy infrastructure, almost all sectors of the economy mainly provide low-technology, labour-intensive and low-cost products and services.

Fostering cooperation between higher education, research and businesses supports innovation. The ERP focuses on the digital agenda strategy by continuing to implement the 'triple helix' model and on institutional reform on science. The triple helix should facilitate the application of innovative ideas, increase the readiness for and use of ICT in SMEs, and create an incubator for ICT start-ups. The timeline is clearly set, the challenges and costs are identified, and the objectives are measurable and clearly spelled out. If the project is well implemented, some improvement of competitiveness can be expected. In addition, the digital agenda strategy includes a number of specific measures and instruments to enable SMEs to make better use of innovation and ICT.

The aim of the institutional reform is to strengthen the scientific base through higher education restructuring. The new law on higher education and scientific research in higher education is a first step in the right direction and establishes two agencies for scientific research and higher education funding. However, the law defines only the main functions of these agencies without detailing implementation. In addition, what is missing is a clear strategy to increase capacity by inter alia capitalising on the sizable Albanian diaspora. Increased funding and a more focused RDI-strategy in a number of specific sectors (Smart Specialisation Strategy), notably in energy, agri-food and sustainable tourism, would support the country's capacity to attract investment in RDI.

Trade integration

There is substantial room to increase trade and foreign direct investment. Albania's openness to trade and per capita FDI stock lags behind most of its regional peers. Trade is held back by complex customs procedures, insufficient cooperation between agencies, and a low diversification of exported products. As the ERP correctly points out, the reduction of tariffs alone will not deliver the desired result of boosting trade integration. FDI levels remain below potential for various reasons, such as land ownership issues, the informal economy, respect of intellectual and industrial property rights and corruption. Both trade and FDI obstacles are linked with other challenges addressed by the ERP's top priorities, such as improving the transport infrastructure and reducing the number of administrative procedures. Addressing these challenges therefore necessitates a holistic approach.

Measures planned in the area of trade integration aim to address underlying structural bottlenecks to trade and FDI. The measure entitled 'facilitate trade through deep interagency cooperation' focuses mainly on strengthening the capacities of the National Food Authority. There is scope for better aligning domestic and regional trade policies, although this is not addressed in the ERP, while the establishment of the National Trade Policy Committee is only briefly mentioned. The text puts special emphasis on Kosovo as a main export market for Albanian products, but other markets, particularly within CEFTA, could be equally relevant. The focus on the implementation of the 'authorised economic operator' concept is welcome and would speed up export procedures. The measure regarding the implementation of legislative changes to promote new investments is a response to the strong need for FDI in the absence of a robust domestic private sector. The measure focuses on the implementation of the law on strategic investment, economic zones and public-private partnerships. A key element of the implementation is ensuring the Agency for Investment and Development (AIDA) is operational so that it can implement the law on strategic investments. Albania is still struggling with reputation risks, and this may have a negative impact on FDI decisions. In this context, the proposed measure may have a real medium- to long-term effect on the country's competitiveness.

Employment and labour markets

Increased economic activity in Albania has brought some labour market improvements, but has not translated into significant gains in employment outcomes. The first three quarters of 2015 saw a slight increase in labour force participation from 63% to 64.7% (in the age group 15-64 years). The employment rate for the same age bracket has also increased somewhat, to 53.3%, while the overall unemployment rate was 17.5%. Youth unemployment (15-29 years) stood at 32.3% in the third quarter of 2015. The employment rate for men was 16.4 pps. higher than for women.

Albania continues to be faced with low labour market participation, especially among women and youth, and overall long-term unemployment remains high. Better aligning education outcomes with labour market needs remains a key challenge. Activation and outreach of active labour market policies (ALMPs) and employment services remains insufficient. High levels of informality continue to act as an impediment to growth and full participation on the labour market, which also affects the social situation of the population. Other labour market challenges relate to legal and institutional labour market framework and include deficiencies in social dialogue and stakeholder involvement.

There has been some progress in improving higher education and the VET system. The new law on higher education has been adopted and preparations for accrediting higher education institutions are underway, but there has been no progress on the higher education strategy. Gradual progress has been made in establishing VET multifunctional centres.

Albania plans to address skills-mismatches and to improve the VET system. The Albanian Qualifications Framework is planned to be implemented by 2018 and a new law on crafts is to introduce a dual education system based on the German model. Establishing an apprenticeship system and tracking VET graduates are steps in the right direction. Nevertheless, implementation capacities may pose risks to effective implementation of the measures.

Boosting the capacity of employment offices and the ALMPs is relevant, but the expected impacts are low and there is a lack of strategic focus to combat informal employment. Limited employment gains point to unaddressed inefficiencies, such as insufficient activation and high engagement in informal employment. There have been some attempts to improve activation measures through better control of unemployment benefits and combining ALMPs with VET training, but the measures have yet to be implemented. A campaign has been conducted to increase the registration of employment, however there is no strategic and comprehensive approach to combatting undeclared work and increasing formal employment.

Social inclusion, combatting poverty, promoting equal opportunities

Albania's social protection system displays weaknesses in terms of both the efficiency and quality of social assistance and service provision. Overall, the challenges and priorities in the areas of pension and social security systems are adequately identified in the ERP, but an inadequate overview and assessment of Albania's social situation make it difficult to target and provide for sufficient outreach of social assistance.

A key challenge for the social protection system is to remove disincentives to work, while targeting assistance to those in need. The ERP presents an extensive list of expected outcomes that the reform measures should achieve, but it is often not clear how the actions will be carried out. The implementation of the 2015 pension reform appears to be showing some positive initial results, such as decreased social insurance expenditure and an increased number of contributors, but there is no comprehensive assessment of the reform. The expected outcome of reducing the dependency ratio from 80% in 2013 to 61% in 2017 appears over-optimistic. The reorganisation of social security services is only briefly mentioned in the ERP. In order to make cash assistance more targeted and efficient, a national electronic registry is planned to be established by 2017 along with a social reintegration scheme, which would link social assistance with inclusion in the ALMPs. As important elements of improving activation and targeting of social assistance, they warrant being developed more thoroughly and with strong commitment. Another important measure is introducing social inclusion monitoring, which would cover impacts on employment, education and the social and health situation in the country, and develop relevant statistical indicators.

One of the key challenges to improving the social situation of the population is improving access to and the quality of all levels of education in Albania. Poor performance in basic skills not only affects future labour market prospects, in particularly of young people, but has also significant impact on the social and economic situation of the broader population, including socially vulnerable groups. With regards to this, new curricula are planned to be introduced in the pre-university education system by 2018, which will be accompanied by relevant teacher training. While the timeline is adequately prepared, the ERP gives little information on the content of the changes and there is no indication of the implementing institutions or the system that will be used to monitor progress and effects. There is insufficient focus on preparing labour market entrants for a more entrepreneurial and digital economy. There is no reference to pre-school education, which is the means of preparing children of all backgrounds to have equal chances of succeeding in formal education.

1.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2015

2015 policy guidance	Summary assessment
PG 1: Pursue fiscal consolidation in line with the objective to put the public debt ratio on a downward path and lower it to less than 66% of GDP by 2017. At the same time, preserve fiscal space for growth-enhancing public investment by making sure that revenue performance remains on track, allowing for the initially budgeted capital expenditure to be executed.	Albania has not addressed PG 1: The budget deficit came in lower than planned, at 3.8 % of GDP against the 4 % target, which also includes arrears clearance expenses worth around 1.2 % of GDP. However, this was achieved thanks to expenditure under-execution, largely affecting capital spending. Revenue significantly underperformed against the target as a result of optimistic assumptions about the 2014 revenue base, nominal GDP growth in 2015, and gains from better tax administration. The debt ratio has yet to start falling. Forecasts assume that this will happen in 2016. The ERP's debt trajectory has been revised slightly upwards from the previous year and expects the debt ratio to fall to 68 % in 2017 and further to 63.9 % in 2018.
PG 2: Progress towards eliminating high fiscal risks posed by the electricity sector by reducing distribution losses at an average rate of 5 percentage points in the coming years and by improving the bill collection rate. Evaluate the fiscal impact of the property compensation scheme and accommodate the costs in the medium-term budget, if necessary by adjusting the parameters of the scheme with the aim of creating a realistic, transparent and sustainable compensation framework.	Albania has partially addressed PG 2: Electricity-sector reforms yielded significant gains and distribution losses were reduced by 6 pps. in 2015 while the collection rate reached 107 % of the target. The ERP now expects that as from 2020 the electricity sector will operate without support in the form of state-guaranteed loans. The medium-term budget increased allocations for property compensation to 0.3 % of GDP annually, and a recently-approved law aims to adjust the existing scheme by compensating former property owners at current market value based on historical land classification. However, it is not clear to what extent the fiscal bill, previously estimated at as much as 70 % of GDP, will be reduced as a result of these changes. Moreover, the law still faces legal hurdles as its constitutionality has been challenged.
PG 3: Reinforce the budget management framework by implementing the public finance management strategy agreed with the Commission and adopted in December 2014, in particular by moving towards adopting a credible fiscal rule which will effectively ensure the sustainability of public finances in the long run and by	Albania has partially addressed PG 3: A draft fiscal responsibility law has been prepared at technical level but is not reported in detail in the ERP, which only mentions that the draft is available and ready to be sent to the Council of Ministers. Contrary to the previous ERP, no date of

strengthening budget forecasting.	expected adoption is given. A dedicated revenue unit has been established at the Ministry of Finance. One of its aims is to improve bottom-up revenue forecasts. It is not clear how the inherent optimism bias in macroeconomic forecasts will be addressed.
PG 4: Take further measures to address the issue of non-performing loans, involving all key stakeholders including the Bank of Albania as necessary, with a view to achieving a sustainable reduction of their level. In this context, addressing impediments related to judicial enforcement and collateral execution would appear helpful.	Albania has partially addressed PG 4: The NPL ratio decreased to 18.2 % at the end of 2015 from 22.8 % a year earlier. This was mainly due to mandatory loan write-offs. A high-level inter-ministerial working group has been established and in September 2015 an NPL action plan was adopted jointly with the central bank. It integrates and sequences reforms with regard to supervision, enforcement, debt restructuring and insolvency. The implementation of the action plan has started but is yet to produce tangible results.
PG 5: Adopt and start to implement the law on higher education, as well as the new strategy for higher education. Establish an independent accreditation system for all public and private universities. Continue the restructuring of the VET system with a view to improving the relevance of the training for the needs of the labour market.	Albania has partially addressed PG 5: The new law on higher education was adopted in 2015 and the accompanying implementing laws are to be adopted in 2016. No reference to the strategy for higher education is provided. An agreement was signed with British Quality Assurance Agency for the latter to carry out the accreditation of the higher education institutions and to assist in capacity building of the national accreditation agency, with the aim of approaching the European Network of Quality Assurance. Measures related to VET refer to the National Employment and Skills Strategy 2020, adopted in 2014, but appear to have not yet been implemented and there is no overview of the implementing bodies provided to adapt training offers to labour market needs and improve the quality and effectiveness of provision. The new measures presented in the ERP appear to be more of a preparatory nature, postponing the actual implementation to 2016 and beyond.
PG 6: Improve the overall business environment, including by implementing the merger of the NRC (National Registration Centre) and NLC (National Licensing Centre) to further ease the regulatory and administrative burden for businesses. Start the implementation of the simplification regime for authorisations. Make the newly established	Albania has fully addressed PG 6: The National Business Centre (NBC) was established in November 2015 as a one-stop shop for business registration and licensing to further ease the regulatory and administrative burden for

investment council fully operational.	businesses. The implementation of the simplification regime for authorisations is ongoing. The newly established investment council is by-and-large operational.
PG 7: Adopt and start to implement the transport strategy and action plan for 2016-2020. Focus investments on the core network. Adopt and start to implement the national energy strategy and the Power Sector Law, including speeding up the unbundling of the energy sector. Prepare single sector pipeline of priority investments for both transport and energy.	Albania has partially addressed PG 7: The transport strategy is being drafted and should be completed in the third quarter 2016. Focusing investments on the transport core network will be facilitated by project prioritisation through the single project pipeline (SPP). The Power Sector Law entered into force in June 2015 and work is progressing on bylaws, especially on unbundling of the energy sector.
PG 8: Adopt a strategy on the land cadastre and concrete measures to increase momentum in agricultural land consolidation.	Albania has not addressed PG 8: Specific measures to increase momentum in agricultural land consolidation are envisaged within this ERP. No real progress has been observed on the adoption of a strategy on the land cadastre.

1.6. THE 2016 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, 25 May 2016

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

1. Pursue fiscal adjustment by ensuring that revenue and expenditure targets and, by extension, the deficit target, are met. Evaluate and quantify fiscal risks stemming from all active PPP and concession contracts and from local government arrears.

2. Underpin fiscal consolidation by improving the fiscal framework; in particular, (i) strengthen medium-term budget plans by empowering the Parliament to approve binding three-year ceilings at programme level and by clearly showing in the MTBP which funds are effectively committed and which are new expenditure under the ceiling; (ii) move decisively towards adopting a fiscal rule which ensures debt sustainability, counter-cyclicality and transparency.

3. Continue to address risks to financial stability and the real economy by following-up on the NPL action plan which has been adopted and developing a medium-term strategy to promote the use of the local currency in the financial system, including all relevant stakeholders. Throughout this process, the central bank's monetary policy stance may remain accommodative insofar as the path of fiscal consolidation remains favourable, but risks related to further policy easing should be carefully assessed.

4. Fully implement the obligations under the Energy Community Treaty including, in particular, the full unbundling of transmission and distribution activities in the electricity and gas sectors in order to improve energy security and allow market entry of independent operators.

5. Strengthen administrative capacities to ensure smooth legal land registration, the full functioning of the cadastre in general and especially the e-cadastre until 2019. Implement the e-procedure for building permits in order to cut red tape and encourage investments.

6. Increase the coverage of active labour market policies and improve the activation of unemployed and inactive persons, especially youth, women and long-term unemployed. Step up current efforts to achieve a comprehensive approach to reducing undeclared work.

Annex: Overall assessment of programme requirements

Albania's Council of Ministers approved the economic reform programme (ERP) on 27 January 2016 and submitted it to the European Commission on 29 January 2016. The programme is in line with the annual budget for 2016 and the Macroeconomic and Fiscal Framework for 2017-2019.

Ownership and internal coordination

The ERP was centrally coordinated by the Ministry of Economic Development, Tourism, Trade and Entrepreneurship. It was prepared by an inter-institutional working group with representatives and experts from relevant institutions of the Albanian Government and the Bank of Albania.

Stakeholder consultation

Stakeholders have not been consulted. The ERP was presented to the Albanian Parliament after it had been adopted. There has been no public consultation or consultation with the social partners on the ERP. Social dialogue and stakeholder involvement in the preparation of the ERP needs substantial improvement.

Macroeconomic framework

The programme presents a concise but reasonably comprehensive picture of past developments. Almost all the relevant data are covered, but weaknesses remain, not least regarding labour market and wage statistics. The macroeconomic framework is coherent, consistent and sufficiently comprehensive and provides an adequate basis for policy evaluation and discussions. This part of the ERP maintains the same quality as last year's programme, although some indicators of external sustainability have been dropped from the analysis this year. Some of the factors affecting financial intermediation could have been also covered more in detail.

Fiscal framework

The fiscal framework is detailed and well integrated with the policy objectives. It is also consistent with the macroeconomic framework. However, data on the implementation of the 2015 budget are not comprehensive as they cover only the first three quarters, which is a step backwards from the previous ERP. On the other hand, the factors behind the projected rise in revenue are presented more clearly, including the expected fiscal impact of economic growth, discretionary measures, and better tax administration. There is room to better describe the planned expenditure measures and their anticipated budgetary impact. Forward-looking plans regarding debt management are much less developed than in 2015. Fiscal data do not conform to ESA2010 requirements as regards the delimitation of general government, the distinction between financial and non-financial transactions, and the recording of accruals. Since November 2014, Albania has submitted regular excessive deficit procedure notifications to Eurostat and is expected to gradually align its fiscal statistics to EU requirements.

Structural reforms

The section on structural reform priorities follows the guidance note and presents in general a good diagnostic per area. It also reports on the implementation of the policy guidance adopted at the Economic and Financial Dialogue with the EU in May 2015. The structural reform priorities as included in the 17 measures correspond well to the key obstacles to growth and competitiveness identified in the diagnostics and are in many cases in line with the policy guidance. Taking into account the tight budgetary space, the ERP presents a balanced blend of ongoing and new measures. It is worth mentioning that the ERP covers not only public investment projects, but also long-term strategies and market economy oriented adjustments of the legal framework.

The description of the majority of reform measures is overall sufficiently detailed in terms of specific actions, timeline, budgetary impact and competitiveness to allow adequate monitoring and follow-up.

2. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

2.1. EXECUTIVE SUMMARY

The economic recovery continues, but fiscal discipline disappoints again. A surge in household and public spending, and robust export growth underpinned the economic expansion in the Former Yugoslav Republic of Macedonia in 2015. Real GDP increased by 3.7%, slightly accelerating from its performance in the preceding year. After repeated slippages in the past years, the government was again required to resort to a supplementary budget in mid-year and to raise the deficit target, even though it had benefitted from revenue over performance. The revised target was met at year-end, but spending remained tilted towards social transfers, and capital expenditure was again markedly under-implemented compared to the budget.

The government expects an important acceleration of GDP growth until 2018. Economic activity is projected to strengthen gradually to 4.5% in 2018, on the back of accelerating growth in private consumption and a renewed pick-up in investment. Net exports are expected to weigh on growth throughout the programme's horizon. This growth scenario seems overly optimistic, as the expected surge in domestic demand depends critically on further employment growth and increases in disposable income, as well as on the implementation of the government's planned public works. These are subject to important downside risks. Moreover, the country is undergoing a severe political crisis which can deter foreign investors and impact negatively on the government's ability to implement investments and reforms. While there is little immediate concern about external sustainability, the level of external debt remains elevated. It is not likely to diminish in the medium term, as public sector financing needs remain sizeable and will be met in large part by loans from abroad.

The government remains committed to fiscal consolidation, but misses to point out concrete supporting measures. The government intends to reduce the fiscal deficit to 2.6% by 2018, while at the same time maintaining a low tax environment. It has not specified any revenue or expenditure measures supporting these targets and is planning further substantial expenditure increases in 2016. General government debt, as well as public debt, which includes the guaranteed liabilities of state-owned enterprises, are expected to increase further, and to stabilise post-2018.

The main challenges that the country faces in order to improve economic governance, stimulate growth and translate it into employment are the following:

In the absence of identified revenue and expenditure measures or policy changes, the success of the envisaged path of fiscal consolidation hinges critically on the programme's optimistic growth assumptions.

Debt stabilisation is subject to risks from potential slippages in the government's fiscal consolidation path. Additional vulnerabilities are created by the high financing needs of the government and state-owned enterprises. Fiscal risks emanating from the operations of the wider public sector are increasing.

The efficiency of public spending is impeded by weaknesses in budget planning and in the management of capital investment. Shortcomings remain in particular as regards a conclusive medium-term budget framework, and the need for stronger linkages between annual budgets and the medium-term fiscal strategy.

Progress in making fiscal documentation more comprehensive and more transparent would improve the efficiency and the credibility of public finances.

Public finance management (PFM) is affected by insufficient prioritisation of public investments and by a weak procurement framework. The National Investment Committee and the single project pipelines are important first steps towards increasing transparency and comparability of projects. A comprehensive PFM reform programme has been in preparation for some time, but has not yet been adopted.

The unpredictable regulatory environment and difficult access to finance remain major obstacles for small businesses. Shortcomings in access to finance exist both on the supply and demand side. Commercial banks are risk averse in the face of high non-performing loans and SMEs have an insufficient capacity or willingness to access external finance.

Key challenges in the labour market include high unemployment (in particular long-term), high youth unemployment and the difficult transition from school to work, stagnating labour productivity, and low employment rates among women and people with low qualifications. Skills mismatches are one of the main concerns in the areas of employment and education. While the labour supply measures included in the ERP appear relevant and proportionate, the demand side policies to create jobs are largely absent. The unfavourable employment and social situation is due in some measure to the lack of an integrated approach including both active labour market policies and social assistance measures.

The macroeconomic and fiscal framework of the ERP is coherent, consistent and provides an adequate basis for policy discussions, while the structural reform section remains analytically weak. The measures included are unbalanced in favour of large-scale public investments in infrastructure. Some regulatory reforms have been included, in particular in agriculture and the business environment, albeit with limited expected impact on the competitiveness of the overall economy.

Implementation of last year's policy guidance has started, but remains partial and fragmented. While the government has initiated a number of measures in transport and energy infrastructures; business environment; access to finance; and, regarding the labour market, these reforms, in many cases, lack an overall strategy and are only insufficiently targeting the key challenges. Notwithstanding the adoption of single project pipelines by the National Investment Council, it is not obvious on which basis priority infrastructure investments are selected.

2.2. ECONOMIC OUTLOOK AND RISKS

Robust growth in 2015 was driven by household consumption, government spending, and exports. In 2015, annual real GDP increased by an estimated 3.7%. The economic expansion was underpinned by accelerating private consumption spending, an important public stimulus, and robust export activity. The latter, driven by the increased production of foreign direct investors, weathered a challenging external environment. Given the flat import demand in the first three quarters, net exports contributed to economic growth. Industrial production, including manufacturing, was disappointing, while construction remained strong, in particular in the second half, supported by demand for public road works.

The authorities expect the economic expansion to gather pace on the back of domestic demand. The government forecasts that GDP growth will accelerate to 4% in 2016, to 4.3% in 2017, and to 4.5% in 2018. Domestic demand would be the sole growth driver. Supported by rising employment and disposable incomes, and by further increases in household credit, annual growth in private consumption spending would accelerate in each of the three years, averaging 3.2%. Investment, after a lacklustre performance in 2015, is set to post gradually higher annual increases each year, averaging 7.8%. The latter would be underpinned by public, and by, mainly FDI-related private investment, driving the economy's investment ratio from 31.4% in 2015 to 34.6% of GDP in 2018. The foreign balance is projected to constitute an increasingly heavy drag on GDP growth in 2016 and 2017, with only slight improvements anticipated in 2018. An extension of production capacities by both foreign and domestic companies underpins the expected gains in exports. These would, however, be outweighed by domestic demand-related import increases. A reduction in current transfer inflows, and a bigger primary income deficit are set to widen the current account deficit in 2017. The economy is forecast to operate at potential as of 2017, but domestic price pressures are expected to remain low.

Domestic demand may prove less buoyant than projected. The authorities may be overestimating the projected expansion of domestic demand. Investment, on the one hand, hinges critically on the implementation of the government's public investment programme. However, the track record of previous years demonstrates that projects financed through the government's capital expenditure budget are prone to fall prey to mid-year budget adjustments, undertaken to meet previously underestimated current expenditure obligations and deficit targets. Also, budgeted capital expenditure has been consistently subject to marked under-realisation in the past. Private corporate investment is inhibited by liquidity strains and difficulties in accessing financing. Household spending, on the other hand, is susceptible to a potential slowdown in the growth of disposable incomes and employment. Overall growth in compensation is sluggish. Renewed, though moderate, price pressures are weighing on real net wages, which, in 2014 and 2015 had been increasing mainly due to deflationary pressures. These gains would stop, if inflation were to become positive. Private transfers from abroad, a stable source of household income, which averaged 19% of GDP over the past five years, are projected by the government to return to their long-term average of 16% by 2017. And, the growth of consumer loans may loose speed, in response to recent measures by the central bank aiming at slowing down their expansion. Moreover, the domestic private economy would have to account for a larger share of job creation for it to have the expected impact on economic growth, whereas job creation has been restricted to established foreign companies and the government sector in recent years. More jobs would also have to be created in higher-productivity sectors with above-average gross compensation. Overall, economic growth may hence be lower than the programme assumes, and may continue to depend importantly on export growth, rather than domestic demand.

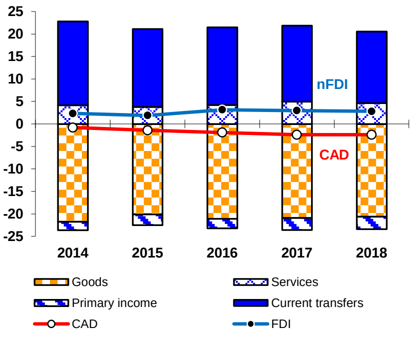
Table II.2.1:
Macroeconomic developments and forecasts

	2014		2015		2016		2017		2018	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	3.5	**3.5**	3.3	**3.5**	3.3	**4.0**	3.5	**4.3**	na	**4.5**
Contributions:										
- Final domestic demand	4.8	**5.5**	3.1	**3.7**	3.3	**4.5**	3.8	**5.1**	na	**5.2**
- Change in inventories	0.7	**na**	-1.3	**na**	-1.0	**na**	0.0	**na**	na	**na**
- External balance of goods and services	-1.9	**-1.9**	1.4	**-0.2**	1.0	**-0.5**	-0.2	**-0.8**	na	**-0.7**
Employment (% change)	1.7	**1.7**	2.1	**2.1**	2.1	**2.4**	2.3	**3.2**	na	**3.5**
Unemployment rate (%)	28.0	**28.0**	27.0	**26.9**	25.8	**25.7**	24.6	**24.3**	na	**22.8**
GDP deflator (% change)	1.1	**1.1**	-0.5	**1.5**	0.4	**1.7**	1.2	**1.7**	na	**1.7**
CPI inflation (%)	-0.3	**-0.3**	-0.3	**-0.3**	0.7	**2.0**	1.5	**2.0**	na	**2.0**
Current account balance (% of GDP)	-0.8	**-0.8**	0.2	**-0.5**	0.2	**-1.9**	0.1	**-2.4**	na	**-2.4**
General government balance (% of GDP)	-4.2	**-4.2**	-3.8	**-3.6**	-3.5	**-3.2**	-3.1	**-2.9**	na	**-2.6**
Government gross debt (% of GDP)	38.2	**38.2**	39.6	**38.6**	40.8	**39.4**	41.6	**40.7**	na	**41.5**

Sources: Economic Reform Programme (ERP) 2016, Commission 2016 Winter Forecast (COM)

Export dynamics benefit from positive fundamentals. The external balance may weigh less on growth than assumed in the programme. Supported by an increasingly dynamic external environment, exports are likely to increase at solid rates. A number of recently established foreign companies are expected to start production in 2016, and the ongoing change in the export structure towards higher value-added products is having a first positive impact on export values. Import demand may remain more subdued than the programme assumes, given that both drivers, public and foreign direct investment, and household spending may turn out less buoyant than projected. However, export activity is likely to remain driven by a limited number of foreign companies established in the tax-advantageous industrial zones, which source almost all their inputs from abroad.

Graph II.2.1:
Changes in the current account balance, in % of



Sources: ERP 2016, Commission calculations

Short-term external vulnerabilities are still contained. The financing of external deficits relies heavily on remittances from abroad and on foreign direct investment inflows. The trade deficit for goods and services, while remaining sizeable, fell somewhat in 2015, to some 16.5% of estimated GDP which was more than covered by private transfers. Yet, the current account deficit increased slightly, to 1.4% of GDP, as a result of the widening primary income deficit. It was overcompensated for by net inflows of FDI. The authorities expect the current account deficit to widen further and stabilise at 2.4% in 2017 and 2018. A further deterioration of the primary income deficit and a decline in private transfer inflows would offset further improvement in the trade balance. Yet, the impact of enhanced production capacity by exporting foreign investors, and a reduction in the import-intensity of exports may only be noticeable in the medium-term, while the expected reduction in private transfers may be more immediate and put additional pressure on the current account in the short-term. Also, FDI inflows remain low and volatile, and the authorities have revised downwards their projections for 2016-2018.

Public sector financing requirements create risks for external sustainability. While key indicators of indebtedness, such as the coverage of short-term external debt by foreign reserves, suggest that the country has a low external debt, the actual level remains high. At the end of 2015, the share of gross external debt in estimated GDP stood at 69.9%, having risen by about 14 pps since 2009. This rise was mainly accounted for by increased government borrowing abroad, with the share of external private debt in GDP remaining largely constant. At the end of 2015, the external debt of the public sector came to about 31% of GDP, having risen by 12 pp since end-2010, and markedly exceeding central bank reserves. The maturity structure is favourable, limiting refinancing risks, as short-term debt accounts for only 15% of total. Yet, sizeable foreign trade credits to the private sector and short-term intercompany lending contain rollover risk. The programme does not inform about the currency breakdown of foreign debt or, on upcoming repayment obligations. The authorities expect the share of external debt in GDP to stabilise at the 2015 level. Yet, given the government's reliance on foreign funding for financing its public investment agenda and the budget deficit, external debt is set to rise further. Meeting the authorities' medium-term targets for the stabilisation of external debt thus hinges critically on strong growth performance. The sustainability analysis in the programme would have benefitted from a clearer identification of debt-creating flows, and from an assessment of vulnerabilities arising from potential shocks to interest rates or to the primary current account.

The alternative scenario fails to take into account downside risks to domestic demand. The authorities have presented an alternative macroeconomic scenario based on weaker external demand from the main trade partners. The resultant fall in the growth rates of exports and investment would lower real GDP growth by an average of 1pp in 2016, 2017, and 2018, compared to the baseline scenario. This scenario would have benefitted from an analysis of the impact of domestic risk factors, such as delayed implementation of critical structural reforms, under-implementation of public investment, renewed political uncertainties curbing confidence, or, adverse developments in households' disposable income on domestic demand.

External factors are expected to exert moderate pressure on prices. The fall in prices for fuels and, consequently, transport, was the main factor that drove the average annual inflation rate down below zero again in 2015. This was supported by lower prices for food, accounting for over 40% of the CPI structure. The government assumes that the CPI will rise by 2% in each year covered by its forecast. External factors would be the main drivers, as the downward trend in oil prices is expected to come to a halt, while prices for food and some other commodities are expected to rise again. The authorities see few pressures arising from stronger domestic demand.

The banking sector remains resilient, but credit risk lingers on. The sector's performance remained robust in 2015. Banks posted markedly higher profitability in 2015 than in the preceding year. Liquidity indicators remained sound, as did solvency indicators, with the capital adequacy ratio about double the domestic supervisor's required minimum of 8%. Amid some easing of lending conditions, growth in credit to the private sector accelerated further. Credit risk remains high, however, with the average ratio of non-performing loans (NPL) to total loans in the non-financial sector in 2015 only slightly below its level in the preceding year. About 90% of all NPLs consist of mortgages with immovable commercial property as collateral, according to the authorities. While banks have resorted increasingly to restructuring, in response to the central bank's credit risk management regulation of March 2013, they find the sale of foreclosed assets difficult in illiquid property markets. To facilitate sales, the authorities are working on two registers taking stock of property transactions and estimated values. In December 2015, the central bank imposed an obligation on banks to write-off fully-provisioned loans that have been on their books for more than 2 years, with effect in June 2016. Overall, monetary policy kept its neutral stance, to which it reverted in 2014. It kept the key interest rate unchanged at 3.25%, and successfully defended the currency peg, against the background of declining foreign exchange reserves.

Table II.2.2:
Financial sector indicators

	2011	2012	2013	2014	2015
Total assets of the banking system, mEUR, at end-year	5,385	5,738	6,008	6,509	6,889
Foreign ownership of banking system, in % of total equity	73.8	75.1	74.5	75.4	74.8
Credit growth to private sector, annual change in %	8.1	7.3	4.3	8.4	9.1
Deposit growth, annual change in %	4.6	7.2	4.8	8.2	7.9
Loan- to-deposit ratio (Q4)	86.4	88.1	88.8	88.1	90.6
Financial soundness indicators					
- non-performing loans (in % of total loans to the non-financial sector)	9.6	10.4	11.9	11.6	11.4
- regulatory capital to risk weighted assets	16.7	17.3	17.2	16.4	16.0
- liquid to total assets	31.2	31.8	33.0	33.0	32.0
- return on equity	1.4	1.7	3.0	6.1	9.1
- forex loans (in % of total loans)	58.7	56.6	54.0	50.7	47.7

Sources: National Central Bank, DataInsight

2.3. PUBLIC FINANCE

Fiscal discipline was again disappointing in 2015. The government did not use the revenue overperformance in the first half of the year, caused by a recent broadening of the profit tax base, to create buffers against unforeseen fiscal pressures later in the year, or to frontload consolidation. Rather, in a mid-year supplementary budget, both current and capital spending were increased, and the deficit target was raised by 0.2pps to 3.6% of GDP (and met at year-end). VAT revenues underperformed yet again in 2015, pointing to persistent difficulties in collection. On the expenditure side, the supplementary budget raised salaries and allowances, in particular for the police, and expenditure on goods and services, mainly as a result of the migrant crisis. Pensioners benefited from supplementary ad-hoc indexation, with pensions raised by 10% overall, above the 5% indexation cap in force. Although the budget for public investment projects was also raised in mid-year, capital expenditure was noticeably low yet again, with only 84% of budget implemented. The authorities point out that some of the underperformance relates to non-productive capital spending on the budget users' own accounts, while the remainder is due to delays in the procurement and implementation.

The 2016 budget is again based on over-optimistic assumptions. The macro framework underlying the 2016 budget – assuming 4% real GDP growth - appears overly optimistic, leading to a likely overestimation of public revenues. The authorities expect total general government revenue, on the assumption of no changes in revenue policies, to increase by over 17%, in nominal terms, over the 2015 outcome, with the revenue share in GDP almost unchanged. The expenditure share in GDP is expected to decline by 0.2pps. Yet, meeting this consolidation target depends on the government's growth projections coming true, as it plans further substantial increases in spending: a further 5% indexation increases in pensions planned for September 2016 and 2017; a possible supplementary indexation of pensions; possible increases in public wages still being considered by the government; a 5% increase in social transfers planned for July 2016; and, a 15% increase in budgeted public investment expenditure. The fiscal stance is expected to be more restrictive, with the cyclically-adjusted deficit declining from 3.8% in 2014 to 3.2% in 2018 (closing of the output gap assumed for 2017 by the government). The government's plans for financing the projected 2016 deficit (308m euros) by parts of the proceeds from its November 2015 Eurobond (270m), possibly a further Eurobond in 2016, and, if necessary, recourse to its sizeable deposits at the central bank, seem well-reasoned.

Box: The 2016 budget

*	On 24 November 2015, the parliament adopted the 2016 general government budget, based on the assumption of 4% real GDP growth and 2% inflation.

*	The budget assumes an almost unchanged revenue ratio of 32.3% of projected GDP, and a decline in the expenditure ratio by 0.2pp to 35.6% compared to the 2015 revised budget.

*	The general government deficit target is set at 3.2% of GDP, after an estimated 3.5% deficit in 2015.

Main measures in the 2016 budget

Revenue measures	**Expenditure measures**
	5% increase in social benefits as of July (0.07% of GDP p.a.)
	5% increase in pensions as of September (0.5% of GDP p.a.)
	Increase in agricultural subsidies (extent not specified)

Source: ERP 2016

Medium-term fiscal consolidation needs to be underpinned by concrete measures. In line with the 2015 fiscal strategy, the authorities predict that the general government deficit will decline gradually from 3.6% of GDP in 2015 to 2.6% in 2018. This would be managed by a 1pp drop in the revenue ratio, to 31.2% of GDP over this period, and a 2pps decline in the expenditure ratio, to 33.8% of GDP. Total revenues would rise by 27.5% between 2015 (actual outcome) and 2018, while total expenditure would rise by 23%, in nominal terms. While overall net lending would decrease, in terms of GDP, the government is not predicting a decline in the cyclically-adjusted balance (the programme does not contain information on temporary or one-off measures so as to project changes in the overall structural balance). The amounts allocated to the main current expenditure items - social transfers, subsidies, and collective consumption - are expected to decline, as a share of GDP, over 2016-2018. Yet the government's medium-term fiscal strategy does not specify measures to support such ambitious fiscal consolidation. Rather, the intended annual increases in entitlement spending, and the large public investment agenda, raise questions about the credibility of the mid-term scenario. As a result of a flat tax rate, a relatively narrow tax base, and shortcomings in VAT collection, in particular, income from personal and corporate income taxes has been low. The persistent underperformance of tax revenues - by an average of about 8% between 2009 and 2014 - and, in particular, overestimation of VAT revenues, which make up between a third and a quarter of total central government revenue, appears to be a major cause of unheeded financing pressures arising in mid-year. It is also not clear whether the government expects the 2015 surge in profit tax revenue to be sustained in future years. The projected decline in both, revenue and expenditure share in GDP, therefore seems to rely overly on GDP growth assumptions. The authorities point to recent and forthcoming measures to streamline social spending, and measures aimed at improving the efficiency of public financial management, but do not quantify the expected savings. The government may need to identify concrete measures, or at least guidelines such as keeping constant the share in GDP of certain categories of entitlement spending under less optimistic GDP growth assumptions; reflect on revenue-enhancing measures; and consider improvements in the efficiency of tax collection. The government does not inform in the programme about planned policy changes in areas with high reform needs, such as the pension system.

The composition of public expenditure could be more growth-friendly. The general government budget continues to be heavily dominated by entitlement spending, reducing the room for manoeuvre as regards fiscal contingency planning in the event of disappointing fiscal outcomes. Social transfers including pensions account for some 45% of total budgeted spending. Pensions alone make up about one quarter of total spending. As a share of GDP they have been rising continuously, widening the pension fund's deficit, which has already undergone several rounds of cuts in contributions, and which is covered by the central government budget. The share of pensions and pensions-related payments in GDP is expected to rise further in 2016 and beyond, from 8.5% in 2011 to 9.6% in 2018. The share of all social transfers has also been rising continuously, to about 15.1% in 2015, according to government estimates, while it is projected to fall by some 0.5pps until 2018, given both diminishing annual nominal increases and the strong growth performance. On the other hand, the share of capital expenditure in total general government expenditure averaged only 11%, amounting to 4.5% of GDP over the last 10 years.([1]) The authorities plan to increase public investment spending temporarily to 5.4% of GDP in 2016. The ratio is then projected to fall again reaching 5% of GDP by 2018.

Public investment projects need to be prioritised and management of capital investment improved to contain budget pressures. While budgeted capital expenditure is already relatively modest as a share in GDP and total expenditure, and subject to under-execution, the lack of clear prioritisation among the many donor and budget-financed projects, and of regular and timely information on the state of their implementation, jeopardises the implementation of investment projects which could have a major impact on economic growth. Better prioritisation of infrastructure investment projects with high growth potential is needed to avoid risks to public debt stabilisation. The link between the calculated budgetary impact of the many ongoing projects in the programme, and the annual budget and multi-annual fiscal framework is unclear. Implementing these projects seems to significantly exceed budgeted capital expenditure, thereby calling the envisaged fiscal consolidation path into question. Nor does the programme make it clear whether and, if so, to what extent off-budget capital investment planning and annual and medium-term budget planning are linked.

([1]) However, this does not take into account public infrastructure projects financed by the Public Enterprise for State Roads since 2013.

Table II.2.3:

Composition of the budgetary adjustment (% of GDP, general government)

	2014	2015	2016	2017	2018	Change: 2015-18
Revenues	29.8	32.2	32.3	32.0	31.2	-1.0
- Taxes and social security contributions	25.9	27.1	27.1	26.8	26.5	-0.6
- Other (residual)	3.9	5.1	5.2	5.2	4.7	-0.4
Expenditure	34.0	35.8	35.6	34.9	33.8	-2.0
- Primary expenditure	33.0	34.6	34.6	33.7	32.6	-2.0
of which:						
Gross fixed capital formation	4.3	4.9	5.4	5.2	5.0	0.1
Consumption	11.3	11.9	11.5	11.0	10.6	-1.3
Transfers & subsidies	17.5	17.8	17.7	17.5	17.0	-0.8
Other (residual)	-0.1	0.0	0.0	0.0	0.0	0.0
- Interest payments	1.0	1.2	1.0	1.2	1.2	0.0
Budget balance	-4.2	-3.6	-3.2	-2.9	-2.6	1.0
- Cyclically adjusted	-3.8	-3.3	-3.1	-3.1	-3.2	0.1
Primary balance	-3.3	-2.5	-2.2	-1.7	-1.4	1.1
Gross debt level	38.2	38.6	39.4	40.7	41.5	2.9

Source: ERP 2016. Figures for 2015 are based on the Finance Ministry's projections from mid-2015.

Public debt is expected to increase markedly while the rise in government debt is likely to remain more contained. The authorities expect general government debt, driven by sustained primary fiscal deficits, to increase by 2.9pps to 41.5% of GDP between end-2015 and end-2018. The rise in public debt would be more important, by 5.4pps to 52.4%, on account of government-guaranteed borrowing by state-owned enterprises, which carry out an increasingly large share of the public investment agenda. This implies a rise in government guarantees on borrowing by state-owned enterprises of 2.5pps in this period. In 2015, guarantees, which are contingent liabilities of the government, increased by 1.7pps to 9.4% of GDP, and are expected to increase further on account of the government's large agenda of transport and energy infrastructure projects. The government's debt projections diverge considerably on the upside from the previous year's programme. Information on the reasons would have been helpful. Still, if the current Government programme which comprises an ambitious agenda of budget-relevant policy initiatives and investment projects, were to be fully implemented, without any compensatory revenue-raising or expenditure-reducing measures, or cost-reducing policy changes - to contain a widening pension deficit, for example - it is unlikely that the fiscal consolidation path could be implemented or, that the public debt trajectory would be complied with as projected.

Debt stabilisation is subject to significant risks. The authorities predict that general government debt will gradually rise further, reaching 41.5% of GDP by 2018, from 38.6% in 2015. Under this scenario, debt stabilisation remains elusive. The debt path is sensitive to whether or not the government can implement its plans for fiscal consolidation. Deviation from the fiscal consolidation path through further increases in the primary budget deficit balances would thus have a considerable impact on debt levels. If GDP growth remained below expectations in 2016-2018, the impact on the debt burden would be even larger. The government acknowledges the high sensitivity of the budget deficit to lower – hence more realistic – growth assumption. According to its alternative scenario, the target of driving the deficit to below 3% in 2017 would be missed, if annual GDP growth averaged 3.2% between 2016 and 2018. Increased borrowing by state-owned enterprises poses an additional risk for the debt trajectory, through the possible materialisation of contingent liabilities of the government, on account of its rising amount of guarantees for borrowing by public enterprises. This would also increase external vulnerabilities, through its likely impact on foreign reserves, as a large part of these guaranteed loans is extended by creditors abroad in foreign currency.

Box : Increase in the debt ratio to be mitigated as fiscal consolidation progresses

Gross general government debt is expected to rise by 2.9pps between 2015 and 2018, driven primarily by contributions from primary balances – though these are set to decline - and by fairly steady contributions from interest expenditure. The overall snowball effect is counteracting the rise in the debt ratio, on account of higher inflation expectations and the expected acceleration of GDP growth, while stock-flow adjustment measures weigh on debt levels in 2017 and 2018.

Table II.2.4:

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

	2014	2015	2016	2017	2018
Gross debt ratio [1]	**38.2**	**38.6**	**39.4**	**40.7**	**41.5**
Change in the ratio	4.2	0.4	0.8	1.3	0.8
Contributions [2]:					
1. Primary balance	**3.3**	**2.5**	**2.2**	**1.7**	**1.4**
2. “Snow-ball” effect	**-0.4**	**-0.7**	**-1.1**	**-1.0**	**-1.2**
Of which:					
Interest expenditure	1.0	1.2	1.0	1.2	1.2
Growth effect	-0.6	-1.3	-1.5	-1.6	-1.7
Inflation effect	-0.8	-0.6	-0.6	-0.6	-0.7
3. Stock-flow	**1.3**	**-1.4**	**-0.3**	**0.6**	**0.6**

Notes:

[1] End of period.

[2] The snow-ball 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 data.

Source: ERP 2016, Commission calculations

There are still some shortcomings as regards fiscal transparency and in planning and implementing of public finances. Despite measures taken in 2013 and 2014 to improve the planning and implementation of public finances, such as changes in debt management strategy and tightening up commitment controls, and the publication of fiscal data, such as resuming the publication of public debt figures, significant shortcomings remain in fiscal transparency and in the management of public finances. Budget reporting could, for instance, be improved by adding information on public payment arrears, the budgetary impact of policy changes, deficit financing, and, the government's financial assets. There is as yet no definitive and exhaustive medium-term budget framework, although project work started in December 2015. Moreover, there only seems to be a weak linkbetween the macrofiscal framework and the annual budget allocations, and it is unclear how individual budget users' plans are integrated within the overall revenue and expenditure target. The link between the medium-term framework and the annual budget process remains weak.

2.4. STRUCTURAL REFORMS

Structural bottlenecks are preventing economic growth and productivity gains from translating into meaningful job creation. The economy is dominated by the services sector, which accounts for half of GDP, while industry is stable contributing at around 18% (25% including construction) in 2015. The country is trying to ramp up the position of the manufacturing sector in international value chains. To this end, the government is actively pursuing simplification of the business environment and developing investments and it has a proactive strategy for attracting FDI. Although these have produced some results, the effects on employment are unclear, in terms of number and quality of jobs created. Moreover, domestic companies do not yet benefit sufficiently from the presence of foreign investors in terms of technology transfer and access to wider markets, despite the government's initiatives to develop backward linkages. Unemployment is persistently high especially among the young who account for a large proportion of the population.

The economy's private sector suffers from weak access to finance for SMEs, an unpredictable business environment with a frequently changing regulatory framework and insufficient law enforcement. Private investment is low, including in research, development and innovation (RDI), and entrepreneurial skills are weak, including financial literacy. These result in low labour productivity and insufficient competitiveness on international markets and a low technological level.

Economic data are insufficient to conduct evidence-based policies. In the absence of a proper census or civil registry covering the whole population, information on employment/unemployment is insufficiently accurate. Moreover, sectoral data are also insufficient.

The policy guidance jointly adopted in the Economic and Financial Dialogue of 12 May 2015 was only partially addressed. Some ad-hoc programmes and training, as well as a database of potential suppliers, have been developed to create supply linkages between foreign and domestic companies. The National Investment Committee has adopted single project pipelines in four sectors, but the assessment methodology used to rank investments has some shortcomings. Measures to improve and accelerate bankruptcy procedures have been adopted. However, there has been no progress towards creating a predictable legal and regulatory environment or improving the enforcement of contracts or payment discipline. No specific action has been taken to combat corruption and informalities in the economy more robustly.

The measures presented in the Economic Reform Programme broadly contribute to growth but are not sufficiently focused and lack balance between infrastructure projects and sectoral reforms. The ERP has no information on the analytical approach applied to identifying the constraints to growth and competitiveness; the ranking of investment is not transparent and it seems that the investment projects are not assessed against their potential contribution to growth, competitiveness and job creation. Hence, there is no evidence of prioritisation of reform measures. Moreover, many of the measures presented are funded by donors or IFIs and it is unclear how sustainable they would be in the long run if this support ended. Reform measures in the strict sense of the term, such as measures to establish a competitive and transparent regulatory system, privatise land, reform the transport and energy sectors, and reform the labour market are largely absent.

Public finance management

Public finance management (PFM) is weak and the country needs a comprehensive PFM reform programme, which is currently being drafted. The main gaps relating to public finance management are insufficient capacities in medium-term budget planning and in public investment management; an inefficient mechanism to monitor the budgetary impact of government proposals; and, an insufficiently transparent and efficient procurement system. An in-depth review of public finance management is ongoing in the country, and the government is drafting its PFM reform programme.

Infrastructure

Existing transport infrastructure poses less of a binding constraint to growth than assumed in the programme. The road transport network is well-developed by regional standards. While the infrastructure needs upgrading, reforms should also focus on regulatory measures. These include ensuring adequate maintenance, removing obstacles to integration, creating a transparent regulatory environment and fixing fees for the use of roads that are both affordable for users and allow repaying and maintaining the infrastructure. Addressing those weaknesses would contribute to opening up the economy to external markets.

The recommendation to prioritise investments has been partially addressed. The selection of infrastructure investment projects is not based on a transparent impact analysis. A National Investment Council (NIC) has been set up and four single project pipelines put in place. However, the NIC does not seem to consider the fiscal effect of the investments nor, the impact on economic growth and competitiveness in its cost-benefit analyses. It is thus difficult to compare investments and set priorities on the basis of evidence.

The measures presented in the Economic Reform Programme will help link the country better to the region and the EU, but would benefit from a better and clearer prioritisation. As in 2015, the

ERP focuses on investments in infrastructure. The investments listed are part of the government's agenda for the South East Europe Transport Observatory (SEETO) corridors. Accordingly, they will help linking the country to the European market, and improve passengers and goods transport. However, it should also be ensured that they correspond to specific needs of businesses. Moreover, only construction costs have been assessed, leaving out budget allocations for maintenance and the returns expected from the investments have not been quantified. Finally, the risks of under-execution of investments are not properly assessed, and regulatory reform measures, such as re-opening the rail market, are not addressed.

The possible effects of public sector access to financial markets to finance these projects should be analysed and considered. Large infrastructure projects carry a higher risk of malpractice and corruption. The future PFM reform programme and a rigorous monitoring of these expenditures provide an opportunity to address possible shortcomings.

The investments in energy foreseen in the ERP are not sufficient to meet the country's needs. Businesses identify insufficient access to diversified and cheap energy as a constraint on competitiveness. The country has an aging energy system About 2/3 of the electricity production based on coal, gas and oil while the rest is from hydropower. The environmental impact of these power plants fails to meet the existing legal standards. The country needs to begin a diversification of its energy sources, for which gas is only an intermediate step, given the heavy dependence on Russian gas. Moreover, utilities markets are not sufficiently competitive or liberalised, which causes distortions and inefficiencies.

The two energy measures will make the system more efficient and reduce technical losses, but they fail to address the over-arching need for market liberalisation. Both the construction of an interconnection with Albania and the rehabilitation and modernisation of the transmission network and power system are well described and their potential benefits detailed. They contain timelines and costs are properly estimated. However, these investments are partial measures. There is no indication of how to manage the aging power generation plants, tackle the dependency on imported gas, or address the high energy intensity of the economy. Moreover, there is no reference to regulatory reforms to link the domestic energy market with those of its neighbours or to liberalise the sector.

Sector development

Agricultural sector development

The agricultural sector is facing serious structural challenges which are affecting its competitiveness potential. Agriculture contributes to some 10% of GDP. The share of irrigated land is significantly lower than in neighbouring countries or those at the same latitude with similar physical patterns or production structures. Agricultural land is fragmented, with private farms too small to take advantage of economies of scale or generate enough savings to invest in new technologies and skills acquisition. Certain large state-owned or recently privatised farms are either not operating or are in difficulty and most of the pastureland is still state-owned. Moreover in the absence of a proper legal framework, a large part of the land is abandoned. The sector is weak as regards agri-food processing, which has higher value-added.

The two measures on agriculture are well-conceived. The measure designed to improve irrigation systems is based on a thorough analysis. The measure also assesses future requirements, including those arising from climate change, and the growing need for irrigation. The measure on the consolidation and defragmentation of agricultural land is well-designed with a credible timeframe. Land consolidation is a major reform, which is expected to produce significant positive effects if implemented in full. However, the activities included in the ERP only refer to two pilot projects between 2016 and 2018 whose impact on the sector and on competitiveness has not been quantified. A broad reform of the sector should include developing a proper legislation related to abandoned land, efficient monitoring of the use of state-owned land (database) and the revision on the law on land consolidation, to incorporate state-owned land in the process.

Industry sector development

Despite efforts to attract FDI and establish a competitive manufacturing sector, industry's share in GDP remains below 25 % (2014). The manufacturing sector is the one most affected by shortcomings in the business environment, such as the unpredictable regulatory framework, access to finance and energy, skill gaps, and an insufficient technological level of domestic companies.

Services sector development

Services employ over half of the workforce and provide 65 % of GDP. Tourism seems to have a significant potential and specialised and thematic tourism is being developed. However the legal framework for tourism is insufficiently developed as regards fiscal incentives to private investments, as well as labour market regulations which do not sufficiently support improving professional skills. The government is also supporting ICT services and a reference is made to a short term national ICT strategy.

The measure on increasing market employability lacks a clear over-arching objective. The support for IT companies and development of skills could have a positive effect on this sector. Human capital development responds to the need for a high value added sector and could be relevant. However, the description of the measure is not focused enough and its potential impact on the services sector or on the competitiveness of the economy is not sufficiently developed. Moreover, most of the actions consist of supporting the sub-sectors identified, whose activity is expected to increase and as a consequence, employ more staff, but not to specifically arm job-seekers to respond to the demand for new, diverse skills. The development of ICT services requires that in addition to adequate infrastructure, competition among operators and independence of the regulator are ensured. The ERP makes no reference to these.

Business environment, corporate governance and reduction of the informal economy

Companies identify the large informal sector, poor access to finance for SMEs and shortcomings in electricity supply as the main obstacles to doing business. Another major challenge is the unpredictable legal environment, including frequent changes to the legal framework, insufficiently independent courts, and uneven and unpredictable application of regulations, linked to increasing concerns about judicial independence. According to the 2016 Small Business Act (SBA) assessment, in 2013, 43.4% of those employed worked in SMEs while the value added by SMEs accounted for 42.7% of total value added. SMEs tend to be very small and financial literacy and capacity for innovation need to be improved. The presence of large foreign investors has not raised the technological level of domestic companies or integrated them in international value chains to any significant extent.

Access to finance for SMEs is a major constraint. Collateral coverage rates for loans are among the highest in the region, because of the large proportion of non-performing loans. At the same time, there is no tradition of capital market financing. The insufficient implementation of the otherwise advanced legal framework for corporate accounting, for valuing real estate and the inadequate capacity for drawing up business plans are the main obstacles to closer business relations between SMEs and commercial banks. Finally, the enforcement of credit recovery is slow, increasing the risks to lenders.

The recommendation to improve the business environment has been partially addressed, and a number of relevant measures have been adopted. The ERP presents measures to improve and accelerate bankruptcy procedures. The authorities have taken steps to accelerate digitalisation of procedures (such a registering and valuing property, e-government, enforcement of intellectual property rights etc.), but these do not seem to be part of a comprehensive coherent project. While actions have been taken to improve access to finance, this remains a major constraint and requires further action by all parties including businesses, banks and public authorities. No progress has been made in addressing the recommendations to create a more predictable legal and regulatory environment, enforce contracts, or improve payment discipline and the quality and integrity of inspection services. No specific action has been taken to step up efforts to fight against corruption and informalities in the economy. At the same time, some ad hoc programmes and training, as well as a database of potential suppliers, have been developed to create supply linkages between foreign and domestic companies.

The discussion of the business environment and of the constraints to growth provided in the ERP is not analytical enough and the measures proposed are too narrow. The measure to finance companies through business angels is welcome; it is expected to facilitate access to finance, particularly for start-ups, and support innovation. However, it is a very specific initiative whose impact is likely to be confined to a few of the most innovative companies. The measure to support competitiveness of the enterprise sector is not sufficiently developed and the activities lack adequate information to determine the potential impact on competitiveness. The establishment of one-stop-shops for business licenses and permits is a welcome measure that has been ongoing for some time. It has proved effective so far, together with the initiatives aimed at simplifying requirements for licences and unnecessary regulations (regulatory guillotine).

Technological absorption and innovation

The capacity for technological absorption and research, development and innovation (RDI) is low. Total R&D expenditure as share of GDP is limited (0.44 % of GDP) and consists mostly of public expenditure. Researchers represent 0.21% of the workforce, which is much lower than in advanced economies, but on par with other countries in the region. Support for research and development both for academia and industry is very low although with the recent creation of the Innovation Fund, the government has substantially stepped up efforts for SMEs to engage in innovation.

The recommendation to step up the use of instruments provided by the Innovation Fund has been partially addressed. The implementation of the actions envisaged to stimulate innovation by the Innovation Fund has started and the National Technology Transfer Office is planned to be established in the first semester of 2016. However, the absorption capacity by SMEs is low, due to the lack of sufficiently performing small businesses and the overall level of economic development. Therefore more effort should be made to help SMEs develop the skills and technologies they need to engage in more innovative activities.

The measures presented in the programme correspond well to best practices to stimulate innovation. It will be important, however, that in parallel measures are taken to stimulate SMEs to engage more in research and innovation. The measure designed to establish a triple helix partnership between universities, the government and the private sector could have a significant impact on the economy if it were sufficiently developed and widespread. The envisaged extension of operations of the Innovation Fund to more beneficiaries is welcome. If properly implemented, this would fill a gap that the financial market is currently unable to address. However, both measures tackle the supply-side, which presupposes that a demand for these services already exists. This is questionable, given the already low absorption of the Innovation Fund instruments. Therefore, measures to stimulate the demand are also necessary, such as measures to strengthen the research capacity by increasing the national funding for research on areas of domestic interest and to take measures to increase human capital development.

Trade integration

As a small economy, the country relies on international trade to grow. There is contradictory evidence that technical and regulatory barriers to trade affect businesses, as only 12% of the country's growth can be attributed to trade compared to 40% prior to 2002. The EU is the main trading partner, accounting for about two-thirds of imports and exports, while CEFTA accounts for about 10-15 % of trade.

Measures to facilitate trade integration address some tariff-related, technical and structural barriers, but they remain fragmented and insufficiently selective. The measure involving advancing free trade within CEFTA commits the country to supporting the finalisation of the ongoing negotiations on the regional protocol to liberalise trade in services and the framework agreement on trade facilitation. The application of the Regional Convention on Pan-Euro Mediterranean preferential rules of origin is relevant given the weight of the transformation-based manufacturing sector, and thus the country's need to be able to cumulate preferential origin with its closest partners. However, whether this measure is completed does not only depend on the authorities of the former Yugoslav Republic of Macedonia, but also on ratification procedures in the other signatories. Therefore, the added value and the relevance of this measure in the ERP are unclear. Trade facilitation would benefit from identifying more concrete and selective activities that can be implemented nationally.

The measure to upgrade customs clearance at two important border crossings is consistent with investments in infrastructure. However, the ERP refers to preparatory activities, while actual work is likely to start only after the current programme's timeframe. Although these preparatory measures are necessary, it is not clear why they are a high priority and they do not, in themselves, constitute a reform. At the same time, meaningful activities to do with the functioning of customs are underway, in particular in the area of IT services, and it would have been more appropriate for them to be included in the programme.

Employment and labour markets

Although there were some positive trends in recent years, the economy continues to face persistent labour market challenges. The employment rate (20-64 years) is still quite low - 51.3 % in 2014, 5 pps higher than in 2008. At the same time there is a huge gap between the male (61.6 %) and the female (40.8 %) employment rates. The unemployment rate continued decreasing to 24.6 % in 2015 Q4 – a drop by 3 pps compared to the same quarter of 2014 and 9.2 pps compared to 2008. In particular, conditions for young people remained strained - the unemployment rate in the age group 15-24 stood at 47.3 % in 2015 Q4, marking a drop by 3.1 pps from the same period a year earlier.

The level of basic and transversal/soft skills of the labour force is insufficient, as is the quality of education. This is due to the low efficiency of education spending, limited opportunities for permanent in-service teachers training, oversized classes and a shift system operating in the country. The education system is not equipping students and graduates with skills needed in the modern labour market. Moreover, there is a need for better qualified and trained teachers, in particular given the recent introduction of the Cambridge Curriculum.

Performance evaluations of active labour market policies (ALMP) have been partially strengthened **through a revised strategic and employment framework.** In October 2015, the Government adopted the National Employment Strategy (2016-2020). The country has also started proactively developing an Employment and Social Reform Programme in a wide consultation with all relevant stakeholders. While there is progress in terms of monitoring and evaluation of ALMPs, those activities are mainly on an ad-hoc basis and there is no established regular monitoring system. The spending on these policies still appears comparatively low (0.15 % of GDP in 2015) relative to the magnitude of unemployment in the country. On the other hand, the increased spending would need to go in parallel with the continuous improvement of their efficiency and targeting and the implementation of complementary measures to support labour demand.

The measure on the improvement of the public employment services, in particular by profiling of unemployed persons and designing individual employment plans appears relevant and timely. While a lot has been done recently to modernise the Employment Service Agency (ESA) as a customer-oriented service provider, the insufficient staff and financial resources continue to hamper its effectiveness. In this context, the proposed measure strives to improve the targeting and to ensure that the scarce public resources are spent for the most disadvantaged people. However, the ERP fails to indicate the number of job seekers who will potentially be targeted and no information is provided on the estimated impact on ESA staff. It is reported that the measure has no fiscal implications which is not plausible. There is also no timeframe for the activities.

The envisaged activities of the measure on education and qualifications for all, while relevant and important, risk remaining fragmented if not coordinated with other ongoing efforts to address the skills mismatch. The measure primarily refers to the development of the National Qualifications Framework (NQF), which can play a very important role in better matching the supplied and demanded skills. The challenge is how to bring together the processes/models implemented by the different institutions from both the educational and the employment fields and how to transform the findings into policy actions. In a context of weak institutional capacity to monitor the portfolio of projects, there is a risk that reforms addressing the NQF will be diluted and ineffective. In addition, as the majority of these activities are supported by external assistance on a project basis, it is crucial that the new developed processes are sufficiently internalised and the staff of the government institutions adequately trained to ensure sustainability.

Fostering social inclusion, combatting poverty and promoting equal opportunities

The former Yugoslav Republic of Macedonia faces high levels of poverty (22.1 % in 2014) and material deprivation (35.7 % in 2014). The main sphere where the social inclusion approach is more recognisable is related to investment in early childhood education, particularly aimed at more deprived communities (Roma). This approach has already had positive effects on the reduction of the early school leaving rate in the country.

Overall, the direction of the country's social policy is moving towards more residual social provision, due to limited economic resources and the wide scope of social risks that need to be covered. There is also an evident lack of an integrated and harmonised approach between different areas such as social welfare, social insurance, education, health and housing, which makes social policy measures isolated and partial in their impact. One of the main strengths of social policy governance is the wide network of social service providers and these could be used more efficiently to address the country's social challenges.

The measure aimed at improved inclusion of all children in the education system and equal access to all education levels regardless of their origin and competences is well-articulated but fails to provide concrete targets beyond the already on-going support activities. The focus in the next period will be on children from vulnerable groups to complete primary and secondary education. However, it does not cover pre-school education, which is the key to making headway on these problems as it would enable the marginalised groups to have equal chances of succeeding scholastically, staying in school longer and prospects of a better future.

2.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2015

2015 country policy guidance for MK	**Commission summary assessment**
PG 1: Improve the management of public finances by adhering rigorously to the 2015-2017 medium-term fiscal targets outlines in the ERP, and frontload consolidation so as to be on track for the 2017 budget deficit target of 2.9% of GDP. Use any additional fiscal space for further consolidation measures, so as to protect growth-enhancing capital spending in case of unexpected budget pressures. Keep tight control on the development of transfer payments, pensions, and public wages. Introduce a medium-term expenditure framework. Inform in a timely and regular manner on the size of the government workforce and payroll.	PG1 has not been addressed: Revenue overperformance in 2015 was used to increase spending rather than frontload consolidation. Public investment expenditure spending reached only 84% of budget. Entitlement spending and public wages were increased ad hoc in mid-year.
PG 2: Improve the composition of spending, by prioritising investment projects according to their productive potential, and be more transparent on the cost-benefit analysis underlying transfer and investment spending items on the budget. Provide more timely and detailed data on planned and executed capital expenditure.	PG2 has not been addressed: The government points to the budgeted infrastructure investment spending 2016-2018, and underlines that projects are selected on the basis of feasibility studies, including a cost-benefit-analysis (CBA). However, it is not clear whether CBA is publicly available. There also seem no apparent improvements in the provision of more granular information on project execution and budget impact.
PG 3: Improve the fiscal transparency by including more comprehensive data on the debt of public companies and contingent liabilities in the government's debt management strategy and inform about arrears. Speed up transition to ESA 2010 reporting and resume fiscal notifications. Continue to keep tight control on guaranteed and non-guaranteed borrowing by state-owned enterprises and municipalities.	PG3 has not been addressed: The government points to strict control procedures regarding public guarantees, as provided for by the Public Debt Law. A fiscal notification was not provided. Information on public payments arrears is not available.
PG 4: Improve the employability of workers, by better aligning skills with labour demand needs notably by developing the education system. Strengthen performance evaluations of active labour market policies with a view to better targeting skills development, and inform on their methodology and results in a timely manner.	PG4 has been partially addressed: An impact assessment of ALMPs revealed limited effectiveness of wage subsidies, self-employment and certain specialised/small scale training schemes. Instead, internships and training schemes for employers proved to be more rewarding in terms of future employment in the primary labour market, and wage gains. However, the ERP provides limited

	information on how the set of active labour market measures was adjusted to these results, in terms of eligibility criteria or implementation rules. The country continued efforts on better aligning skills with labour demand needs notably by further reforms of the education system, including a new teaching programme for innovation and entrepreneurship; a skills observatory; and, a board for the National Qualifications Framework.
PG 5: Step up efforts to create supply linkages between foreign and domestic companies with a view to enhancing productivity and employment in the domestic economy.	PG5 has been partially addressed: The "Supplier Development Pilot Programme", supported by the World Bank, was started in 2015 with an initial 5 domestic companies benefitting from training measures. A database of potential suppliers was developed, needs of foreign companies were identified, assessment of capacities of a number of local companies was made. In order to fulfil the recommendation, the findings will need to be used to design and implement appropriate measures on a wider basis.
PG 6: Increase efforts towards facilitating the disposal of non-performing loans by banks, involving all key stakeholders including the central bank as necessary, with a view to removing potential obstacles to credit extension in the context of a sustained pick-up in credit demand.	PG6 has been partially addressed: The NBRM obliged commercial banks in December 2015, effective as of June 2016, to write-off non-performing loans that have been fully booked for more than two years. The NBRM has taken measures to prevent instability arising from the recent increase in non-performing consumer loans.
PG 7: Review the transport strategy in order to align it with the regional agenda on connectivity, with a particular focus on the core investment priorities (core network) and establish a credible planning and funding mechanism. A single sector pipeline would help prioritise investments.	PG7 has been partially addressed: The investment projects are generally part of the main regional / European corridors. The National Investment Committee has adopted single project pipelines in four sectors (transport, energy, environment and social sector). So far, there is little information available on issues such as stage of implementation and macrofiscal impact. The methodology for ranking the projects should be clarified, and the analysis of planning, costing and long term sustainability should be developed further.

PG 8: Improve the business environment by designing and implementing the Master plan for Competitiveness and the related Government Action Plan. These should include measures affecting competitiveness, such as a more predictable legal and regulatory environment, enforcement of contracts, respect of IPRs, payment discipline, labour legislation, quality and integrity of inspection services, etc. Ensure regular and structured dialogue with social partners regarding the implementation and review of the Master plan. Step up efforts to fight against corruption and informalities in the economy.	PG8 has been partially addressed: An ad-hoc working group for the master plan for competitiveness and the corresponding action plan was established. Most of the deadlines for specific outputs set in the Master plan 2015 have already passed.
PG 9: Improve access to finance for SMEs and speed up bankruptcy procedures. Implement the innovation strategy, and step up the use of instruments foreseen by the Innovation Fund.	PG9 has been partially addressed: Several measures have been adopted to facilitate access to finance. Measures to improve and accelerate bankruptcy procedures have been adopted. Measures under the innovation strategy are designed and progressively implemented. However, demand for these measures remains muted.

2.6. THE 2016 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, 25 May 2016

In light of this assessment, Participants hereby invite the former Yugoslav Republic of Macedonia to:

1. Underpin fiscal consolidation by identifying concrete revenue and expenditure measures; move towards a better targeting of transfer spending and improve the growth-friendliness of public finance, in particular by fully executing planned priority public investment spending. Protect against fiscal risks by using any excess revenue to create fiscal buffers.

2. Improve fiscal transparency and budget planning capacity by the swift introduction of a medium-term expenditure framework; by providing multi-annual projections of detailed revenue and expenditure components in the medium-term strategy as well as by comprehensive reporting of extra-budgetary expenditure in the consolidated fiscal reports. Inform systematically about payments arrears.

3. Develop comprehensive strategies involving all relevant stakeholders in order to both further foster the resolution of non-performing loans by banks and further promote the use of the local currency with a view to reducing risks to financial stability and the real economy. There would be a case for a gradual removal of the central bank's accommodative monetary policy stance to the extent that authorities' sanguine macroeconomic scenario is realised (including through its impact on inflation expectations and on the output gap).

4. Adopt a credible public finance management reform programme. Prioritise public investments against clear policy objectives and identify the needs to which they respond. Increase the transparency on the selection criteria for the investments and on their impact on economic growth and on the fiscal path.

5. Ensure a reliable and predictable regulatory environment for businesses by reducing the use of the urgency procedure for legislation, ensuring proper consultation of the stakeholders and reinforcing the independence of commercial courts.

6. Strengthen the provision of activation measures especially for vulnerable youth, women and long-term unemployed and further improve the capacity of the Employment Service Agency for profiling and personalised counselling of job seekers.

Annex: Overall assessment of programme requirements

The Economic Reform Programme was submitted by the government on 31 January 2016. It was drafted in consultation with the social partners. It covers the period 2016-2018 and is broadly in line with the medium-term fiscal strategy and the 2016 Budget Law. Responding to the requirements to progressively adapt the economic and fiscal surveillance of the enlargement countries to the EU strengthened economic governance, the programme includes sections assessing the sustainability of the external position and the main structural obstacles to growth.

Ownership and internal coordination

The preparation of the ERP was centrally coordinated by the Ministry of Finance. The programme was formally endorsed by the government. An inter-ministerial ERP working group involving seven Ministries and several agencies and other offices worked on its preparation. The ERP did not include a meaningful diagnostic of the main structural obstacles to competitiveness and growth, which affects its relevance and credibility.

Stakeholder consultation

The government made a draft of the Economic Reform Programme available online between 23 and 31 December 2015 in order to consult external stakeholders, including social partners. The government also invited several stakeholders directly to make a contribution. These are included as an annex to the ERP.

Macro framework

The programme presents an accurate review of recent macroeconomic developments largely based on the most timely available data at the time of drafting. As in previous years, it presents a very optimistic medium-term macroeconomic framework, that does not sufficiently consider downside risks to growth emanating from external and domestic uncertainties. The authorities present an alternative scenario based on lower growth in the country's trade partner economies. This scenario could have also taken into account growth risks stemming from domestic factors, such as delays in the implementation of critical structural reforms. The programme complies with the Commission's request to provide an assessment of the medium-term sustainability of the economy's external position. The presentation includes an analysis of the development and breakdown of gross external debt and of the international investment position. It informs about external financing needs and repayment obligations, and refers to the standard indicators of external indebtedness.

Fiscal framework

The programme provides fiscal projections for 2016 to 2018, in line with the presented medium-term macroeconomic scenario, but lacking a clear link to the structural reform agenda. There is limited information on intended revenue and expenditure measures and their likely budgetary impact. In the presentation on the structural balance, information on intended one-off- and temporary measures would have been useful to gauge more accurately the impact of discretionary fiscal measures on the economy. Data reliability is limited and comparison of published data with benchmarks according to EU accounting standards is difficult, as a compilation of EDP and GFS statistics in line with ESA 2010 classification is still missing. The authorities did not submit a fiscal notification to Eurostat in 2015.

Structural reforms

The structural reform priorities section does not follow the guidance note as it does not present an analytical approach overall or per area. As a consequence, the structural reform priorities as included in the 19 measures do not correspond to key obstacles to growth and investment identified. Some notable exceptions were measures 1, 2, 6, 7, 12 and 13 where some analysis was included. Tables 10-12 in the annex have been filled in. Table 11 should have contained more detailed timelines and descriptions of activities at least by year if not by quarter. The summaries in table 12 are very helpful and sufficiently detailed. The policy guidance implementation is only included in the overview table at the beginning of the ERP and is not further discussed in the section on structural reform priorities. The presentation remains general, in large part, and would have benefitted from more concrete description of individual measures. Some measures refer to initiatives taken before the 2015 targeted policy guidance was issued.

The programme contains information on action the authorities have undertaken in response to the Council's 2015 policy guidance. The presentation remains general, in large part, and would have benefitted from more concrete description of individual measures. Also, a number of measures mentioned have not yet been adopted, or remain at the stage of strategy papers, without clear information on intended implementation. Some measures refer to initiatives taken before the 2015 targeted policy guidance was issued.

3. MONTENEGRO

3.1. EXECUTIVE SUMMARY

Montenegro's economic activity has strengthened, supported by construction and tourism. Growth is set to remain robust in the coming years if the investment pipeline, including a major highway project, develops as planned. Private consumption is expected to strengthen following recent increases in public sector wages and pensions and a modest recovery of credit activity. External imbalances are of structural nature, reflecting a small and open economy with a very limited production base and large investment needs. The tourism industry contributes to a gradual reduction of the current account deficit, but high external financing needs and limited policy discretion makes the country highly vulnerable to external shocks. The unemployment rate remains high, hindered by poor labour mobility, labour market rigidities and widespread skills mismatches.

A high and growing public debt and depleted fiscal buffers put fiscal sustainability at risk. Also, political uncertainty emerges in the electoral year 2016 as a risk for the sustainability of public finances and the implementation of the structural reform agenda. The main challenges in these respects include the following:

Enhancing the growth potential is crucial to further reduce the share of external and internal debt in GDP. While strong investment activity helps in this regard, at this juncture the key challenge facing Montenegro is to find new ways to boost productivity and competitiveness so as to sustain sources of growth beyond the current investment cycle.

The banking sector, while liquid, is still struggling with a high but slowly declining, share of nonperforming loans. This situation constrains banks' disposition to lend to private domestic companies and reduces the growth potential of the economy. Moreover, banks are trying to maintain profitability by keeping lending rates high, which further hampers lending, in particular to small businesses.

The fiscal framework does not offer an appropriate policy response to a high and rising public debt. On the contrary, the 2016 budget and recent increases in pensions, social benefits and public sector wages confirm the existing expenditure pressures, which are partially related to the electoral cycle. Montenegro would need larger fiscal buffers and additional consolidation measures to stabilise and eventually bring down its public debt ratio and to compensate for growing wage and pension expenditure.

High transportation costs and weak regional energy connectivity are limiting Montenegro's economic growth. The country's infrastructure is constrained by its difficult topography, which results in high investments and maintenance costs. Montenegro's Economic Reform Programme (ERP) has a strong focus on large infrastructure and public investment projects. It is important that such investments are based on a sound cost-benefit analysis and complemented by less costly regulatory reforms. Montenegro's continued efforts are needed to strengthen trade integration, including the implementation of soft measures that tie in with the regional connectivity agenda.

Montenegro's economy is dominated by services, in particular the all-important tourism sector. By contrast, the industrial and agricultural sectors suffer from low competitiveness. Poor access to finance, in particular for SMEs, remains a key barrier to increasing competitiveness. Informality, access to electricity, licensing, contract enforcement and cumbersome tax administration procedures are the other weaknesses of the business environment identified by the business community. Further efforts are needed to build up high quality business support services, strengthen the rule of law, reduce the informal sector, and tackle corruption. This will ensure that regulatory improvements translate into an improved investment climate.

High long-term unemployment and low labour market participation of youth and women remain a challenge. Widespread skills-mismatches limit employment opportunities, particularly for young people. Lack of activation measures, coupled with low outreach of labour market policies, wide-ranging of informal work and early labour market exits are hindering employment growth. Insufficient coverage and targeting of social assistance is likely to create disincentives to formal work. There are weaknesses in social protection system and providing incentives to work.

The macroeconomic, fiscal and structural reform frameworks offer a mixed picture. While the ERP's macroeconomic framework is consistent and provides an adequate basis for policy discussion, this is not the case of the fiscal reform agenda, which appears insufficient to address the ambitious policy objectives and challenges. The structural reform section of the ERP is comparable to last year in terms of compliance with the guidance note. It identifies correctly some of the obstacles to Montenegro's growth and competitiveness and outlines a number of relevant measures to address them, even though in some cases their linkages are not always well justified.

Last year's policy guidance has been partly addressed, except for the recommendations in the area of public finance. Although there was some progress on the financial sector, labour market and other structural reforms, the results are particularly negative on the fiscal side due to the adoption of a series of budget expenditure increases defying fiscal sustainability. Notably, the commitment to fiscal discipline derailed due to a significant deviation from the plan and the inadequate fiscal response presented for the 2016 budget. Moreover, the plans for reducing early retirement, rationalising public sector wages and reviewing the financial sustainability of the old-age pension resulted, inversely, in further growth of these expenditures. Contract enforcement was further streamlined, the single sector pipeline for investment priorities was set up and steps were taken to improve the quality of the land registry. A comprehensive medium-term employment and social reform programme and an employment strategy were adopted, but their implementation has not yet started. In the area of education, the review of existing educational programmes is underway and higher education graduates are offered practical experience through professional training programme. Policy recommendations and an action plan to tackle the high incidence of informal work were adopted, but as of yet no results have been seen. Several other structural reforms remain at a preliminary stage with no concrete steps planned or taken.

3.2. ECONOMIC OUTLOOK AND RISKS

Surging public and private investments are set to drive economic growth in the next few years. The baseline macroeconomic scenario projects average growth at around 4% in 2016 and 2017, which seems plausible as several key public investments are underway or in an advanced state of preparation. Moreover, the recent increase in public sector wages, pensions, and social benefits for mothers are likely to support private consumption due to spill-over effects from public sector wages to the private sector. The programme also forecasts an increase in government consumption, but only as a one-off in 2016. After peaking in 2016, gross fixed capital investments growth is projected to fall to 10.8% in 2017, before plunging to 1.7% in 2018. The latter figure seems in contradiction with planned investments, as works on the new motorway is due to continue until mid-2019 (at least), and work on the new thermal power plant project could also have started by then. Meanwhile, the impact of economic growth on the labour market is low.

Consumer prices increased moderately despite falling oil prices, flat communications costs and virtually frozen wages and pensions. In fact, 'domestic' demand (reflected in a revival of retail sales) improved thanks to fast growth in the number of tourists. As a result, services (in particular accommodation and restaurants) as well as food prices sustained average headline inflation of 1.4% in 2015. The recovery of core inflation also reflects the closing up of the output gap in 2015 thanks to the strong inflow of investments into the country. However, the ERP seems to underestimate the impact of foreign capital inflows in the medium-term inflation forecast, presenting the same inflation rates for 2016 as for the year before and a modest average rate of 2% for each of the outer years covered by the programme.

Table II.3.1:

Comparison of macroeconomic developments and forecasts

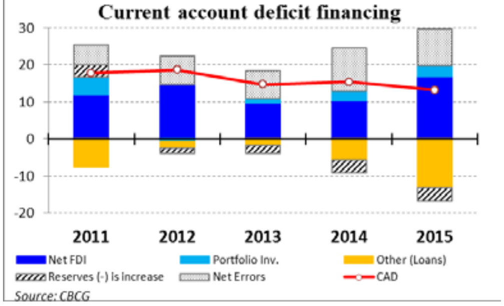
	2014		2015		2016		2017		2018	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	1.8	**1.8**	3.9	**4.3**	4.0	**4.1**	4.1	**4.0**	n.a.	**3.0**
Contributions:										
- Final domestic demand	2.1	**2.1**	2.6	**4.0**	4.5	**4.7**	3.9	**3.6**	n.a.	**1.5**
- Change in inventories	1.0	**1.0**	0.6	**n.a.**	0.5	**n.a.**	1.0	**n.a.**	n.a.	**n.a.**
- External balance of goods and services	-1.3	**-1.3**	0.7	**0.8**	-1.0	**-1.4**	-0.8	**-0.3**	n.a.	**1.2**
Employment (% change)	1.2	**1.2**	1.5	**1.2**	1.5	**0.9**	1.9	**0.8**	n.a.	**0.5**
Unemployment rate (%)	18.2	**18.0**	17.6	**17.0**	17.2	**16.6**	16.8	**16.2**	n.a.	**16.1**
GDP deflator (% change)	1.0	**1.0**	2.1	**1.5**	2.0	**1.5**	2.3	**2.0**	n.a.	**2.0**
CPI inflation (%)	-0.5	**-0.5**	1.5	**1.5**	1.9	**1.5**	2.2	**2.0**	n.a.	**2.0**
Current account balance (% of GDP)	-15.2	**-15.2**	-12.9	**-12.6**	-13.4	**-13.8**	-13.9	**-13.8**	n.a.	**-12.2**
General government balance (% of GDP)	-3.1	**-3.1**	-7.0	**-6.5**	-6.6	**-6.1**	-6.1	**-6.1**	n.a.	**-2.8**
Government gross debt (% of GDP)	58.5	**58.5**	61.4	**65.5**	65.8	**70.7**	68.9	**74.4**	n.a.	**77.9**

Sources: Economic Reform Programme (ERP) 2016, Commission Winter 2016 forecast (COM)

The current account imbalance is of structural nature, reflecting a small and open economy with large investment needs but insufficient domestic savings. However, tourism started to yield strong results in 2015 after investment in tourist capacities and the opening of some 30 new four and five star hotels in the last three years. The growth in tourism, boosting the surplus in the balance of services by an additional 5% of GDP over the year, has become the main factor in the improvement of the external deficit in spite of some further deterioration of the trade deficit. Also, the increase of surpluses in the primary and, to a lesser extent, in the secondary income balances contributed to the reduction of external imbalances. Overall, the current account gap narrowed to 13% of GDP in 2015, compared with a 15% deficit a year before. After the strong performance of tourism in 2015, the ERP forecasts a moderation in exports in 2016 and some gains in 2017. Meanwhile, import growth is projected to slow gradually after 2015. However, this seems unlikely as the work on the motorway is due to speed up in 2016 and 2017, resulting in higher imports.

Gross external financing needs remain high, making the country vulnerable to changes in market sentiment. The external deficit is largely financed by a sustained and non-debt creating inflow of FDI which has remained at above 10% of GDP since 2004 and is expected to average 13.5% of GDP until 2018. Other large transfers relate to tourism and remittances, which are listed under net errors and omissions. Since 2012, net outflows from other investment (mostly bank loans) and reserves have increased gradually. Overall, the sustainability of the current account balance could be endangered by a multitude of factors, like a sudden decrease in FDI inflows, a reversal of investor sentiment, political or financial instability or any other factor which could have a negative impact on tourism.

Graph II.3.1: **Current account deficit financing**

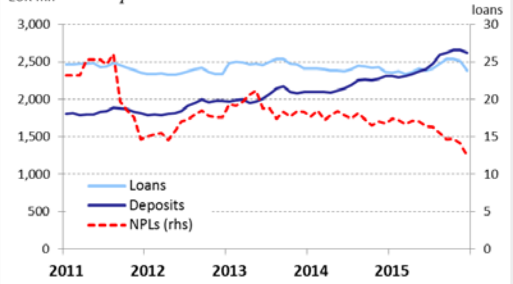


Source: CBCG

The depreciation of the euro together with stagnant wages provided marginal, although insufficient, support to domestic competitiveness. The sharp devaluation of the Russian rouble makes Montenegro's tourism market more expensive compared with its competitors in the Mediterranean southern shore. However, political instability in that region is so far benefiting Montenegro's tourism market. The weakening of the euro against the US dollar resulted in savings of some 1% of GDP from imports of petroleum products in 2015, and also supported Montenegro's aluminium export, which are traded in US dollars. The ERP's analysis of competitiveness based on unit labour costs (ULC) presents some marginal gains due to the stagnation of domestic wages. The ERP also mentions the impossibility – for the time being– of calculating the net international investment position (NIIP) of Montenegro due to data shortcomings.

The banking sector, while liquid, is still struggling with a high but slowly declining share of nonperforming loans. This situation constrains banks' disposition to lend to private domestic companies, whose loans stock grew by a mere 2% year-on-year in 2015. So far, the restructuring of impaired loans by banks has been carried out on a client-bank basis instead of using the restructuring framework offered by the Law on voluntary financial restructuring (known as the 'Podgorica approach'). Nevertheless, between the adoption of the law in May 2015 until the end of the year, the stock of non-performing loans fell by 22%. The fact that interest rates remain high also exacerbates the risk of a feedback loop from the real economy to the financial sector, as expensive loans makes more difficult for companies to service their loans on time. After several years implementing a risk-averse lending policy, banks show high liquidity, with deposits growing by 14% year-on-year in 2015. Also, the aggregated capital adequacy ratio improved markedly, reaching 16% at the end of 2015, well above the regulatory minimum of 10%. However, banks profitability remains particularly weak.

Graph II.3.1: **Financial sector indicators**



3.3. PUBLIC FINANCE

The 2015 budget misalignment was driven by the repayment of unplanned obligations from previous years. In 2015, the central government cash-base deficit surged to 7.9% of GDP, significantly exceeding the full year target of 6.7%. While part of the expenditure increase was expected due to the planned increase in public investments by 4.5% of GDP, overall capital spending turned out to be 20% below the plan at the end of the year as some projects were delayed. Budget revenue remained broadly in line with the annual plan, thanks to growing social security contributions compensating for the decline from tax income, and in particular from much higher VAT returns than a year before. However, the main reason for the budget deviation was due to the unplanned repayment of arrears worth some 2% of GDP.

A high and growing public debt and depleted fiscal buffers put fiscal sustainability at risk. In practical terms, the medium-term fiscal framework is to remain largely constrained by the financing of the priority section of the motorway to Serbia. The highway project, which commenced in 2015, represents a considerable budgetary cost of some 20% of GDP spread over four years. Therefore, the main scope for consolidation will remain concentrated on the current budget. To keep this one balanced, a series of ad-hoc revenue measures are planned, such as new fees on fuel and other excise duties. However, given the large proportion of non-discretionary items on the expenditure side of the budget, savings need to be of a structural nature, as proposed in the Economic and financial Dialogue policy guidance of May 2015 (see Annex II). This would require the rationalisation of the public sector, restrictions for early retirement, and restructuring tax arrears of local governments. In an effort to attract private investments, Montenegro's fiscal policy also offers tax exemptions for investments in priority areas, like tourism, energy, transport or agro-industry.

Table II.3.2:

Composition of the budgetary adjustment (% of GDP)

	2014	**2015**	**2016**	**2017**	**2018**	**Change: 2015-18**
Revenues	44.8	41.9	42.9	40.7	39.6	-2.3
- Taxes and social security contributions	38.1	35.4	35.5	34.6	33.8	-1.6
- Other (residual)	6.7	6.5	7.4	6.1	5.8	-0.7
Expenditure	47.9	48.4	48.9	46.8	42.4	-6.0
- Primary expenditure	45.7	46.2	46.8	44.3	40.1	-6.1
of which:						
Gross fixed capital formation	3.4	7.8	9.8	9.3	6.3	-1.5
Consumption	25.6	23.5	21.5	20.3	19.5	:
Transfers & subsidies	14.8	14.3	14.4	13.8	13.5	-0.8
Other (residual)	1.9	0.6	1.1	0.9	0.8	0.2
- Interest payments	2.2	2.2	2.1	2.5	2.3	0.1
Budget balance	-3.1	-6.5	-6.1	-6.1	-2.8	3.7
- Cyclically adjusted	:	-6.5	-6.1	-6.1	-2.8	3.7
Primary balance	-0.9	-4.3	-4.0	-3.6	-0.5	3.8
Gross debt level	58.5	65.5	70.7	74.4	77.9	12.4

Sources: Economic Reform Programme (ERP) 2016, MoF update.

Contrary to the ERP's spirit of budget consolidation, the 2016 budget is a reflection of spending pressures that have already materialised. The central government budget for 2016, adopted by the Parliament on 29 December 2015, envisages a fiscal deficit of 7.15% of GDP. This is basically on account of the commitment of 6.8% of GDP for the capital budget to finance the priority section of the motorway this year. In this context, pension and disability rights increased from January following the re-activation of the indexation formula (frozen since 2012). This raised pension benefits by 1.2% year-on-year starting from January. However, in March the government also adopted the indexation for the second half of the year too, setting further 3% increase from July for normal pensions and a 20% increase for minimal pensions. Conditions for early retirement of workers from companies with (any) public ownership formally ceased to exist in 2015. Amendments to the Law on Social and Child Protection provide as of 2016 for mothers of any age with three or more children and with 15 years or 25 years of contributory period to receive a monthly benefit of between 40% and 70% of the national monthly average salary. Despite having to renounce their pension, the benefit is likely to be more favourable. While the measure, intended to encourage the birth rate and make up for gender wage inequalities, it will likely push women away from the labour market and burden budget expenditures (annual cost are estimated at EUR 13 million, but the figure could end up reaching some EUR 50 million, or 1.3% of GDP). The new Law on Wages of Public Sector employees, adopted on 24 February 2016 with the intention of setting uniform and transparent rules for all salaries across public institutions, will result in substantial increase of salaries by up to 16% (depending on the category of workers). The Law also introduces some budget sustainability clauses, like the reduction of public sector wages if the budget deficit (excluding spending on the new highway) rises above 2% of GDP. The reduction from 13% to 11% from January 2016 of the higher tax rate on personal income paid by the employer was designed to stimulate the economy. This reduction will result in a decrease in this tax revenue. The net budgetary impact would be mitigated to some extent by deducting the savings for the State itself as employer.

The announced revenue measures will not suffice to compensate for the expenditure increases even if introduced in 2016. Overall, total expenditure from new measures represent some 2.76% of GDP, similar to the expected income from new revenue sources (around 2.65% of GDP). However, further actions might be required soon to balance the budget as 0.6% of extra revenue in 2016 comes from a one-off measure, while spending already appears underestimated. On the revenue side, the 7 eurocent fee per litre of fuel introduced in April 2015 managed to collect some EUR 10 million until October, but at that point the measure was declared unconstitutional. To replace this source of revenue, the government adopted a similar increase in excise on fuel and oil derivatives. The measure, which is still to be adopted by the Parliament, is expected to increase budget revenue by some EUR 10 million. The budget will also be reinforced by a one-off concession of radio electric frequencies to broadcasters (i.e. the digital dividend), and by a series of new or revised taxes to support municipalities budgets, like the upwards revision of the real estate tax and the new tourist tax for vessels used in nautical tourism. The Ministry of Finance has also announced a plan to introduce criminal penalties for irregularities over taxes and social security contributions on salaries. However this measure seems to lack of sufficient support for its adoption.

There is scope for improving budget planning, especially on the expenditure side. General government revenue projections are often realistic, but unplanned costs materialises repeatedly on the expenditure side. In previous years, budget targets derailed by the calling in of unplanned guarantees in bankrupt industries, unplanned redundancy and early retirement plans, the clearance of liabilities from state funds and municipalities, and unfavourable court decisions against the State.

Contingency measures are needed to maintain the budget in line with the plan. For instance, setting up an appropriate fiscal buffer instead of resorting –too often– to borrowing. In this way, the budget could plan additional increase in reserves in the annual budget and design measures for an equivalent increase in revenue (or savings). Such measures would free up space to deal with an unexpected slippage or, if this does not occur, provide a stronger position for the following year. The alternative low-growth scenario confirms the need for prudence and a fiscal buffer. The main risks identified in the ERP are a refugee crisis or a terrorist threat, which would impact negatively on tourism and related services. This would cause the economy to slow down and tax revenue to decline, amplifying the budget deficit.

The electoral cycle emerges as an additional risk for public finances in 2016. Parliamentary elections are scheduled to be held in the autumn of 2016. Relations between the government and the opposition have been tense recently, culminating in a vote of confidence in January – which the Prime Minister won. In order to overcome the current political situations, negotiations are ongoing for the establishment of a new government, with opposition participation, tasked with organising the elections. The structural reform programme could be delayed during the pre-election period or in a situation where the government may find it hard to obtain sufficient support to get important laws through Parliament, further compromising fiscal stability.

Box: The budget for 2016

* On 21 October 2015, the Ministry of Finance presented to the government the State draft budget for 2016. The budget was adopted by the government on 14 November and by the Parliament on 29 December.

* The deficit target is 7.15% of GDP, basically on account of the commitment of 6.8% of GDP to build the priority section of the motorway.

* The macroeconomic scenario supporting this budget is the same as the ERP 2016 baseline scenario, which also estimates real GDP growth of 4.1% and average inflation of 1.5%.

* The main expenditure measures are the introduction of social benefit for mothers and the increase in public sector wages. The main measures on the revenue side they are the increase in fuel excises, and the (one-off) proceeds from the "digital dividend'.

Table: Main measures in the budget for year 2016

Revenue measures*	**Expenditure measures****
Increase in public sector wages (by up to 16%) -implicit tax revenue– under new Law on the wages of public sector employees (0.36% of GDP)	Increase in public sector wages (by up to 16%) under new Law on wages of public sector employees (0.80% of GDP)
Digital dividend (purchase of freed up radio-broadcasting spectrum) (0.65 % of GDP) [one-off]	Reduction from 13% to 11% of the personal income tax maximum tax rate paid by the employer (other than the State) (0.1% of GDP net)
Increase in excise duty on mineral oil (0.26% of GDP)	Pension indexation (0.19 % of GDP)
Collection of tax arrears through taxpayers' assets (0.26% of GDP)	Early retirement pensions for workers of bankrupt public companies (0.10 % of GDP)
Law on real estate (increase in the tax rate from 0.1% to 0.25%,) (0.54% of GDP - allocated to municipalities)	Amendments to the Law on Social and Children's care (benefit for mothers of 3 or more children) (1.29% of GDP)
Tourist tax for vessels used in nautical tourism (0.01% of GDP - allocated to municipalities)	Other social care transfers

Criminalisation of tax evasion (on social security contributions) (0.52 % of GDP)	(0.28 % of GDP)
Higher income from other taxes (e.g. coffee) (0.05 % of GDP)	
Total from revenue measures: 2.65% of GDP *(of which, 0.65% of GDP is a one-off)*	**Total from expenditure measures: 2.76% of GDP**

* Estimated impact on general government revenues.

** Estimated impact on general government expenditure.

Source: ERP, Ministry of Finance

The budget is expected to show signs of improvement in 2018, the last year of financing for the highway. According to the ERP's medium-term framework, budget revenue and expenditure would remain broadly constant over the year in 2017. With no other budgetary measure announced in the programme, 2018 could witness a decrease of some 3% of GDP in capital expenditure when the last (and substantially lower) final instalment is paid for the highway construction. As a result, the general government deficit would almost halve, from 6.1% of GDP in 2017 down to 2.8% in 2018.

Maintaining access to capital markets appears as a key challenge. Gross financing needs are very high, totalling around one third of GDP in the period 2016-2018. In March 2016, the government completed a EUR 300 million five-year sovereign sale. However, weak demand compelled the government to scale back the original offering target of EUR 480 million to obtain a coupon interest rate of 5.75%. This was significantly higher than the 3.87% rate obtained a year earlier. Currency risk concerns some 12% of the total public debt denominated in US dollars. However, a weakening of the euro would increase the cost of servicing the US-dollar denominated loan for the construction of the highway, which is worth some 20% of GDP. To reduce this risk, the ERP announces the possible subscription to a hedging arrangement.

Box: Debt dynamics

Implementation of structural reforms is becoming more pressing as the public debt stock will further grow by some additional 7% of GDP in the 2016-2018 period. The public external debt is set to further increase in the medium term driven by further borrowing in international capital markets to finance a budget deficit fuelled by capital spending, and in particular, withdrawals from the loan to finance the highway. The share of domestic debt (around 12% of the total debt stock in 2015), would further decrease to 3.5% of GDP by the end of 2018; This is because part of this debt is composed of legacy state bonds (i.e. restitution, and frozen foreign currency savings bonds) which are gradually cleared each year.

Table :

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

	2015	2016	2017	2018
Gross debt ratio [1]	**65.5**	**70.7**	**74.4**	**77.9**
Change in the ratio	5.9	5.2	3.7	3.5
Contributions [2]:				
1. Primary balance	**4.3**	**4.0**	**3.7**	**0.5**
2. "Snow-ball" effect	**-0.9**	**-1.4**	**-1.6**	**-1.2**
Of which:				
Interest expenditure	2.2	2.1	2.5	2.3
Growth effect	-2.3	-2.5	-2.7	-2.1
Inflation effect	-0.8	-1.0	-1.3	-1.4
3. Stock-flow adjustment	**2.5**	**2.6**	**1.6**	**4.2**
Memorandum item				
Highway loan [3]	**4.9**	**6.4**	**6.0**	**3.2**

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on

[3] Includes loan and government own contribution.

Source: Economic Reform Programme (ERP) 2016, ECFIN calculations

The government is preparing a series of strategies to reinforce public debt sustainability. However, the situation requires prompt implementation of corrective measures. In June 2015, the government adopted the debt management strategy for the period 2015-2018. The strategy sets the share of domestic debt with fixed interest rate to remain between 65% and 75% of the total debt, introduces a lower limit for euro-denominated public debt at 70% of the total debt stock, as well as an upper limit to the stock of domestic T-bills of EUR 70 million at the end of 2016, and a minimum level of government deposits of EUR 20 million. In addition, under Montenegro's fiscal rules, once the public debt reaches the limit of 60% of GDP the government should present a plan to bring the debt below this threshold in the next five years. According to the ERP, such a plan is expected to be adopted in November 2016, just after the elections.

There is room for further improvement in Montenegro's tax administration performance. The major obstacle to tax collection is the lack of an integrated information system, an issue which is currently being addressed with technical assistance from the IMF and World Bank experts. The efficiency of the budgeting process is also particularly weak at municipal level, often characterised by underspending and accumulation of arrears (towards banks, providers and the tax administration). The situation could improve if the memorandum of understanding subscribed by several municipalities with the Ministry of Finance for support on restructuring local debt in exchange for streamlining their workforce and limiting their expenditure is correctly implemented.

3.4. STRUCTURAL REFORMS

Montenegro's economy is dominated by services, in particular those related to tourism. The industrial sector is being transformed from the past predominance of metal production to other industries, such as energy. Industrial and agricultural products in particular suffer from low competitiveness, low value-added production, and a marginal inclusion in global supply chains. Access to finance, in particular for SMEs, remains a key barrier to increasing growth and competitiveness. Banks are confronted with a high level of non-performing loans and problems of debt recovery (securing and selling collaterals), resulting in scarce and expensive credit.

Structural reform needs are essentially concentrated on the labour market, human and physical capital as well as business support services to facilitate the internationalisation of SMEs. The labour market is characterised by high youth unemployment, low participation of women, and high long-term unemployment. More labour market flexibility and effective active labour market policies are needed, together with education reform. Addressing transport bottlenecks in a fiscally sustainable and transparent manner, based on sound cost-benefit analyses, will contribute to more efficient transport links within the country and across the Western Balkans. Business support services need to be enhanced, also in view of better integrating local companies in regional and international production processes. The rule of law is still weak, corruption substantial and the informal sector large, creating unfair market conditions.

The policy guidance of the Economic and Financial Dialogue with the EU of May 2015 was partially addressed. Contract enforcement was further streamlined, the single project pipeline for investment priorities was set up and steps were taken to improve the quality of the land registry. However, several structural reforms remain at a preliminary stage. There is a need to further pursue financial sustainability of the pension system. Moreover, the newly introduced life-long social benefits for mothers of three children (adopted without an appropriate fiscal impact assessment) may negatively affect the labour market participation of women. Adoption of a new labour law is planned only for 2017.

The Economic Reform Programme correctly identifies the key obstacles to growth and competitiveness, and outlines a number of relevant measures to address them. The 19 reform measures are in line with the government's goals and are appropriate for fostering growth and competitiveness. However, the link between the obstacles and the reform measures could be strengthened and their expected results and impact on competitiveness remain essentially unquantified. The ERP has a strong focus on infrastructure and large public investment projects. Given the significant budgetary deficit and a rapidly growing public debt, less costly regulatory reforms could be prioritised. With regard to public finance management (PFM), sector developments and business environment, the reform measures are broadly relevant and, if implemented, will contribute to increased competitiveness. Implementing PFM and education reform could potentially yield higher and more sustainable returns in the medium to long term.

Public finance management

Weaknesses in public finance management undermine fiscal discipline and transparency. The existing fiscal responsibility framework is weak, and the deficit and debt thresholds established by the fiscal rule were exceeded in the executed budget for 2015 as well as in the fiscal framework 2016-18. This raises issues about the enforceability of the current framework. The fiscal reporting remains weak with successive fiscal data revisions, especially on the spending side. There is scope for improving reporting on municipal arrears. Other areas for reform concern weaknesses in medium-term financial planning, internal audit capacities, as well as public procurement. The public procurement system accounts for 13.6% of GDP, similar to the EU average. It suffers from the almost exclusive use of price (acquisition cost) as the only award criterion, which detracts from the quality of the items procured. Moreover, the area of concessions is not aligned with EU rules. A public investment management system which uses sound cost-benefit analyses to inform budgetary priorities would improve fiscal control and increase transparency. Against this background, the full implementation of the comprehensive Public Finance Management (PFM) reform programme, adopted in December 2015, would help tackling identified weaknesses. Therefore, a clear reference to the PFM reform programme in the ERP structural reform part would have been appropriate.

The measure to introduce e-procurement could have a positive impact on transparency in the use of public funds and could potentially lead to increased competition for public tenders. Planning appears credible and realistic and the measure is consistent with the PFM reform programme. The ERP also recognises the need to regulate concessions and public private partnerships in line with the EU acquis. This will regularise the way the state establishes partnerships with businesses and help ensure a level-playing field for businesses, while stimulating further economic development and competitiveness. A law on concessions and public-private partnerships has been in preparation for several years and further delay could hinder private investments.

Infrastructure

Weak regional connectivity and high infrastructure costs hinder economic growth. Infrastructure development is constrained by the country’s difficult topography, which results in high investments and maintenance costs. Montenegro could become more competitive in energy by contributing to the development of a regional energy market and exporting potential surplus energy. The large public investments in roads, railway, and power interconnectors are broadly in line with the priorities agreed under the connectivity agenda, but weigh heavily on the fiscal framework. Investment planning needs to take into account the fiscal constraints and be accompanied by sound cost-benefit analyses and good infrastructure management. Embedding capital investment in infrastructure in wider sector policies, including regulatory measures, can bring significant benefits for relatively little cost. On this issue, further efforts are needed to improve railway safety and interoperability, including ensuring sufficient capacity for and independence of the rail regulatory body and rail safety authority. In the area of energy, for the effective separation of the energy entities, in line with the EU’s third energy package, proper safeguards can be put in place. This way, the market’s opening benefits customers through guaranteeing, for instance, obstacle-free supplier switching for customers.

The recommendation to strengthen the transport development strategy and ensure alignment with the regional connectivity agenda has not yet been addressed. However, Montenegro has included this as a reform in the ERP 2016-2018 and has ongoing discussions with IFIs to secure funding and set up a clear implementation timetable.

The measure on continuing the construction of the Bar-Boljare motorway could bring substantial benefits in the long run, but at the expense of postponing other important investments. The ERP points to a number of substantial competitiveness benefits linked to building of the motorway, such as improved flow of goods and people, more balanced regional development, and growth in tourism. However, the full benefits of the Bar-Boljare motorway, as Montenegro's biggest-ever public infrastructure investment project, are likely to materialise only when the entire network is finalised, linking the port of Bar to Belgrade, via Podgorica. Opportunity costs of not investing in other areas and the expected benefits need to be carefully considered. Due to the resources invested in this project, other important transport bottlenecks may not be properly addressed. The high costs and fiscal risks create an urgent need to take complementary measures that ensure the sustainability of public debt.

Infrastructure-related measures have significant potential to improve the competitiveness of the economy, when complemented by regulatory reform. The measure to modernise Bar-Vrbnica section of the rail network could ensure that climate-friendly transportation options are available. It is well developed with a good level of project maturity, but it is dependent on financial support from donors and IFIs for its implementation. The impact also depends on similar steps being undertaken by Serbia to rehabilitate the rest of the line to Belgrade. As regards energy, the planned inter-connection to the EU and Serbian electricity markets presents a good opportunity for electricity exports, in particular from hydro sources, and will increase network stability. Risks of negative environmental impacts should be accounted for and mitigated. The measure needs to be complemented by soft measures that encourage competition on the energy market, as well as promote energy efficiency. The implementation of obligations under the Energy Community Treaty should be given priority. The measure on the construction of a waste water purification plant and water-supply and sewage networks seeks to improve the availability of services of general interest and compliance with environmental standards in this area. However, it remains vague in terms of its potential impact on competitiveness and to what extent it addresses a key growth constraint.

Sector development

Agricultural sector development

Montenegrin agriculture is characterised by low production due to a difficult topography with limited fertile land, the small size and fragmentation of plots, outdated technology and limited access to credit. Dependence on agricultural imports is high. To reach a more favourable business environment for farmers, Montenegro needs to develop a multiannual agro-budget, a system for consolidating land, provide support to education and training of farmers, and assist producers in developing and marketing products.

Progress has been recorded in the field of EU food safety and sanitary and phytosanitary standards through the adoption of several framework laws. They were complemented by a strategy for transposing and implementing the EU *acquis* for food safety, veterinary, and phytosanitary policy. However, the strategy does not identify the products' level of preparation for EU accreditation or specific areas where Montenegro perceives the biggest export potential, as suggested by the 2015 policy guidance.

Montenegro is right to continue support for investments in primary agricultural production and expanding it to manufacturing capacities, envisaged under the priority reform measure and this is in line with the diagnostic. To develop this area, Montenegro needs to allocate adequate resources and to strengthen the capacity of all IPARD bodies to take on budget implementation tasks.

Industry sector development

Although the share of industry in Montenegro's economy is declining, an increased diversification from metals into other sectors like energy or pharmaceuticals has been noted. The production of competitive higher value-added products remains limited. The local industry is characterised by low labour productivity and marginal participation in global supply chains. Access to finance, in particular for SMEs, remains a key barrier to increasing competitiveness. Financial support has increased in recent years, but largely depends on external funding from IFI loans. The SME Policy Index 2016 highlights that while Montenegro has established a solid institutional framework for SMEs, additional work is required to enhance the provision and range of business support services as well as to improve SME access to foreign markets.

Incentives to invest in the industrial sector aim to support new production technologies and create new jobs. The measure already anticipates an impact on employment. Support is concentrated on the manufacturing industry and is limited to established businesses for their expansion on condition of creating new jobs. Six projects were selected during the first call in 2015 which are expected to create almost 300 new jobs with a total own investment of EUR 21 million, supported by EUR 620,000 in subsidies. Monitoring and evaluating the effectiveness of the scheme, including terms of its impact on production, increased sales, and exports, will allow a good allocation of the resources.

Services sector development

Services remain the main engine of the economy. The sector accounts for more than 70% of gross value added. Montenegro aims to become a high-end tourism destination. For this, challenges are in particular the lack of R&D business uptake, the need for more quality accommodation infrastructure, as well as the development of a sustainable natural and cultural offer. Other services sectors could benefit from more regulatory alignment with EU rules. The country has not yet aligned its legislation with the EU Directive on Services. Also, an important facilitator for the development of the service sector is an effective ICT broadband infrastructure, which includes a legal and regulatory framework. Furthermore, enhancing the independence of the telecommunication regulator and requiring network operators to coordinate their engineering, to share their infrastructure, and to specify the conditions for granting aid, will amongst other things lead to increased competition between fixed and mobile operators as well as among them.

The measure to develop skiing infrastructure in the north of Montenegro seeks to diversify the tourism offer and reduce strong seasonality. So far, most tourists remain concentrated on the coast during the summer while the north of the country is not sufficiently developed. The programme proposes the development of basic infrastructure to attract investors for the further development of some winter resorts through public-private partnerships. However, the lack of interest from private investors is a cause for concern.

Business environment, corporate governance and reduction of the informal economy

The business environment is improving but there is ample room for further progress. The main obstacles identified by the business community are: the informal economy, access to electricity, weak contract enforcement, limited access to credit, and cumbersome tax administration procedures. Further efforts are needed to strengthen the rule of law, to reduce the informal sector, and to tackle corruption to ensure that regulatory improvements translate into an improved investment climate. The outcome of judicial proceedings is at times difficult to predict as court orders are not always enforced or followed by law enforcement institutions.

The ERP includes five reform measures that are all relevant to improving the business environment. The upgrade of ICT systems to improve the functioning of one-stop shops introduced in

2012 for issuing construction permits has the potential to significantly shorten the time needed to issue such permits. The budgetary commitment this year indicates that the timeline is realistic. By ensuring the correct implementation of the amended Law on state survey and immovable property cadastre (adopted in July 2015), Montenegro seeks to make the land registry better and increase its coverage through streamlining the registration process for ownership rights. However, the description of this measure remains vague and does not set out any further steps.

The completion of the regulatory simplification project is delayed until 2017, when Montenegro also plans to evaluate its results and effectiveness. The introduction of electronic fiscal invoices will allow a further reduction of the informal economy by strengthening tax discipline. The measure is specific, its budgetary impact estimated, and has a precise timetable for implementation.

The improvement of financial support to SMEs seeks to expand the range of instruments and credit lines to make them more effective. The financial support channelled through the Investment and Development Fund (IDF) has increased in recent years from some EUR 66 million in 2013 to EUR 115 million in 2015. For 2016, the ERP announces support of approximately EUR 100 million. IFIs and the EU are the main supporters of the IDF lending instruments. While basic services for SMEs and start-ups are available, Montenegro could expand the range of services offered, including through the development of private business support providers.

Technological absorption and innovation

Montenegro recognises the importance of research and innovation as a driver for competitiveness and is in the process of taking several measures to link academia to industry. However, the number of domestic innovative and internationally competitive enterprises is low. R&D investment amounted to 0.38% of GDP in 2013.R&D personnel represented 0.26% of the workforce in 2013.

The construction of the first Science and Technology Park 'Tehnopolis' in Nikšić remains a priority in the measures, but was delayed by a year to 2016 due to procurement-related problems. It is important that Montenegro elaborates on how to attract academia and industry and the services they want to offer. For example, funds for training and equipment have not yet been secured. Strengthening the current limited research capacity inside and outside universities, including innovative SMEs, will contribute to an increased technology and innovation absorption capacity. In order to maximise the impact, research funding would need to focus on a limited number of key research areas, such as organic food, sustainable tourism, marine science or bio-ICT, and other areas to be identified in a Smart Specialisation Strategy. Montenegro's Innovation Strategy 2016 (under preparation) may provide further clarity.

Trade integration

Trade openness in Montenegro is high, reflecting a strong dependence on goods imports and exports of services. The trade and current account deficits are substantial, totalling some 40% and 13% of GDP respectively in 2015. Exported goods consist predominantly of low added-value products with only a few companies that trade internationally. The expansion of SME support services will improve SME internationalisation and foster their inclusion in global value chains.

Enhanced harmonisation with the requirements of international quality standards will be encouraged by direct support scheme for SMEs. The scheme contributes to higher quality domestic companies and their products, increased consumer confidence, thus strengthening competitiveness. While the ERP reports a 'pronounced interest' among SMEs, there is no information on the results and impact achieved to date (e.g. on increases in sales). The ERP could also have given more prominence to foster regional trade integration, including the ongoing CEFTA negotiations on the liberalisation of trade in services and trade facilitation. There are significant gains to be made on intra-regional economic integration, especially if combined with regulatory approximation with EU rules in related areas.

Employment and labour markets

High long-term unemployment and low labour market participation of youth and women remain a challenge. Young people suffer from an unfavourable position on the labour market, greatly as a consequence of the skills-mismatch. Widespread engagement in informal work coupled with weak activation remains a challenge, given the existence of disincentives to work and early exits from the labour market. The recently adopted measures for mothers of three children are likely to largely discourage women from participating in the labour market.

There was some formal progress in developing employment strategies and aligning education and skills with labour market needs. A comprehensive Employment and Social Reform Programme 2015-2020 and Employment Strategy 2016-2020 were adopted, but implementation has not yet started. Educational programmes are being reviewed and a programme for professional training of university graduates is being rolled out. Adoption of the new labour law is planned for 2017. Combatting undeclared work was prioritised through institutional and operational reforms, but the results will only be visible in the future.

There is a need to improve vocational education and training outcomes in line with labour market needs. By 2017, Montenegro plans to carry out activities to develop new or modify existing qualifications and programmes - based on learning outcomes - accompanied by training for teachers. Focus needs to be given to introducing work-based learning, promoting entrepreneurship and career guidance. Furthermore, weak learning outcomes in basic education and soft skills are a further element of concern, in particular as these not only affect performance on higher educational levels, but also impact future employment and social situation of the population.

While targeting has improved somewhat, the outreach and coverage of active labour market policies (ALMPs) remain low. Measures aiming at better inclusion cover both areas of labour market and social protection. Action is planned to strengthen ALMPs and employment services, through staff trainings and reviewing of existing ALMPs. A grant scheme will offer capacity building and training programmes for the long-term unemployed, women, youth and other hard to employ groups. Nevertheless, there remains a wide scope to increase the low coverage of ALMPs, particularly for groups vulnerable on the labour market and for the less advantaged in order to achieve better integration and participation on the labour market.

Fostering social inclusion, combating poverty and promoting equal opportunities

Weak activation measures, gender inequalities and insufficient social and child care services are key challenges. Insufficient coverage and targeting of social assistance is likely to create disincentives to work, especially combined with the opportunities in Montenegro to engage in informal work. Tackling key social challenges requires increasing labour market participation, and strengthening social assistance and care provision to better target those in need.

Reconciling work with family life for women appears difficult due to disincentives to work and insufficient coverage of child care. In 2015, changes to the Law on social and child protection introduced a measure which allows mothers with three or more children to obtain life-long social benefits, amounting to 40-70% of average wage after only 15-25 contributory years or inscription in the employment registry. This is highly likely to discourage women from participating in the labour market and will encourage early exits in the same way as early retirement, while the costs will put further pressure on social protection expenditures. There is insufficient focus given on prolonging working lives, which could be linked to measures on reducing early retirement.

Further support measures are necessary to improve the social protection system. To address this challenge, Montenegro plans an analysis of the social situation, tying it with the ongoing “Social Card” reform project, aiming at establishing an integrated social protection information system, strengthening the capacities of social welfare centres and linking social services with the activities of employment offices, thereby introducing activation measures for the most disadvantaged. However, stronger focus is missing on addressing regional disparities and targeting the most disadvantaged groups, such as Roma, Egyptians and Ashkali and people with disabilities. Better focus is lacking to improve access to social services at the local level and on decentralisation of social services, while community-based organisations should also be targeted.

Participation and coverage of pre-school education is a priority, although the focus appears to be on facilities only. Under the Council of Europe Development Bank project, seven new pre-school institutions will be built and existing ones renovated by the end of 2017. While investments in pre-school education are an important aspect of social inclusion, there is no mention of complementary measures and activities to increase participation in and the quality of pre-school education and upbringing. Infrastructure development lacks accompanying measures of investment in teachers. The measure is linked with the strategy for early and pre-school education but there is no indication on how the proper management of the institutions will be ensured.

3.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2015

2015 policy guidance	**Summary assessment**
PG 1: Sustain the commitment to fiscal discipline, establish a credible track record on the basis of the new rules-based fiscal framework and revise the public debt management strategy to bring the public debt into a downwards trajectory in line with the ERP medium-term framework. In this context, municipalities are also called to contribute by strengthening their own budgetary position. In order to improve transparency, develop the necessary administrative capacity to implement the European System of Accounts (ESA2010).	Montenegro has not addressed the PG 1: Budget expenditure deviates significantly from the target due to the unplanned repayment of arrears. Moreover, the decisions to increase public sector wages and benefits will further derail public finances. In June 2015, the government adopted the Public Debt Management Strategy for the period 2015-2018. Another plan to reduce the debt below Montenegro's fiscal rules threshold is announced for November 2016. In July 2015, the Ministry of Finance improved the fiscal position of 14 municipalities bringing forward by one year the programme for restructuring their debts. This was in exchange for a plan (to be implemented) for the municipalities to optimise their number of employees. Activities continue under the Action plan for implementation of ESA2010 methodology in the government finance statistics. Full implementation is planned in 2017.
PG 2: Consider additional reforms for attaining long-term sustainability of the budget, such as the introduction of further restriction for early retirement and the consideration of options for individual participation into the old-age pension system on a mandatory basis, as well as the implementation of a common policy for public sector wages in the context of rationalisation and modernisation of the public sector.	Montenegro has not addressed the PG 2: There have been measures taken to reduce early retirement. In 2015, amendments to the Law on pension and disability insurance restricted early retirement to miners and parents of children with severe disability. While staying on the labour market is financially incentivised by a further pension increase, the motivation to stay at work appears low. On old age pensions, the government decided to postpone further development of the second pillar (individual compulsory participation) due to budget constraints. Implementation of policy guidance had opposite effects than expected for public sector wages. The simplification of public sector wages across government institutions to rationalise costs, will

	not be neutral but result in an increase in salaries of up to 16%.
PG 3: Implement the planned voluntary financial restructuring programme (the so-called "Podgorica approach") to address the high burden of non-performing loans on bank balance sheets from a flow perspective. In order to address the NPL stock issue, improve deadlines and efficiency of contract enforcement. Introduce effective supervision of factoring companies to improve the transparency of the financial system.	Montenegro has partially addressed the PG 3: The plan for voluntary financial restructuring (i.e. Podgorica approach) was adopted but it failed to yield the expected results. There was some fine-tuning of secondary legislation supporting the work of public bailiffs. But some additional measures are still necessary to facilitate banks' collateral execution and contract enforcement. Regulation of factoring companies has been included in the 2016 government programme.
PG 4: Amend labour legislation in order to introduce further market flexibility. Reinforce sanctions to discourage undeclared work. Better target active policies for workers at risk of losing their employments and enhance labour market participation in view of an ageing population.	Montenegro has partially addressed the PG 4: Labour law is in preparation, planned for adoption in 2017. Government recommendations and action plan to fight informal economy were adopted in 2015. The 2015-2020 Employment and Social Reform Programme and the 2016-2020 Employment Strategy were adopted in 2015. ALMPs focus on the long-term unemployed, youth and women, but no evaluation of their effectiveness has been provided. There is little focus on participation in life-long learning and no specific focus on the labour market participation of older workers.
PG 5: Actively continue education reform with a view to better aligning education and skills with labour market needs, and strengthening cooperation between education and business.	Montenegro has partially addressed the PG 5: Educational programmes are being reviewed and Sectoral committees and the Qualifications Council provide a link with employers over the development of qualifications. A programme for professional training of university graduates is in place and a similar programme is planned for vocational training. A feasibility study was conducted into establishing a tracking system for university graduates.
PG 6: Strengthen the transport development strategy ensuring alignment with the regional agenda on connectivity, with a particular focus on	Montenegro has partially addressed the CPG 6: The revision of the transport development strategy

the core investment priorities (core network), and establish a credible planning and funding mechanism in the form of a single sector pipeline.	has been included as a priority reform in the 2016 ERP, but the required resources have not yet been secured. A National Investment Committee was set up in May 2015. A Single List of Transport Priority Infrastructure Projects has been designed.
PG 7: Further improve the business environment by ensuring the timely implementation of the so-called "regulatory guillotine" (simplification) project, enhancing the functioning of one-stop shops at municipal level for the issuing of construction permits and the quality of the land registry.	Montenegro has partially addressed the PG 7: Out of 1446 measures from the "Regulatory Guillotine", 1103 have been implemented by mid-2015; completion is foreseen by end-2017. Implementation of one-stop-shops is ongoing, but the upgrade of the IT system was delayed. This is now foreseen under this year's ERP. In July 2015, amendments to the Law on State Survey and Immovable Property Cadastre were adopted in order to strengthen and streamline the process of land registration. A measure to monitor its application is included in the ERP 2016.
PG 8: Make further progress with a comprehensive and strategic approach in the field of EU food safety and sanitary and phytosanitary standards to receive accreditation for exporting agricultural and food products to the EU. Efforts in this direction should commence with those products where preparations are advanced and where Montenegro sees the biggest export potential.	Montenegro has partially addressed the PG 8: In September 2015, Montenegro passed the Food Safety Law, as one framework law in this area, covering among others competent authorities, import & export, registration of establishments, official controls and specific rules for feed. Other framework laws were adopted to facilitate meeting the conditions for the export of food products to the EU. The government also adopted a Strategy for Transposing and Implementing the EU Acquis for Food Safety, Veterinary, and Phytosanitary Policy. However, the strategy does not include a detailed plan for receiving accreditation for exporting different agricultural and food products to the EU.

3.6. THE 2016 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, 25 May 2016

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

1. Stabilise the debt-to-GDP ratio net of debt related to capital investments already underway in 2016, and then reduce it over the remainder of the programme period.

2. Take immediate measures to restrain current spending, including on pensions and the public sector wage bill. To generate budgetary savings and improve revenue collection, conduct a comprehensive review of tax expenditure as well as exemptions, and implement tax increase in a growth-friendly manner.

3. Develop a comprehensive strategy to further foster the disposal of non-performing loans by banks, including participation by all relevant stakeholders, while establishing a bank lending survey to better gauge underlying credit dynamics.

4. Ensure effective, efficient and independent regulatory and safety authorities to implement the full opening of rail and energy markets.

5. Continue to facilitate the provision and range of financial and non-financial support services for SMEs with a view to foster participation in global value chains. Support the development of the private consultancy market.

6. Prolong working lives and reduce disincentives to work through strengthening the link between activation measures and social assistance, in order to improve the labour market participation of the long-term unemployed, women and youth. Implement strategies to align education and skills policies with labour market needs.

Annex: Overall assessment of programme requirements

Montenegro's second Economic and Reform Programme (ERP 2016-2018) was submitted to the European Commission on 30 January 2016. The ERP represents the economic policy of Montenegro and the basis for economic dialogue with the Commission. The authorities submitted one further update of the programme, on 15 February 2016, providing summary information on the implementation of the policy guidance adopted at the Economic and Financial dialogue with the EU of May 2015.

Ownership and internal coordination

The preparation of the ERP was centrally coordinated by the Office of the Deputy Prime Minister, the Ministry of Finance, and the Ministry of Economy. The programme was formally adopted by the government in January in 2016 and submitted on time. An inter-ministerial ERP working group involving line Ministries worked on its preparation.

The proposed 19 priority reform measures are in line with the Government's goals, national strategies, SEE2020 Strategy, EC report on Montenegro and correspond to a certain extent to the joint recommendations of the May 2015 Economic and Financial dialogue. The level of maturity of the proposed measures varies in scope, financial impact and time horizon. Measurable indicators need to be associated to each measure. Additionally, there is a high overlap with last years' measures.

Stakeholder consultation

The ERP working group first developed the draft and further discussed it with the stakeholders in initial phase. The draft ERP was published on the Government's website from 18 December 2015 to 24 December 2015. No comments or suggestions were presented. The Government, additionally, organised a consultative roundtable on 23 December 2015. In addition to relevant line Ministries, representatives from the Parliament, Central Bank of Montenegro, MONSTAT, Union of Municipalities, State Audit Institution as well as UNDP or the Office of the World Bank in Podgorica attended the event. While well attended, the event is not considered to have brought substantial added value to the process. Several prominent Montenegrin NGOs, as well as representatives of professional bodies including the Employers Federation, were not present. The draft ERP 2016-2018 was not shared with the relevant Parliament's Committee for comments.

Macro framework

The programme presents a clear and concise picture of past economic developments. The baseline macroeconomic scenario supporting economic policy seems plausible given the fact that several large investments supporting the overall strategy are already commenced or are in an advanced state of preparedness. Analytical capabilities are gradually improving, in particular on the analysis of the cyclical position of the economy and the sustainability of the external sector, although some further fine-tuning is still required. The ERP 2016 also presents –for the first time– the set of external assumptions underlying the programme's macroeconomic projections (although these are still incomplete for 2018). Like last year, some data coverage remains incomplete, in particular on the labour market and external sector developments. However, the baseline framework appears coherent, consistent and sufficiently comprehensive. The programme also offers an alternative but cautious low-growth scenario based on the occurrence of two potential risks: deterioration in the refugee crisis and the threat of terrorism. Both risks would have negative repercussions on tourism, one of the key engines of growth and with multiplicative effects on sectors like transport, culture or catering. In this scenario, aggregated demand would contract due to the reduction of exports, investments, and private consumption.

Fiscal framework

The fiscal framework appears insufficient to support the ambitious policy objectives. At first glance, the measures presented in the programme are broadly balanced, with both revenue and expenditure measures accounting for some 2.7% of GDP each. However, on the revenue side there are some one-off measures, or they still depend on uncertain political support for adoption. By contrast, the measures on the expenditure side have been already adopted. Often, their final costs surpass the ERP's early estimations, calling for corrective measures, and possibly, a budget rebalancing too. The programme also offers and alternative low-growth fiscal scenario. However, this alternative scenario is much less developed than the macroeconomic one, failing to provide any estimate or rationale for the effects of the economic downturn on some components of the budget, like on interest rates or state guarantees. Work is continuing under the action plan for implementation of ESA2010 methodology in the government finance statistics, with full implementation planned for the end of 2017.

Structural reforms

The section on structural reform priorities follows the guidance note in presenting a diagnostic per area, rather than for each measure. The ERP 2016-2018 correctly identifies some of the obstacles to Montenegro's growth and competitiveness and outlines a number of relevant measures to address them. However, the diagnostic is at times vague or too general in some areas. The linkages with the chosen reform measures are not always well justified. The reporting of the implementation of the policy guidance can be improved and provide more precise information about the actions taken and their impact. As a result, assessing the state of play of the policy guidance has been at times unnecessarily complicated, requiring extra research and clarifications. Tables 10-12 are properly filled in following the guidance note. Montenegro's ERP 2016 does not integrate Annex 2 which includes information on the consultation process of external stakeholders on structural reform priorities and fulfilment of SEE 2020 national targets before the ERP is drafted. No information was included on the consultations of stakeholders before the ERP drafting.

4. SERBIA

4.1. EXECUTIVE SUMMARY

Economic growth is expected to slowly gather pace. The economy has recovered faster than envisaged, supported by increased confidence as a result of implemented reforms and low oil prices. A gradual acceleration of economic activity is forecast to be driven by robust investment and export growth. Employment is expected to pick up moderately. Price pressures are likely to remain low, although with the strengthening of domestic demand, inflation is forecast to return to the central bank target band. Further reductions of the current account deficit are expected to be marginal but foreign direct investment should fully cover the deficit.

The macro-fiscal scenario is plausible and risks to it are clearly outlined. The economy continues to be exposed to multiple external risks and remains highly sensitive to international capital flow reversals and fluctuations in oil prices. Potential relaxation in fiscal consolidation and structural reform efforts also remain significant internal risks, although these have been reduced as a result of recent policy measures.

The main challenges in these respects include the following:

The forecast medium-term budget deficit reduction is appropriate, although short-term adjustment efforts are less ambitious. The authorities have not reassessed their target of achieving primary surplus only in 2017. The envisaged consolidation drive is planned to remain predominantly on the expenditure side and the overall deficit to fall to 1.8% of GDP in 2018. However, contrary to last year, the adjustment is deferred and the structural deficit is planned to decline marginally in 2016 before falling strongly in the year after.

The strong budget consolidation in 2015 masks delays in some reforms and deficiencies in budget planning and execution. The restructuring of large publicly-owned enterprises has progressed unevenly and the public administration reform has encountered delays. Significant one-off revenue and expenditure have continued to influence the budgetary outcome. Strengthening the tax administration in a business-friendly manner is key to sustaining and further improving revenue collection.

Implementing planned reforms should strengthen financial sector resilience. Macroeconomic stabilisation has already brought down borrowing costs and led to an easing of credit standards. However, the banking system still faces important challenges, like a particularly high level of non-performing loans, and bank lending, especially to corporates, remains muted. The oversight over majority state-owned financial institutions is being strengthened and there are ongoing efforts to prepare the privatisation of some of them.

Under-execution of capital expenditure remains an issue. It curtails a much needed contribution from the public sector to growth. Weak physical networks and inefficient markets in the energy and transport sectors are slowing down economic integration with the EU and the region.

Although improving, the business environment remains weak, in particular for SMEs. Private investment is restricted, among other reasons, by a costly, unpredictable and non-transparent system of para-fiscal charges, difficult access to finance and red tape. Credit growth is limited in the absence of guarantee instruments or a well-functioning cadastre.

The level of state aid is too high and granted to a large extent to unprofitable public companies or to non-transparent FDI projects. Investment aid is not granted on the basis of clear predefined criteria.

The level of public and private sector investment in research, development and innovation is low and below the needs of the economy. There is significant room to increase competitiveness in agriculture; however, the potential of the sector is held back by land fragmentation and low productivity due to outdated technologies.

Despite a recent slight increase in employment, high youth and long-term unemployment, as well as low female participation and a high prevalence of informal work, remain considerable labour market challenges. Reforms in the education and training system at all levels are needed in order to ensure a better match of skills supply with future labour demands. The reform measures for responding to these challenges focus on strengthening labour market institutions, in particular employment services and initiating longer-term reforms in the education system.

Over recent years, poverty rates have increased, with children, the unemployed and large households being most at risk. Along with policies for boosting growth and employment, policies aim at maintaining the level of social protection for the most vulnerable segments of society. Social benefits have been expanded but with little effect so far on alleviating poverty. A key challenge in this respect is to improve the adequacy and targeting of social assistance for addressing poverty.

The macroeconomic and fiscal framework of the ERP is sufficiently comprehensive and coherent, providing a good basis for policy discussions, while the structural reform section has improved considerably compared to last year. The description of each reform measure is detailed enough in order to follow up annually. However, the programme would have benefitted from a more market oriented approach. Implementing the envisaged reform agenda remains key to reducing economic imbalances, improving competitiveness, and supporting sustainable growth.

The authorities have undertaken steps to address last year's policy guidance. Strong measures contributed to a significant structural adjustment, bringing the budget deficit down to 3.8% of GDP. Fiscal consolidation provided room for monetary policy relaxation. Despite delays, the restructuring and resolution of state-owned enterprises and the implementation of the public administration reform have advanced. The authorities, including the central bank, have designed and have been implementing a comprehensive resolution strategy and action plans to address the issue of high non-performing loans. However, the very slow implementation of public infrastructure projects has a negative impact on recovery. The reform of the construction permit system supported economic development, but access to finance remains expensive and undermines further expansion of private investment. The fight against the grey economy has been intensified with stricter inspections and improved tax collection, but does not yet comprehensively tackle informal employment.

4.2. ECONOMIC OUTLOOK AND RISKS

Economic growth is forecast to slowly gather pace. Despite a significant fiscal consolidation in 2015, increased confidence as a result of implemented reforms and low oil prices helped the economy recover faster than expected. The programme envisages a continuing, gradual acceleration of economic activity, driven mainly by robust investment and exports. The baseline growth path is broadly in line with the latest Commission forecast. Private consumption, after being a drag on growth for a number of years, is also seen rebounding marginally in the first two years of the programme, before picking-up in 2018. As fiscal consolidation efforts are envisaged to continue, public consumption is forecast to decline by an average of 0.6 % over the next three years.

Investment is forecast to join exports in reshaping the economy's structure. At the end of the programme period, a decade after the 2008 crisis, the economy is envisaged to be much more open. Following a continuously robust performance, exports' share is expected to reach more than half of GDP, nearly doubling in real terms in ten years. The basis for the still modest economic recovery is likely to be more solid, as investment is also forecast to increase by a cumulative 30 % since its trough in 2014 and to be more than 20 % of GDP in 2018. Investment growth has already been very strong in 2015, benefiting from reforms to improve the business environment, measures to reduce the budget deficit, and monetary easing. Maintaining the authorities' commitment to implementing the planned structural reforms would undoubtedly remain an important factor to sustain this growth momentum, increase the economy's potential, and underpin sustainable economic growth. Investment is seen as the main driver of domestic demand as both public and private consumption remain subdued.

Table II.4.1:

Macroeconomic developments and forecasts

	2014		2015		2016		2017		2018	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	-1.8	**-1.8**	0.8	**0.75**	1.6	**1.75**	2.5	**2.2**	n.a.	**3.5**
Contributions:										
- Final domestic demand	-1.7	**-1.8**	0.6	**0.7**	1.8	**1.6**	2.7	**1.5**	n.a.	**2.7**
- Change in inventories	0.5	**0.6**	0.0	**0.0**	0.0	**0.0**	0.0	**0.0**	n.a.	**0.0**
- External balance of goods and services	-0.6	**-0.6**	0.2	**0.1**	-0.1	**0.1**	-0.2	**0.8**	n.a.	**0.7**
Employment (% change)	10.1	**10.6**	0.9	**1.1**	0.7	**0.5**	1.2	**0.9**	n.a.	**1.5**
Unemployment rate (%)	19.4	**20.1**	17.4	**18.5**	16.8	**17.0**	16.1	**16.1**	n.a.	**14.6**
GDP deflator (% change)	2.7	**2.7**	1.2	**1.5**	2.4	**2.6**	3.5	**3.2**	n.a.	**3.7**
CPI inflation, annual average (%)	2.1		1.4	**1.9**	2.4	**2.8**	3.6	**4.0**	n.a.	**4.0**
Current account balance (% of GDP)	-6.0	**-6.0**	-5.1	**-4.6**	-4.9	**-4.5**	-4.9	**-4.1**	n.a.	**-4.1**
Budget deficit (% of GDP)	-6.6	**-6.6**	-3.8	**-4.1**	-3.7	**-3.9**	-3.5	**-2.6**	n.a.	**-1.8**
Government debt (% of GDP)	70.4	**71.8**	76.2	**76.0**	79.9	**79.1**	81.8	**78.6**	n.a.	**75.7**

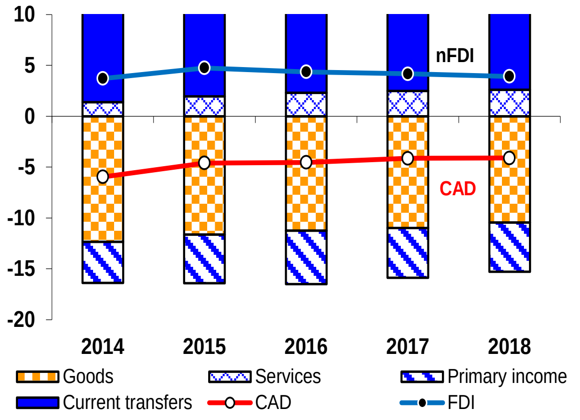
Sources: Economic Reform Programme (ERP) 2016; Commission Winter 2016 Forecast

The macroeconomic scenario is plausible and risks to it are clearly identified. The programme also presents an alternative, pessimistic scenario on the assumption that some of the identified risks materialise, envisaging lower cumulative real GDP growth of just 3.3 % in the period 2016-2018. The economy continues to be exposed to a multitude of external risks, stemming mainly from developments in the EU, which is its main export market and the source of most foreign investment. It also remains highly sensitive to international capital flow reversals and fluctuations in oil prices. In comparison with last year's programme, the risk matrix has shifted to the external side, due to increased role of export and FDI to support growth and heightened geopolitical tensions. Nevertheless, although reduced as a result of recent policy measures, the programme also flags some key domestic risks, mainly related to potential delays in fiscal consolidation and structural reform efforts.

Inflation is expected to return to the central bank target band but price pressures are likely to remain low. Inflation has been persistently below the central bank target tolerance band in the last two years. The spell of subdued inflation has been due to low international prices, in particular of key commodities, restrictive fiscal policy, weak domestic demand and exchange rate stability. The long period of price moderation has helped anchor inflation expectations and provided room for significant monetary policy relaxation. The programme envisages that short-term price pressures remain low. Over the medium term inflation is forecast to gradually approach the 4 % target, pushed up by regulated price increases and as disinflationary effects from the international environment and aggregate demand start to wane. A steady implementation of the announced reform measures and continuing fiscal consolidation are key assumptions substantiating this inflationary path.

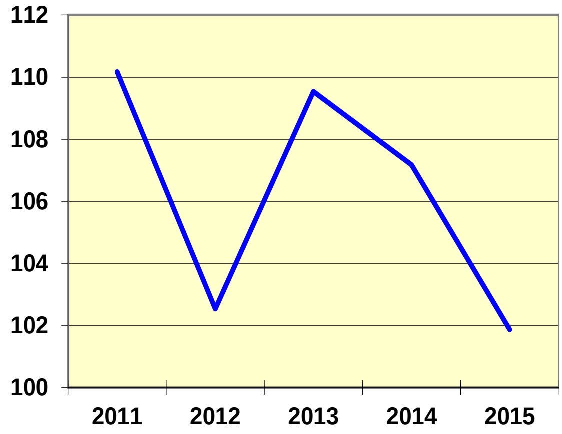
Graph II.4.1: External competitiveness and the current account

Evolution of the current account balance
(% of GDP)



Source: Economic Reform Programme (ERP), Commission calculations

Real Effective Exchange Rate
(CPI based, total economy, 2010=100)



Further reductions of the current account deficit are forecast to be marginal. The moderately high current account deficit reflects low income and savings levels and the still underdeveloped export potential. The programme envisages that the closing of the public savings-investment gap would be an important factor supressing the current account deficit over the medium term. However, it is likely to be counterbalanced by growing private investment. Should this investment be channelled into tradable sectors, it would further expand the export base and sustain export growth. A number of reforms improving the business environment, implemented over the last few years, are already having a visible effect on external competitiveness. This is seen not only in overall export growth but also in the fact that Serbia has gained global market share. In addition, external competitiveness received a temporary boost last year due to the depreciation of the euro against the US dollar. As their effects decline, further improvements in competitiveness would require a continuation of domestic reforms and careful prioritisation of investments.

Foreign direct investment is expected to cover the current account deficit. Net FDI has increased markedly in 2015, covering 113 % of the current account deficit. The programme is relatively conservative in assuming a constant nominal level of net FDI inflows, broadly at the level of the current account deficit in each of the years. Higher FDIs, along with currency revaluations, were one of the main factors for the continued deterioration in the international investment position (IIP). In view of the forecast external imbalances, the IIP is set to worsen further, although probably less so in its debt-driven components. However, a comfortable level of official foreign exchange reserves is likely to remain an important buffer against external risks. A continued steadfast implementation of the Stand-By Arrangement with the IMF should additionally anchor stability-oriented policies and provide reassurance in case of negative shocks.

Implementing planned reforms should strengthen financial sector resilience and facilitate a revival of credit activity. Commercial bank lending, especially to corporates, remains muted. However, macroeconomic stabilisation has already brought down borrowing costs and led to an easing of credit standards. Although the banking system still faces important challenges, such as a particularly high level of non-performing loans (NPLs), a number of policy initiatives have been undertaken to address them. The authorities, including the central bank, have designed a comprehensive NPL resolution strategy and action plans. The central bank implemented a special diagnostic study, covering most of the system, which did not identify capital shortfalls for any of the participating banks and has led to a limited decrease of the aggregate capital adequacy ratio by 176 basis points to 18.45 %. Steps have been taken as well to further develop micro- and macro-prudential policy frameworks. The oversight of majority state-owned financial institutions is being strengthened and there are ongoing efforts to prepare the privatisation of some of them.

Table II.4.2:
Financial sector indicators

	2011	2012	2013	2014	2015
Total assets of the banking system, mEUR	36,015	35,163	34,836	35,696	35,938
Credit growth	5.5	12.9	-6.5	6.7	7.7
Deposit growth	9.2	10.4	3.3	8.1	6.5
Loan to deposit ratio	1.3	1.4	1.2	1.2	1.2
Financial soundness indicators					
- non-performing loans	19.0	18.6	21.4	21.5	22.0 Q3
- total provisions to gross NPLs	121.4	120.7	113.8	114.5	115.0 Q3
- regulatory capital to risk weighted assets	19.1	19.9	20.9	20.0	21.2 Q3
- liquid to total assets	37.8	34.5	38.5	37.1	35.9 Q3
- return on equity	0.2	2.1	-0.4	0.6	5.6 Q3
- forex loans to total loans*	69.0	73.1	70.9	70.0	70.6 Q3

4.3. PUBLIC FINANCE

Strong consolidation measures have reduced the budget deficit to 3.8 % of GDP([1]) in 2015. Public wage and pension cuts, implemented at the end of 2014, and better collection of tax revenue have contributed the most to a significant (2.5 % of GDP) structural adjustment. The structural measures to limit fiscal imbalances also included an extension of the attrition rule on new hiring in the public administration, the introduction of a gas transit fee and a 7.5 % excise duty on electricity. In addition, as in previous years, significant one-off revenue and expenditure have influenced the budgetary outcome. Although the deficit turned out much lower than initially planned mainly due to an over-performance on the revenue side, the consolidation was still predominantly expenditure-driven. The better than expected budget performance led to a marked downward revision of the initial 5.8 % of GDP deficit target and allowed for accommodation of a partial reversal of the wage and pension cuts([2]) and unplanned one-off payments([3]) by the end of the year.

([1]) The text comments on the actual execution data for 2015, which differ from those in the ERP.
([2]) Pensions were increased by 1.25 %. There was also a wage indexation of 4 % for employees in primary and secondary schools, 3 % for employees in health and social protection institutions, up to 2 % for employees in higher education institutions, and 2 % for police and army employees. Both wage and pension indexations became effective as of January 2016.
([3]) The one-off payments included pension liabilities of close to RSD 10 billion, following a Constitutional Court ruling in favour of military pensioners, RSD 23.4 billion in takeover of Srbijagas debt to NIS (majority-owned by Gazprom), RSD 9.6 billion in agricultural subsidies, and RSD 1 billion in bonus payments to employees in the education sector.

Table II.4.3:
Composition of the budgetary adjustment (% of GDP)

	2014	2015	2016	2017	2018	Change: 2015-18
Revenues	41.5	41.9	41.0	40.1	39.0	2.9
- Taxes and social security contributions	36.8	36.3	36.3	35.5	34.7	1.7
- Other (residual)	4.7	5.5	4.8	4.5	4.3	1.2
Expenditure	48.1	45.9	45.0	42.7	40.8	5.1
- Primary expenditure	45.1	42.6	41.5	39.2	37.4	5.1
of which:						
Gross fixed capital formation	2.5	2.6	2.9	2.9	3.1	-0.5
Consumption	18.3	16.9	16.9	15.6	14.6	2.3
Transfers & subsidies	20.8	21.2	19.8	19.0	18.3	2.9
Other (residual)	3.5	1.9	1.9	1.7	1.4	0.5
- Interest payments	2.9	3.4	3.5	3.5	3.4	-0.1
Budget balance	-6.6	-4.1	-3.9	-2.6	-1.8	-2.2
- Cyclically adjusted	-6.3	-3.7	-3.6	-2.3	-1.7	-1.9
Primary balance	-3.7	-0.7	-0.4	0.9	1.6	-2.3
Gross debt level	71.8	76.0	79.1	78.6	75.7	0.3

Sources: Economic Reform Programme (ERP), Commission calculations.

The impressive consolidation masks delays in some reforms and deficiencies in budget planning and execution. The restructuring of large state-owned enterprises has been progressing unevenly and slowly and the reform of the public administration has encountered delays. Although resulting in short-term savings in severance payments and unemployment benefits, the slower than initially envisaged pace of these reforms leads to long-term costs which at the end are covered by the budget. Significant, and sometimes unbudgeted, one-off revenue and expenditure have continued distorting the underlying budgetary performance, reducing transparency and undermining proper allocation of public resources. Persistent under-execution of capital expenditure also remains an issue despite a marked increase in spending in comparison to the previous year.

The forecast medium-term budget deficit reduction is appropriate, although short-term adjustment efforts are less ambitious. The unexpectedly strong and upfront deficit reduction in 2015 has not led to a re-evaluation of the authorities' target of achieving a primary surplus only in 2017. The programme envisages the consolidation drive remaining predominantly on the expenditure side and the overall deficit falling by 2.3 percentage points to 1.8 % of GDP in 2018. However, contrary to last year, the planned adjustment is back-loaded and the structural deficit is planned to decline marginally in 2016 before falling again strongly in the following year.

Box: The 2016 budget

The National Assembly adopted the 2016 republican budget on 12 December 2015.

The general government balance target is RSD 163.4 billion (3.9 % of GDP). The envisaged consolidation measures are moderately dominated by expenditure cuts. The main adjustment is planned to come from reducing employment in the public sector and a wage and pension freeze, following their indexation in the beginning of the year. Increases in excise duties on oil products and the full impact of the excise duty on electricity, introduced in 2015, are the sole measures on the revenue side.

Table: Main measures in the 2016 budget*

Revenue measures	**Expenditure measures**
7.5 % electricity excise duty, introduced August 2015 **(0.3 % of GDP)**	Reducing agriculture subsidies **(-0.2 % of GDP)**
Increase in excise duties on oil products **(0.1 % of GDP)**	Reducing subsidies for public broadcasting companies **(-0.1 % of GDP)**
	Lower pension and wage bill **(-0.6 % of GDP)**
Total revenue effect (0.4 % of GDP)	**Total expenditure effect (-0.9 % of GDP)**

* Estimated impact on general government revenue and expenditure.

Source: ERP

The programme targets a broadly unchanged budget deficit in 2016. Both total revenue and expenditure are expected to fall by 0.9 % of GDP. Mandatory expenditure cuts are planned to continue, although rising interest payments, higher capital expenditure, and pension and wage indexations adopted at the end of 2015 are likely to offset their effects. The attrition rule for new employment in the public sector is being maintained and its application extended to cover state-owned enterprises. Targeted reduction of government employment, by implementing legislation on the maximum number of public sector employees and continuing the public administration reform on the basis of functional review studies, is expected to result in a lower wage bill. Additional savings are envisaged from reducing agriculture subsidies and cuts of transfers to public broadcasting companies. With the exception of increases in excise duties on oil products and the full impact of the excise duty on electricity, introduced in August 2015, major tax rates are planned to remain unchanged. However, there is a non-negligible risk that significant and unbudgeted one-off items could continue influencing revenue and expenditure performance.([1])

The fiscal scenario faces a number of risks. The programme acknowledges them and outlines an alternative fiscal scenario, based on a pessimistic macroeconomic scenario. The public administration reform and the restructuring of state-owned enterprises remain the two pillars for a sustainable reduction of fiscal imbalances. Therefore, further delays in their implementation, in view also of the early parliamentary elections called in the spring 2016, are a key risk to the forecast budgetary developments. However, the better than envisaged revenue outturn last year, not only in comparison to the initial budget

([1]) In January 2016, the budget received RSD 12.7 billion from a ten-year concession for the use of several frequencies.

but also to revised estimates, represents an upside risk to the budget execution. Although the programme fails to capitalise on the better outcome in 2015, any gains on the revenue or expenditure side, including one-offs, should be used exclusively to further reduce the deficit. In addition, elevated uncertainties and still growing government debt also call for a careful evaluation before underwriting new expenditure commitments.

Steps are being taken to improve budgetary processes and institutions. The programme recognises the importance of strengthening the institutional framework. It outlines wide-ranging measures to address identified issues: aligning statistical coverage of the general government sector with ESA 2010 requirements, further developing programme budgeting and advancing the tax administration reform in a business-friendly manner. As part of the drive to improve performance and effectiveness of the public administration, the salary system is planned to be simplified to ensure fairness, reduce inequalities, strengthen budget checks and increase transparency. In addition, fiscal impact analysis and monitoring of state-owned enterprises are being enhanced and there is a commitment to the policy of strictly limiting the issuance of new state guarantees.

The deficit path is consistent with plans to reverse government debt growth in 2017. However, the planned structural adjustment after 2016 is almost exclusively dependent on continuation of the wage and pension freeze and further cuts in public sector employment, which will be increasingly difficult to implement. Government debt is forecast to peak at just below 80 % of GDP in 2016 and the primary balance is expected to turn to surplus in the following year. Importantly, interest expenditure would remain significant, stabilising at around 3.5 % of GDP throughout the programme horizon. Stock-flow adjustments are also likely to remain a major debt-increasing factor in the short-term, although the programme sees them diminishing afterwards.

Risks to the envisaged debt scenario are significant. Budget deficit and debt levels are still very high. Despite recent strong consolidation efforts, fiscal slippages are not excluded, especially if reforms are delayed or commitments to curbing mandatory expenditure are not respected. The poor financial situation in some large state-owned enterprises, in particular, remains a source of implicit liabilities for the budget. As most of the debt is denominated in foreign currencies, debt dynamics remain sensitive to exchange rate fluctuations. A 1 % depreciation of the dinar against a basket of currencies could lead to a 0.6 % of GDP increase in the debt-to-GDP ratio. Refinancing risks also loom large as gross financing needs are expected to increase to 20 % of GDP next year. In view of the elevated risks, reversing the trend of rising government debt remains a significant challenge that would require sustained efforts.

Box: Debt dynamics

Government debt is forecast to peak in 2016. Debt-reducing effects from real GDP growth and inflation are set to increase, while interest payments stabilise at a relatively high level. Consolidation efforts are expected to turn the primary deficit into a small surplus only in 2017. Stock-flow adjustments are envisaged to decline, due to the forecast exchange rate stability and restricted issuance of new government guarantees. Restitution-related debt of up to EUR 2 billion (to be issued in 2018) and potential privatisation inflows from the sale of large state-owned enterprises are not included in this scenario but could potentially and temporarily impact debt dynamics as well.

Table II.4.4:

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

	2014	2015	2016	2017	2018
Gross debt ratio [1]	**71.8**	**76.0**	**79.1**	**78.6**	**75.7**
Change in the ratio	10.7	4.2	3.1	-0.5	-2.9
Contributions [2]:					
1. Primary balance	**3.7**	**0.7**	**0.4**	**-0.9**	**-1.6**
2. "Snow-ball" effect	**2.4**	**1.8**	**0.3**	**-0.5**	**-1.8**
Of which:					
Interest expenditure	2.9	3.4	3.5	3.5	3.4
Growth effect	1.1	-0.5	-1.3	-1.7	-2.6
Inflation effect	-1.6	-1.0	-1.9	-2.4	-2.7
3. Stock-flow adjustment	**4.7**	**1.7**	**2.3**	**1.0**	**0.6**

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

[2] The snow-ball 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 between cash and accrual data.

Source: Economic Reform Programme (ERP) 2016, Commission calculations.

4.4. STRUCTURAL REFORMS

The ongoing economic recovery indicates improvements in competitiveness, but structural bottlenecks persist. The recovery is largely based on increased private investment and continuously growing exports. However, only a small part of the economy is internationally competitive and more efforts should be made to expand the growth potential across sectors. There is no transparent support to attract FDI, which is only slowly expanding beyond a few sectors of the economy. The business environment is generally unstable and characterised by high para-fiscal charges and burdensome procedures. Private companies, in particular SMEs, suffer from expensive access to finance. The large informal sector, estimated at around 30 % of GDP, creates unfair competition and a dual labour market. Serbia remains competitive in terms of wage costs, but productive capacities and new job openings are scarce due to still low public and private investment. Unemployment remains very high, especially among young people.

The structural reform policy guidance of the Economic and Financial Dialogue of May 2015 was partially addressed. Limited progress was achieved in the restructuring of state-owned enterprises, most importantly of large utilities. These restructurings were accompanied by some social policies. However, sustainable reintegration of redundant workers into the labour market remains hampered given the limited job creation. Introducing corporate governance in public utilities still needs to be effectively implemented. The development of energy and transport infrastructure continued but at a slower pace than planned and needed. The share of expenditure as part of GDP for these investments did not increase significantly. Private investment is on the rise in part due to higher FDI and the implementation of the new system of construction permits. The fight against the informal economy intensified, with stricter inspections and improved tax collection. There were no attempts to better regulate para-fiscal charges or to re-launch the 'regulatory guillotine.' Some measures were taken to limit the under-execution of capital expenditure.

The Economic Reform Programme correctly identifies the key areas of structural reforms in the period 2016-2018. The reforms have clear timelines of activities that are sequenced and budgeted for. However, some of the reforms are not ambitious enough, given the challenges faced by the economy. They are limited to measures implemented by a single institution, while cooperation between various actors is not promoted. In the preparation of the ERP, the external stakeholders were consulted, but their influence and input was limited as the consultation came too late in the process. Most measures would have benefitted from a more elaborate analysis of the expected impact on competitiveness and long-term growth, as well as a better analysis of potential implementation risks and actions envisaged to mitigate these.

Public finance management

A comprehensive Public Finance Management (PFM) reform programme for 2016-2020 has been recently adopted and needs to be implemented in order to support fiscal consolidation efforts. There are weaknesses in the preparation and execution of the budget. The execution targets are often missed. Financial management control and managerial accountability are not well understood. Without proper management of public funds, the economy will be negatively affected, with adverse effects on the business climate. Corruption also thrives where PFM is weak, creating obscure and unfair market conditions. It is essential that all measures in the PFM reform programme are implemented according to the adopted timetable.

Transforming the tax administration is of high priority in order to bring systemic gains in revenue collection and improve the business environment. This reform should be driven by the implementation of the programme for the transformation of the tax administration, adopted in 2015. It aims in particular at strengthening the tax administration's capacity and providing financial means to reorganise it and upgrade its IT equipment. The reform should have a continuous positive impact on tax collection, and thus on the fight against the grey economy. It should result in better and quicker services to taxpayers, such as online filing of declarations, improved transparency of internal procedures and predictability of administrative decisions.

Better planning of budget expenditure and improved management of capital investment are needed. The reform envisages improved management of capital investment plans by putting in place a platform for planning and prioritising capital projects and investments on the basis of a cost-benefit analysis. It should strengthen the current weak governance of public investment projects. However, these efforts should build upon existing structures, namely the National Investment Committee and the Single Project Pipeline.

Infrastructure

Persistently low levels of investment in physical infrastructure hamper economic development and regional integration. This affects the government's capacity to provide services to businesses and the public and negatively affects the business environment and, therefore, overall competitiveness. Underdeveloped infrastructure, weak connections with neighbours in the region and the EU and non-harmonised regulation of the energy and transport sectors are slowing down economic development and integration with the EU and the other CEFTA economies. Only 55 % of households have broadband access to internet. The amount of public services offered via e-government is limited.

There are delays in building new infrastructure and reorganising the existing one. The policy guidance to increase public investment and improve the implementation of public projects has been only partially addressed: there is progress on investment projects on corridor X, while corridor VII, though mentioned in the recommendation, is not covered. The recommendation to improve governance of energy firms, regulation of the network and the construction of gas interconnectors has been partially addressed: the restructuring of the energy public utilities is still ongoing but the gas utility remains to be un-bundled. The construction of the Serbia-Bulgaria gas interconnector will not start before 2018, much later than initially planned.

The transport and energy sectors would benefit from swift implementation of a number of soft measures. The envisaged construction or modernisation of seven segments of physical infrastructure in the transport and energy sectors is too wide to be considered just one priority. Moreover, these investment projects do not necessarily reform the transport or energy sectors. Therefore, any public investment in transport and energy has to be accompanied by restructuring of public utilities. Equally important is the implementation of the obligations under the Energy Community Treaty as well as the so-called soft measures as agreed at the Western Balkans 6 summit in Vienna in August 2015. The programme would have benefitted from further emphasis on measures such as traffic management, road safety and maintenance in the transport system and the establishing of a regional electricity market rather than solely on the construction of new infrastructure. In order to reform the energy sector, more focus should be directed towards demand management, particularly energy efficiency, and measures to reduce energy intensity.

Developing and improving the national broadband communication infrastructure is important but its timing should be accelerated. In 2016, only the adoption of a law on broadband access is contemplated. This law is planned to set up a comprehensive new regulatory framework. It remains undefined in terms of requirements for network operators to coordinate their civil engineering and sharing the infrastructure. At this stage, it does not specify the conditions for granting aid and rules of access to subsidised infrastructure. EUR 116 million is planned in 2017-2018 for the roll-out of the broadband network, without detailed information on various costs.

Sector development

Agricultural sector development

Agriculture remains of key importance for economic growth, employment and trade. It accounts for around 10 % of GDP, employs half a million people (significant portion of which works in grey area) or 20 % of total employment, and generates significant foreign trade surpluses. However, the sector's potential is weighed down by land fragmentation, low productivity due to outdated technologies, small economic size and low utilisation of agricultural land per farm compared to the EU average. Further alignment of phytosanitary regulations with EU standards and border control procedures would also facilitate increases in exports.

There is significant room for increasing competitiveness in agriculture. The expected increase in agricultural productivity needs to be substantiated by a stable subsidy policy, better integration and correlation with cross-cutting measures such as ring-fenced finance for specific problems of small and medium farms, land consolidation, the development of modern agricultural infrastructure (irrigation systems, cadastre management, rural planning, access roads, storage facilities, etc.), establishment and further consolidation of advisory, certification, testing and inspection/control systems, development of marketing standards, integration into the environmental framework, etc. The status of agricultural holdings is correctly identified as a priority but the use of Rural Development component of the Instrument for Pre-accession Assistance (IPARD) funds should not be seen as the only solution to the structural problems. The indicative financial allocation under IPARD of EUR 175 million by 2020 has the potential to contribute significantly to the modernisation and development of the sector. However, most benefits could be realised in the medium and long term and will be directly dependent on the IPARD institutional framework becoming fully functioning. The correct functioning of the Managing Authority, the IPARD Agency and the Advisory system depend not only on sufficient allocation of staff and resources, but also on long-term stability, transparency and retention of expertise.

Industry sector development

The deindustrialisation of the 1990s and 2000s has contributed to the unfavourable export structure. Although the deindustrialisation appears to have stopped, the level of productivity in the sector remains very low (40 % below the one in Central and Eastern Europe). Sustained investment in industry and manufacturing is needed to safeguard and upgrade the skills, improve productivity and so ensure the integration of a larger number of firms into global value chains.

The planned changes concerning industrial policy do not go far enough to constitute a substantial reform of the sector. The level of state aid is very high, and too much aid is granted to unprofitable public companies or to non-transparent FDI projects. The envisaged policy measure boils down to the effective implementation of the recently adopted Law on Investments. The plan is to improve administrative capacity at local and central level to better manage subsidies, in particular towards priority industries identified in action plans. The scope and content of this measure could be better defined to ensure that less but better targeted and growth-inducing aid is granted. In addition, it should also ensure that investment aid is granted on the basis of clear criteria in line with the EU and SAA state aid rules, and according to fully transparent procedures.

Services sector development

Job gains in the services sector in the past decades have not been accompanied by major productivity gains. Services are currently dominated by retail and administration, the latter including a high number of public administration employees. As in industry, Serbia enjoys good comparative advantages in some services sectors. The share of services in total exports is comparable to similar countries, information and communication technologies and transport being the two most important exports. Tourism is lagging behind, although there has been a revival in recent years, in particular in Belgrade. Overall, the sector will benefit from the general measures on the improvement of the business environment and the fight against the informal economy.

Business environment, corporate governance, and reduction of the informal economy

Business-friendly reforms have continued but there are still barriers to attract and facilitate private investment. The recent adoption of simplified procedures for issuing construction permits was an important improvement. However, private investment remains hampered by *inter alia* a costly, unpredictable and non-transparent system of para-fiscal charges, difficult access to capital for smaller firms, and red tape. The very low inflation and reduced risk premia contributed to lowering interest rates. However, credit remains expensive due to the lack of collateral mechanisms such as guarantee schemes or mortgages and enforcement deficiencies. Competition remains distorted by state-owned enterprises and the large informal economy.

The policy guidance to improve the business environment was partially addressed. The simplified construction permit procedure and the new law of conversion of right of use of land into right of ownership are both expected to have a positive effect on business activity. Similarly, the fight against the informal economy was intensified with stricter inspections and tax collection. However, there were only limited attempts to better regulate para-fiscal charges and to re-launch the ‘regulatory guillotine.’ The privatisation and liquidation process of state-owned enterprises, in particular of large ones, and the restructuring of utility firms are still ongoing. The Law on Inspections still has to be effectively implemented.

The measure on improving access to finance for SMEs addresses the main obstacle to SME development in Serbia. However, it tackles a symptom rather than the underlying structural obstacles to affordable access to finance. A number of proposals to reduce the lending rate have been put forward, including a guarantee scheme, operated by the European Investment Bank. It is very much needed for SMEs that are unable to access commercial loans at affordable rates, especially considering that the implementation of this scheme has been delayed for over two years. However, more structural obstacles to access to finance have not been addressed. For example, the mismatch between demand and supply of sufficient collateral is a key obstacle to credit expansion.

Implementing the reform of public enterprises is a key challenge. The Law on Public Enterprises, adopted in February 2016, provides the basis for introducing corporate governance in public utilities. It is still uncertain how it will be implemented to achieve an effective de-politicisation of management. As regards the three large public utilities – for railways, gas and electricity — plans for corporate and financial restructuring are now underway but obstacles to their effective restructuring remain very high. There is resistance, given the high direct costs, immediate and longer-term social impact, and limited perspectives to find new employment for redundant staff. Therefore, in order to facilitate these reforms, efforts to mitigate their negative repercussions should be given special attention.

The planned reform of para-fiscal charges targets simplifying procedures and reducing the overall administrative burden for businesses. The mapping of administrative procedures and listing of existing fees and charges should improve transparency and predictability for businesses. However, this system should also effectively target a simplification of existing administrative procedures and a reduction of the level of fees and para-fiscal charges. To that end, the implementation of the Law on Fees planned to be adopted at the end of 2016 should be closely monitored. The link to the 'regulatory guillotine' seems obvious, although not mentioned in the programme.

A common information platform for all inspections (e-inspection) is expected to contribute to combating the informal economy. The measure establishes an electronic information system for planning, coordinating and conducting inspections. It is foreseen to have positive results on reducing the informal economy, while relieving compliant companies from the cost of unnecessary and frequent inspections.

Technological absorption and innovation

Serbia has a good scientific base but cooperation between the public and private sector is weak and not systemically supported. The level of investment in research is 0.8 % of GDP in 2014, while 0.5% of the workforce was R&D personnel in 2013. The main focus of the ERP is on strengthening cooperation between public and private sector. The measures aim to promote better application of basic science in industry, inter alia through the 'Technological Development Programme' and an increase of activities of the Innovation Fund. The budget commitment is substantial (EUR 130 million for the period of 2016-2018). However, there is insufficient information about which measures this amount will cover, except that it should serve for the salaries of 6 000 researchers. It is important that the reform commit the government to work directly with the private sector as an equal partner. At the moment, public financing of research in the private sector is only possible via the Innovation Fund, while ministries and public agencies cannot directly support research activities implemented by companies. Serbia has considerable needs for sustainable support to RDI infrastructure such as a technology park, incubators, clusters, etc., which can directly benefit SMEs, as well as for addressing the brain drain of the most technologically skilled people. Increased support to these could complement already planned actions in this area.

Trade integration

The trade deficit remains high, although it has declined over recent years. Total exports of goods and services are only 47 % of GDP, which is below the average for countries of similar size and geographic location. The export base is still heavily concentrated within few companies and sectors. Despite a strong increase in 2015, net FDIs are still only two-thirds of their level before the global crisis in 2008.

Improving the national quality infrastructure (QI) system is an important but not the only component of boosting trade performance. The efforts to reach international recognition of the national QI system should be accompanied by a thorough review of all legislation, technical regulations and standards, as well as the removal of distortive non-tariff barriers to trade that do not derive from the use of certificates of conformity, standards or other technical requirements. The reform measure is supported by an adequate budget allocation and the associated risks are correctly identified.

Foreign and domestic investors need an appropriate set of public services to support their exports. In particular, better services could be offered to support the internationalisation of companies, in particular SMEs, through consultancy, international fairs and projects bringing domestic and foreign companies together. At the same time, more should be done to facilitate both exports and imports through improved procedures at the border and beyond. The ambitious efforts on trade facilitation that are pursued within CEFTA also need to be implemented in time.

Employment and labour markets

Low employment rates, high youth and long-term unemployment are still key challenges for the labour market, despite some improvements. The employment rate reached 53.2 % in 2015 and is particularly low for women (45.8 %), while the youth (15-24) unemployment rate is still over 40 %; one in five young persons is not in employment, education or training. Two thirds of all unemployed are long term unemployed. New and considerable inflows into unemployment are expected in 2016 resulting from the dissolution process of state-owned enterprises and the "rightsizing" of the public administration. Obstacles to the creation of formal jobs such as the high taxation on labour are not identified. A refined diagnosis of structural problems, in particular informal work (close to 20 % in 2015) and identification of the characteristics of the unemployed (age, skills) is mostly lacking. Around 60 % of unemployed have completed upper secondary education, pointing to considerable gaps between skills and labour market demand.

The policy guidance on finalising the National Qualifications Framework (NQF) and adopting a comprehensive and well-targeted set of active labour market policies has been partially addressed. On the basis of existing qualification frameworks for vocational and higher education, an integrated NQF has been developed which is under consultation with relevant national bodies. The budget and coverage of active labour market measures increased in 2015, compared to very low levels in previous years, but remained modest. Out of around 120 000 beneficiaries, the vast majority benefitted from active job search training and job fairs. Reforms in the National Employment Service continued in 2015 with focus on developing a client-centred approach and improving the caseload distribution.

The NQF and active labour market policies are the focus of the reform measures envisaged in 2016-18 but stronger links should be established with other reform priorities. It will also be important to stick to the schedule of reform steps outlined in the programme. The identified risk of inadequate support from social partners in the course of adoption of the NQF and the necessary establishment of sector councils requires further work by the government to involve the social partners in order to ensure progress. No indication is given how the risks mentioned about establishing the Qualifications Agency could be addressed early on in the process. Finalisation of the NQF is presented mainly as an objective in itself and not linked with steps for a progressive reform of the education system at all levels, including expanding pre-primary education, improving the level of basic skills to be acquired by all students, and strengthening teacher training in order to improve the outcomes and relevance of the system for the labour market.

Improving the effectiveness and scope of active labour market policies with special emphasis on young people, redundant workers and the long-term unemployed clearly responds to the social and economic needs. The identification of target groups is adequate, but the planned number of beneficiaries does not yet match the needs. A more robust approach for supporting the labour market reintegration of workers becoming redundant in 2016 and beyond due to the state-owned enterprises resolution process and the public administration reform could be developed within the framework of this measure, and would have to be reflected in next year’s budget. The ongoing reform of the National Employment Service provides the framework for increasing its capacity to roll out support measures to larger numbers of beneficiaries.

Fostering social inclusion, combating poverty and promoting equal opportunities

Social protection of the most vulnerable segments of the society is envisaged to be preserved. However, the current system of financial assistance does not lift beneficiaries out of poverty and does not systematically cover people living below poverty thresholds.

A key challenge is to improve the effectiveness of social assistance for addressing poverty. Foreseen changes in social protection are adequate in terms of objectives (improving adequacy, quality and targeting) but lack focus on spending efficiency. The main pillars of the measure are amendments to the Social Welfare Act of 2011 and new legislation on financial support to families with children. From the information provided about the substance of these legal initiatives they appear to be of rather technical nature. In addition, it is planned to interlink different information systems on the disbursement of benefits in order to improve allocation mechanisms.

It remains unclear how the stipulated objective of moving recipients of social benefits closer to the poverty threshold would be reached. The reform does not sufficiently address the issues of adequacy, targeting and coverage. The budget for this measure indicates an increase by 25 % of social spending in the period 2016-2018, but since the new legislation is not yet in place, it is not clear on which basis this increase is projected. A comprehensive approach to tackling poverty and social exclusion, which would link providing social protection for poverty alleviation to activating policies across relevant sectors such as employment and education and take into account the needs of particularly vulnerable groups is not yet developed.

4.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2015

2015 policy guidance (PG) for Serbia	Summary assessment
PG 1: Strengthen fiscal consolidation by using any excesses revenue and current expenditure savings to further reduce budget deficits in 2015 and the following years. Underpin the medium-term consolidation path by implementing the planned structural reforms.	Serbia has partially addressed policy guidance 1: • The 2015 deficit was lower than expected. Significant one-off revenues have been used to cover one-off expenditures. Part of the budgetary over-performance was channelled to limited pension increases and targeted wage indexation. Implementation of key reforms is ongoing but has encountered delays.
PG 2: Advance the restructuring and privatisation of state-owned enterprises, prioritising the biggest companies. Introduce better corporate governance and advance, as planned, the organisational and financial restructuring of large, loss-making utilities. Review the efficiency of all forms of state aid and take steps to reduce it. Proceed to revisit public sector employment in a sustainable manner by implementing the Action plan on public administration reform.	Serbia has partially addressed policy guidance 2: Privatisation and bankruptcy procedures have been initiated for companies in the portfolio of the Privatisation agency and the agency was closed in early 2016. Deadlines for finding a sustainable resolution for 17 of the largest state-owned companies have been extended to May 2016. The restructuring of the large utilities (EPS, railways and Srbijagas) is ongoing, but not yet completed. Corporate and financial restructuring plans were adopted or are in the pipeline. More needs to be done to reduce state aid and review its efficiency. Introducing corporate governance in companies under public ownership remains to be launched. It is part of the 2016 ERP. Steps are being taken to reduce public employment in a sustainable manner, although this reform is also facing implementation delays.
PG 3: Further strengthen public finance management, notably by improving the budgetary process and the capacity of the tax administration. Compile and start submitting to Eurostat excessive deficit procedure notification tables before the end of 2015.	Serbia has partially addressed policy guidance 3: A public finance management reform programme and a tax administration transformation programme until 2020 were adopted last year. Their implementation is envisaged to significantly improve budgetary processes and the work of the tax administration. Serbia has submitted an unofficial notification in 2015 and is working on a plan to start compiling and submitting official excessive deficit procedure notifications.

PG 4: Advance with the rebalancing of macro-economic policies with fiscal consolidation as a pre-condition for a more accommodative monetary policy stance, with a view to fostering a pick-up in the pace of credit extension. In this context, increased efforts to address the high burden of non-performing loans on banks' balance sheets, involving all key stakeholders including the central bank as necessary, also appear warranted.	Serbia has fully addressed policy guidance 4: The strong fiscal consolidation in 2015 provided room for significant monetary policy relaxation. There are some signs of easing credit standards and a pick-up in lending activity. Non-performing loans remain very high. However, the authorities, including the central bank, have designed a comprehensive resolution strategy and action plans. As part of the efforts to address the problem, the central bank implemented a special diagnostic study.
PG 5: Improve the business environment and tackle the grey economy, notably by better regulating para-fiscal charges, business inspections, and leasing of labour. Take steps to further simplify the regulatory environment by re-launching the "regulatory guillotine".	Serbia has partially addressed policy guidance 5: Several measures were adopted to improve the business environment (e.g. full implementation on simplified construction permit procedures, the law of conversion of right of use of land into right of ownership). The fight against the grey economy has been intensified with stricter inspections and tax collection. However, the business environment remains unpredictable. There has been no attempt to better regulate para-fiscal charges, though this is covered (with limitations) in the 2016 ERP. There was no progress to re-launch the 'regulatory guillotine.' Serbia has not addressed the guidance of leasing of labour.
PG 6: Adopt a comprehensive and well-targeted set of active labour market policies, with a focus on youth and the long term unemployed, as well as dedicated skills upgrade programmes. The finalisation of the national qualifications framework should be the first step in a progressive reform of the education system, aimed at improving the outcomes of the system, thereby enhancing the human capital productivity.	Serbia has partially addressed policy guidance 6: Employment policies targeted workers who lost jobs in the restructuring of state-owned companies. Active labour market measures were stepped up in 2015, with young people as a main target group. Further steps were taken for establishing the National Qualifications Framework, but it has not been finalised yet.
PG 7: Stimulate private investment, for example by establishing public schemes to support lending to SMEs and research activities in companies. To increase public investment, improve preparation and speed up the implementation of public	Serbia has partially addressed policy guidance 7: Financial instruments for SMEs, including most innovative ones, remain underfunded and new

projects. Step up the works on corridors VII and X in line with the regional core network. Improve energy production and transmission, most notably by better governance of energy firms, regulation of the network and the construction of gas inter-connectors.	schemes take long to be established. A programme to improve the management of public investment is introduced as part of the public finance management reform. However, in 2015 government capital expenditure underperformed again. The infrastructure and energy projects listed in the 2016 ERP aim at improving corridor X and interconnection in the field of gas and electricity. The ongoing restructuring of EPS and Srbijagas should also improve in principle their governance.

4.6. THE 2016 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, 25 May 2016

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

1. Further strengthen fiscal consolidation by using any excess revenue and current expenditure savings, and take additional measures, if needed, in order to achieve a primary surplus in 2016 and reduce overall budget deficits in the following years.

2. Support fiscal consolidation by taking steps to find a sustainable resolution of the remaining state-owned enterprises and continuing the organisational and financial restructuring of large utility companies. Advance the reform of the public administration as envisaged. Further improve revenue collection in a systematic and business-friendly way by implementing the tax administration transformation programme.

3. Continue to address risks to financial stability and the real economy by following-up on the NPL action plans which have been adopted, reinforcing the strategy already in place to promote the use of the local currency (‘dinarisation strategy’) in the financial system and shedding increased light on the asset quality of smaller banks that were not covered by the special diagnostic studies. Throughout this process, the central bank’s monetary policy stance may remain accommodative insofar as both inflation expectations remain anchored and a favourable fiscal consolidation path is maintained.

4. Address the under-execution of public capital expenditure by improving its prioritisation and management; as a priority, make significant progress in the preparation of the construction of the Bulgaria-Serbia gas interconnector project and finish road works on Corridor X by end of 2017.

5. Improve the business environment and promote private investment by developing a more transparent and less burdensome system of para-fiscal charges, putting in place a guarantee scheme for loans to SMEs and re-launching the ‘regulatory guillotine.’

6. Step up the provision of targeted active labour market policies to facilitate in particular the reintegration of workers made redundant in the resolution of state-owned enterprises and public administration rightsizing. Increase the capacity of the National Employment Services to roll out such measures to larger numbers of beneficiaries.

Annex: Overall assessment of programme requirements

The government adopted the Economic Reform Programme on 3 March 2016 and formally submitted it to the European Commission on 11 March 2016.([1]) The programme is in line with the medium-term fiscal strategy and the 2016 budget and covers the period 2016-2018. In conformity with the new approach to economic governance, the programme includes an enhanced description of structural reform priorities. However, the programme's structure does not always fully follow the guidance provided by the Commission.

Ownership and internal coordination

The preparation of the programme was centrally coordinated by the Ministry of Finance, which established an ERP working group. Several consultations with ERP coordinators of line ministries and other relevant institutions (the National Bank of Serbia, the National Employment Service, and the Statistical Office of the Republic of Serbia) were carried out.

Stakeholder consultation

Two public consultations were held to give social partners, civil society and all relevant stakeholders an opportunity to contribute, especially to the drafting of chapter 4 on structural reforms.

Macro framework

The programme presents a clear and concise picture of past developments. It also covers all relevant data at the time of drafting it. The macroeconomic framework is sufficiently comprehensive and coherent. The macroeconomic scenario is plausible and major uncertainties and risks are clearly outlined and recognised. The programme also presents an alternative macro-fiscal scenario, envisaging a lower growth path, slower narrowing of the budget deficit and higher debt levels.

Fiscal framework

The fiscal framework is based on the presented medium-term macroeconomic scenario and is coherent, consistent, sufficiently comprehensive and integrated with the overall policy objectives. Most revenue and expenditure measures backing the programme consolidation scenario are well explained, although some are subject to higher uncertainty or would require additional specification. In view of the high government indebtedness and better than expected performance in 2015, the objective of achieving a primary surplus in 2017 could have been more ambitious and brought forward. The programme does not present long-term projections of population trends and of the implications of an aging population on the labour market and public finances, in particular on health and pension systems. As Serbia has only started submitting unofficial fiscal notification data to Eurostat, significant further efforts would be needed to ensure ESA 2010 compatibility of fiscal data.

Structural reforms

The structural reform priorities section follows broadly the guidance note and presents in general a credible diagnostic per area as well as reports on the implementation of the recommendations of the Economic and Financial Dialogue of May 2015. Chapter 4 includes 23 structural reform priorities and measures. In general, the reform measures correspond well to the key obstacles to growth and competitiveness identified in the diagnostics and by and large to last year's recommendations. In spite of the difficult budgetary situation, the programme presents costly infrastructure projects. The programme would have benefitted from more market economy oriented reforms, which may not have significant

([1]) The authorities submitted the programme to the European Commission informally on 2 February 2016.

funding needs but might improve the overall economic framework and socioeconomic outcomes. The description of each reform measure is detailed enough in terms of specific actions, timeline and budgetary impact in order to follow-up annually in the coming three years. However, the authorities should consider a more specific analysis of priority measures' expected impact on competitiveness.

5. TURKEY

5.1. EXECUTIVE SUMMARY

The Turkish economy has grown at an average annual rate of 3.3 % over the past four years. The Economic Reform Programme for 2016-2018 projects optimistically a strengthening of economic growth to 5 % supported by accelerating business investment and double-digit export growth. At the same time, the current account deficit is expected to narrow and inflation to recede. Overall, the projections appear more like policy targets than as a realistic forecast.

Turkey's economy continues to face two major macroeconomic challenges. On the external side, the current account shows a persistent deficit which corresponded to 4.5 % of GDP in 2015. This deficit has to be financed with capital inflows which tend to vary in response to changing risk sentiments and expectations regarding international yield differentials. Although the floating exchange rate absorbs much of this volatility, it can also result in – sometimes painful – macroeconomic adjustments. On the internal side, the economy is suffering from entrenched inflation in the high single digits. This is costly in terms of macroeconomic stability, resource allocation and redistributive effects. The Economic Reform Programme (ERP) projects a reduction in both of these imbalances in the course of the programme period, but without indicating how the macroeconomic policy mix will be adjusted to achieve this.

The ERP provides an account of public finances which have shown moderate deficits in recent years. The fiscal deficit of general government is projected to narrow as GDP growth increases without any move towards a more restrictive fiscal policy stance. Based on relatively modest fiscal deficits and high nominal GDP growth, the debt-to-GDP ratio of general government has trended downwards over the past six years to 32.9 % at the end of 2015. Although the sustainability of public debt is not in question, a more restrictive fiscal policy stance would be appropriate in view of the macroeconomic challenges, in particular the need to increase national saving.

Increasing macroeconomic stability and developing the economy's growth potential are Turkey's major economic policy challenges. Addressing the economy's internal and external imbalances by adjusting fiscal and monetary policies would lower the risk of sudden and severe macroeconomic adjustments. At the same time, implementing comprehensive structural reforms would help achieve the country's economic goals by increasing competitiveness, improving the business climate and raising potential growth. The main challenges are:

Domestic saving is too low in view of the need to reduce the internal and external imbalances. This requires increased incentives for private saving, including significantly positive real interest rates on saving instruments. It also requires a contribution from the public sector by the pursuit of a sufficiently restrictive fiscal policy.

Domestic and foreign investors' confidence is likely to be significantly affected by the security and political developments in the country with negative repercussions on the Turkish economy. The rule of law and the judiciary are being weakened particularly by decisions affecting private sector assets and by the encroachment on fundamental rights, including freedom of expression and of the media.

The narrowing of the current account deficit is held back by a slowdown in the structural reform process, which delays improvement of the economy´s export potential. In the context of the low spending level for research and development, the absence of a comprehensive strategy in support of research and development is a particular problem. Cooperation between research institutions and economic operators is weak. In some industries, the lack of exposure to international competition hinders productivity growth. The ERP addresses these challenges, but does not present an overall strategy to tackle them.

Turkey faces substantial labour market challenges. This is reflected in low female participation and employment rates; a high number of young people not in employment, education and training; a high level of informal work; and a low qualification level of the workforce. These imbalances hamper the achievement of higher productivity and diversification of the economy, which should in turn also support more inclusive growth. The strong minimum wage increase and the influx of refugees risk further increasing informal employment.

Turkey's ERP was again submitted very late, which reflects negatively on the government's readiness to fully engage in the economic aspects of the pre-accession agenda. The ERP's macroeconomic projections are overly optimistic and not fully consistent internally. The programme features for the first time a dedicated section on structural reforms. The level of detail and comprehensiveness of this section is still uneven and it would benefit from a stronger focus on the diagnostic aspects and on a systematic cost analysis, budgeting and scheduling of reform measures.

Last year's policy guidance is generally not addressed. An exception was the introduction of the option of part-time work for parents, which should stimulate female labour force participation.

5.2. ECONOMIC OUTLOOK AND RISKS

Relative to the previous four years, the ERP's macroeconomic scenario provides an optimistic combination of faster growth and reduced underlying macroeconomic imbalances. Since the post-recessionary boom in 2010-2011, the Turkish economy has grown at a relatively moderate pace while inflation has remained in high single digits. Because of a rapidly expanding labour force, the unemployment rate has increased gradually despite significant employment growth. The current account has remained in deficit at a level which is unsustainable in the medium to longer term.

Economic output in the coming years is projected to accelerate and unemployment to decline. In 2015, GDP grew to 4.0% on the back of accelerating domestic demand. Consumer spending increased by 4.5% fuelled by the lower oil price and easy financial conditions. Private fixed investment achieved 2.7% growth after being close to stagnation for two years. Net exports, however, exerted a drag on growth as exports contracted while imports expanded. The ERP projects that GDP growth will increase to 4.5% in 2016 and still further to 5% in the subsequent two years. This seems optimistic given an average annual growth rate of 3.3% in 2012-2015. Potential growth is forecast to increase to 4.3% in 2018 from 4% currently, which is already above most independent estimates. Contrary to recent years, growth is expected to be consistently supported by strong investment activity and positive contributions from net exports. Private fixed investment is projected to accelerate from sluggish growth in recent years to 8% annually in 2016-2018. Exports are projected to increase at an average annual rate of 11.6%, which looks overly optimistic in view of an average annual growth rate of 5.7% over the past four years and subdued growth in Turkey's export market (about 4% annually in 2016-2017 in current Commission projections). The ERP's projections for investments, exports, and potential growth are explained by an acceleration of Turkey's structural reform programme which will serve to promote investments, particularly in the tradable sector, and increase international competitiveness and hence exports. In view of the slow pace in the implementing structural reforms in recent years and the time-lag between reform implementation and macroeconomic results, this scenario is questionable.

In the labour market, solid employment growth is projected to push the unemployment rate back below 10%. The unemployment rate would fall by 0.6 percentage points over the programme period based on 2.4 % annual employment growth and a significant slowdown in labour force growth. While the projected employment growth rate is in line with the recent trend, the decline in labour force growth (from more than 3% in recent years to around 2% in 2017 and 2018) is improbable in view of the structural trend towards higher labour force participation and a steady increase in the working age population. Assuming that the labour force continues to increase at a rate of 3%, the unemployment rate would also continue to increase by about half a percentage point per year as it did in 2012-2015. The ERP does not discuss the impact of the inflow of refugees and migrants on the labour market.

Average annual inflation is projected to decline gradually from 7.7% in 2015 to 5.8% in 2018, denoting a continued over-shooting of the official 5% year-end inflation target. Between December 2014 and December 2015, inflation increased by 0.6 percentage points to 8.8% despite the decline in oil prices. The projected disinflation in the programme period is difficult to reconcile with output growth in excess of its medium-term potential and a closed output gap by 2018, which normally implies rising domestic inflationary pressures. High single-digit inflation rates are problematic in terms of macro-economic stability, resource allocation and re-distributive effects, and have a negative effect on the economy's growth potential. The current level of inflation is so entrenched in the Turkish economy that sustained disinflation would require that price stability is made the clear focus of monetary policy, with other policy objectives being pursued with separate instruments.

The current account deficit is forecast to narrow from 4.5% of GDP in 2015 to 3.5% of GDP in 2018. However, if GDP accelerates as projected in the ERP, it is likely that the current account will worsen considering the historical correlation between the two variables. The oil price decline, which reduced the deficit by 1 percentage point of GDP in 2015, is not expected to continue. It is assumed that the oil price will increase from the long-time low in early 2016 to close to last year's average (52.5 USD/barrel) by 2018. Gross external debt has continued to trend higher, reaching EUR 366.5 billion (59.6 % of GDP) at the end of 2015. The current account deficit and the associated vulnerability can only be reduced by increasing national saving.

The external deficit makes the economy dependent on sustained capital inflows. Net foreign direct investment (net FDI) has declined significantly since the global financial crisis, covering only a modest share of the current account deficit in recent years. In 2015, there was a noticeable improvement in net FDI when it financed 36% of the external deficit. However, most of this is due to one-off factors, particularly large foreign investments in the financial sector. Portfolio investments saw a sharp swing from net inflows to net outflows in 2015, as global investor sentiment turned against Turkey and other emerging markets. This meant that the current account deficit was financed by the banking sector's foreign borrowing, a large drawdown in foreign exchange reserves and an (unexplained) surge in net errors & omissions in the balance-of-payments statistics. Future contributions from foreign exchange reserves to the financing of the external deficit will be constrained by the relatively small size of Turkey's net reserves. A large positive contribution from net errors & omissions is also unlikely to be sustained. For the programme period, the ERP expects some further strengthening of net FDI inflows and a return to large inflows of portfolio investments which would even permit a renewed accumulation of foreign exchange reserves. This presupposes a strong performance of the Turkish lira in the currency markets which has not been the case in recent years. However, the ERP's scenario for external deficit financing is not altogether implausible provided that growth, inflation and the current account develop as benignly as projected. The more likely scenario, where the overall economy develops less favourably than projected, is that the financing of the current account deficit will develop less smoothly. In addition, financing of the external deficit will be complicated by the reduced attractiveness of Turkish assets for foreign direct investors as a result of the recent worsening of the business environment, particularly with respect to security and the rule of law.

The banking sector is adequately capitalised and remains resilient. The sector's net profits increased by 5.9% in 2015, but the return on equity is relatively low at 11.3% considering the level of inflation and considerable credit risk. The capital adequacy ratio stood at 15.6% at the end of the year. This is well above the current regulatory minimum, but has to be seen in light of the introduction of Basel III which will require significantly higher capital buffers. Non-performing loans amounted to 3.2% of total loans at the end of 2015 and were well provisioned. However, banks remain very reliant on external wholesale funding and the relatively high foreign-currency exposure of their corporate customers poses a risk to their asset quality. Net foreign exchange liabilities of the non-financial corporate sector corresponded to around 24% of GDP at the end of 2015.

Table II.5.1:

Comparison of macroeconomic developments and forecasts	2014		2015		2016		2017		2018	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	2.9	**2.9**	3.1	**4.0**	3.4	**4.5**	3.6	**5.0**	n.a.	**5.0**
Contributions:										
- Final domestic demand	1.1	**1.1**	4.1	**5.2**	3.8	**4.7**	3.9	**4.9**	n.a.	**4.6**
- Change in inventories	0.2	**0.0**	-0.4	**-0.5**	0.2	**-0.3**	0.0	**-0.4**	n.a.	**-0.4**
- External balance of goods and services	1.6	**1.8**	-0.6	**-0.7**	-0.6	**0.2**	-0.3	**0.5**	n.a.	**0.8**
Employment (% change)	1.6	**5.4**	2.6	**2.8**	2.8	**2.4**	2.9	**2.5**	n.a.	**2.3**
Unemployment rate (%)	10.1	**9.9**	10.5	**10.2**	10.7	**10.2**	10.8	**9.9**	n.a.	**9.6**
GDP deflator (% change)	8.3	**8.3**	8.6	**8.0**	9.6	**7.6**	7.7	**7.4**	n.a.	**6.0**
CPI inflation (%)	8.9	**8.9**	7.7	**7.7**	9.0	**8.0**	8.5	**6.3**	n.a.	**5.8**
Current account balance (% of GDP)	-5.8	**-5.5**	-4.8	**-4.5**	-4.4	**-3.9**	-4.7	**-3.7**	n.a.	**-3.5**
General government balance* (% of GDP)	-1.5	**-1.3**	-1.4	**-0.6**	-1.7	**-1.3**	-1.6	**-0.9**	n.a.	**-0.6**
Government gross debt (% of GDP)	33.5	**33.5**	33.2	**32.6**	32.1	**31.7**	31.4	**30.5**	n.a.	**29.5**

** excluding privatisation revenues*

Sources: Economic Reform Program 2016 (ERP), Commission Winter 2016 forecast (COM)

5.3. PUBLIC FINANCE

In 2015, the central government's budget deficit declined slightly as a ratio of GDP. The deficit fell from 1.3% in 2014 to 1.2% of GDP which is slightly higher than originally planned (1.1%). Revenues and expenditures increased by 13.6% and 12.8%, respectively. According to the ERP, the fiscal deficit of general government (excluding privatisation revenues) decreased from 1.3% of GDP in 2014 to 0.6% in 2015. (The ERP's general government data are not fully aligned with the ESA2010 standard). The fiscal consolidation in 2015 is, however, much smaller when one uses the "program-defined" primary balance as yardstick. This measure only improved from 0.6% of GDP in 2014 to 0.8% in 2015 and fell clearly short of the target (1.2%) in the ERP for 2015-2017. According to yet another measure of fiscal performance, which is also presented in the ERP and excludes both privatisation receipts and one-off items, the general government deficit narrowed from 2.0% of GDP in 2014 to 1.5% in 2015. The ERP does not explain clearly why the various measures of fiscal performance yield different results. Overall, it seems that there has been some fiscal consolidation in 2015, but less than previously planned.

The budget deficit of central government is projected to increase slightly in 2016. Expenditure is budgeted to increase slightly faster than nominal GDP whereas revenue growth is set to increase slightly below it. This would raise the central government deficit by 0.1 percentage point to 1.3% of GDP, the same level as in 2014. The general government deficit is also projected to return to the 2014 level, i.e. 1.3% of GDP, because expenditure is set to increase significantly faster than revenues. Again, the difference between the general government and the central government budget is not fully explained, but seems to be related to the government's decision to take on part of the burden put on employers as a result of raising the minimum wage by 30% from 1 January 2016.

The fiscal stance in the final years of the programme provides little support for a much-needed increase in domestic savings. For 2017 and 2018, the general government deficit is projected to decline by 0.4 and 0.3, percentage points of GDP, respectively. This deficit reduction is more modest than what was projected in last year's ERP. Despite the declining deficit, the projection must be considered as an easing of the fiscal policy stance in view of the simultaneous change in the output gap from -1% of GDP in 2016 to +0.4% in 2018. Although the projected fiscal deficits are relatively small and there are no imminent risks to public finances, the fiscal policy stance is too accommodative given the macro-economic context.

Table II.5.2:

Composition of the budgetary adjustment (% of GDP)

	2014	2015	2016	2017	2018	Change: 2015-18
Revenues	38.9	40.1	40.3	39.7	39.3	-0.8
- Taxes and social security contributions	30.9	32.2	33.1	32.8	32.5	0.3
- Other (residual)	8.0	7.9	7.2	6.9	6.8	-1.1
Expenditure	40.2	40.7	41.6	40.7	39.9	-0.8
- Primary expenditure	37.2	37.9	39.0	38.2	37.5	-0.4
of which:						
Gross fixed capital formation	3.8	4.0	3.8	4.0	4.0	0.0
Consumption	18.0	18.1	18.4	17.9	17.6	-0.5
Social transfers & subsidies	8.9	9.0	9.7	9.5	9.4	0.4
Other (residual)	6.5	6.8	7.1	6.8	6.5	-0.3
- Interest payments	3.0	2.8	2.6	2.5	2.4	-0.4
Budget balance	-1.3	-0.6	-1.3	-1.0	-0.6	0.0
Structural balance	-1.7	-1.4	-1.7	-1.2	-0.9	0.5
Primary balance	1.7	2.2	1.3	1.5	1.8	-0.4
Gross debt level	33.5	32.6	31.7	30.5	29.5	-3.1

Sources: Economic Reform Program (ERP) 2016, ECFIN calculations, differences due to rounding

The programme includes a number of measures with potential fiscal implications for 2016-2018. Most of the measures remain, however, relatively vague and non-committal (e.g. broadening the tax base, raising tax compliance, simplifying tax legislation, reviewing tax exemptions and transaction taxes). With respect to the expenditure side, the information that wages for public employees will be increased twice in 2016 (5% in January followed by 5% in July) is precise but insufficient in itself for a deeper analysis of public finances in the medium term. It also remains unclear which policies are to increase the efficiency of social programmes and health spending. The programme does not specify the underlying policy measures which would support the significant reduction in current spending and transfers over 2017 and 2018 – by 0.8 and 1.2 percentage points of GDP respectively. The stated intention to move towards a more growth-enhancing budget is not convincingly explained in the fiscal strategy.

The debt-to-GDP ratio has been influenced by exchange rate developments. General government debt, defined in accordance with ESA2010, corresponded to 33.5% of GDP at the end of 2014 and declined to 32.9% at the end of 2015. The ERP's projection (32.6% for the end of 2015) does not seem to have taken full account of the Turkish lira's depreciation in the course of 2015. This has increased the value of the debt in lira terms since a large part of the debt stock is denominated in foreign currencies. For the programme period, the ERP projects a 3.1 percentage point decline in the debt ratio to 29.5% in 2018. If economic growth turns out to be significantly lower than projected in the ERP and fiscal deficits develop as projected by the Commission, the decline in the debt ratio will be less than that.

5.4. STRUCTURAL REFORMS

Turkey´s reform process has stalled in recent years. The economy is diverse with particular strengths in white goods and machinery, as well as in services such as construction and tourism. The country has seen remarkable development since 2001 when the government began an economic and political reform process, which included a number of important structural reforms. However, in recent years the reform process has stalled and even reversed in some areas that are important for the investment climate, such as the rule of law.

The fact that exports have not benefitted much from the sharply decreasing external value of the currency points to the need for some structural reform. Besides the high foreign currency debt held by economic operators, persisting weaknesses in human capital formation and comparatively low investment in research and development are the main obstacles to increased productivity and a sustained high development rate. Considerable segments of the population, in particular women and youth, constitute untapped potential for the labour market. The high level of informality and poor working conditions hamper inclusive growth and perpetuate high rates of poverty and social exclusion.

The Economic Reform Programme 2016-2018 is the first to comprehensively address structural reform needs. There was only one structural reform recommendation adopted at the Economic and Financial Dialogue with the EU in May 2015. This one recommendation was partially addressed. Amendments to the Labour Law were adopted in January 2016 introducing the right to part-time work for parents, with specific rules for female civil servants to stimulate female labour force participation. Training provisions in VocTest Centres have been increased, which should contribute to improving the qualifications of low-skilled workers.

The ERP includes a discussion on key policy objectives in all relevant areas, but is weak on diagnostics and reform measure details. The ERP is closely based on Turkey´s 10th development plan (2014-2018), and sector strategies, as it should be. It aims to increase competitiveness through higher productivity and moving its industry up in the production chain, thus seeking to reduce the current account deficit and the resulting vulnerability to international portfolio investor sentiment. The programme also includes measures intended to support innovation and human capital. Nevertheless, it suffers from several weaknesses. By and large, it focuses more on reporting or expounding objectives than on analysing reform needs, strategic options and risks and does not make any link between strategies and budgetary costs. The distinction between supportive actions and sector reforms is unclear in most cases. Import substitution plays a central role in several sector policies, but is unlikely to achieve its objectives if it ends up protecting weak sectors more than encouraging promising ones. Space for such a policy is also limited under existing international obligations, including the Customs Union with the EU.

Public finance management

Turkey´s public finance management is comparatively strong in terms of institutions, processes and personnel for planning and executing the budget, but should improve on performance-based financial management. The ERP does not include comprehensive cost analysis, budgeting and scheduling of reform measures. This casts doubts on both the credibility of budget estimates and policy outcomes. Moreover, the external audit function and its parliamentary follow-up, which are not mentioned in the document, should be strengthened.

Infrastructure

There is a need to increase the efficiency and capacity of the transport sector – especially in rail and port services – starting with a comprehensive plan for a more balanced development of transport modes. In the energy sector, lack of effective price competition is the main challenge. While the ERP puts a particular focus on logistics, it does not reflect an integrated concept for sector development and linked reform measures. It notes that a liberalisation of railway transport has been initiated but does not mention a rationale for developing new rail interconnections, for example. With regard to energy, the adoption of pending key reforms on gas market liberalisation and the law on nuclear energy are mentioned, but not scheduled. In general, the ERP tends to report on past events rather than developing a future reform agenda.

Sector development

Agricultural sector development

Turkey lacks a comprehensive strategy on agriculture to identify and address shortcomings, including low productivity. Turkey´s agricultural market is fairly protected from international competition, and support for production appears to be on the rise. But the ERP does not include an analytical section on this sector; identification of the main problems and remedial measures to address them is, therefore, rather ad hoc and inconsistent with strengthening productivity. The planned measures to improve agricultural infrastructure are, however, relevant.

Industry sector development

The key obstacles to competitiveness and growth in the industrial sector are low productivity and the large share of low value-added products. The small-scale structure of industry (90% of firms are SMEs) results in small-scale production and does not sufficiently realise economies of scale. The uneven geographic distribution of larger industries is another problem. The ERP analyses these challenges well and outlines a sector strategy, but not in much detail, and thus does not distinguish sufficiently between support schemes and structural reforms. Turkey´s existing Priority Transformation Programme could be explained more comprehensively. Possible trade-offs between the import substitution policy for intermediate goods on the one hand and the objective of increasing productivity on the other hand are not addressed. Finally, the structural transformation programme for healthcare-related industries may favour a protectionist mind-set over one that would attract investment. Instead of seeking a blanket increase in productivity across all sectors, Turkey should consider focusing on sectors with comparative advantages that have more chance of integrating into global value chains.

Services sector development

Turkey has a comparatively strong services sector and comparative advantages particularly in tourism, health and educational services. However, tourism is vulnerable to political developments. The diagnostic and strategic analysis of sector opportunities and risks included in the ERP should be significantly strengthened. This is because the steps to increase service quality and competitiveness are not sufficiently addressed, while infrastructure, marketing and promotional activities seem overemphasised. Potential cross-linkages to labour and education are not explained.

Business environment, corporate governance and reduction of the informal economy

Turkey's weak performance in terms of judicial independence and the rule of law indicate a lack of predictability and stability, factors critical for drawing in and retaining investment. The transparency of the legislative process has diminished as a result of the proliferation of omnibus laws, which amalgamate several amendments to different laws in one package. In addition, frequent changes in technical legislation protecting non-viable companies or sectors, an increase in derogations granted in public procurement, the perception of politically motivated tax inspections and insufficient stakeholder consultation contribute to an atmosphere of legal uncertainty.

The ERP proposes actions to reduce the administrative burden and increase the efficiency of the judiciary, which could be considered as relevant reforms once achieved. However, the ERP does not adequately address the effects on the business environment of targeted actions against critical media and business people, through active use of the tax authority, the financial crimes unit and courts. The government has acquired active control of several media assets (Bugün, Habertürk, Zaman), companies (Koza-İpek group) and a bank (Bank Asia) through appointing trustees in their management.

Technological absorption and innovation

Turkey recognizes the importance of research and innovation as a driver for development. Despite improvements in recent years, the country faces a low, notably private, R&D spending intensity of 0.96% in 2014 (Eurostat), an ineffective venture capital market and a low ratio of R&D personnel in the total labour force (0.45% in 2014). In addition, deficient education in science, weak and scattered cooperation between academia and business, insufficient knowledge transfer mechanisms and low performance on innovation outputs, as reflected by the number of patents can be noted.

The diagnostic elements in this section of the ERP are generally plausible, albeit vague. The ERP presents no clear strategy as to the necessary reforms; the ERP provides insufficient details on implementation, notably on the cooperation between universities and public research institutions and businesses will be incentivised and how the effectiveness of measures will be assessed. While the proposed measures to stimulate R&D and innovation through public procurement could foster the creation of more knowledge-intensive products and services, this has to be done in full respect of competition rules. The instruments envisaged in Turkey´s ERP, notably price preferences and outright exemptions from the public procurement law, are an unlikely or even a counter-productive method of incentivising technological development. Moreover, supporting R&D activities with large procurement lots appears to disadvantage SMEs, in particular start-ups, which can be important drivers of new technology. Finally, stronger support for fundamental research and, in particular, better funding schemes for PhD students will be necessary to strengthen the science base.

Trade integration

Ad hoc barriers to trade and weak logistics infrastructure are key obstacles to the closer integration of Turkey in global value chains. The ERP lists trade liberalisation, better awareness of intellectual property rights, support for R&D activities in critical areas and support for waste recycling as measures that help international trade integration. The measures are aimed at reducing the current account deficit through export-oriented and competitive production. If implemented, they should have a positive impact on the competitiveness of the Turkish economy. However, the ERP also gives priority to reducing the undesirable impact of trade integration, including from the EU-Turkey Customs Union. It remains unclear whether this means that Turkey will seek to conclude more FTAs with countries not having similar deals with the EU. Such a policy would constitute a breach of the Customs Union, and could risk undermining trade integration with Turkey´s single most important trading partner. Moreover, the measures relating to origin deviation appear to envisage defensive trade practices including technical barriers to trade. Instead, the ERP could have mentioned the planned strengthening of EU-Turkey trade relations by modernising the Customs Union.

Employment and labour markets

Turkey faces considerable labour market challenges, reflected in low female participation and employment rates, a high number of young people not in employment, education or training (NEET), and a high level of informal work. Poor working conditions, problems in providing safe and healthy work places and low workforce qualification levels hamper increased productivity, which is necessary for improving Turkey's competitiveness. The ERP touches upon these issues, with the exception of informal work which might be further exacerbated by the recent 30% increase of the minimum wage and the influx of refugees. Overall the ERP is not sufficiently forward looking and does not fully consider labour market challenges in the wider context of the structural reforms for growth and competitiveness included in the ERP.

Turkey has partly addressed the 2015 recommendations, but the ERP does not report on them. Amendments to the labour law were adopted in January 2016 introducing part-time work schemes for female civil servants with small children and a general right to part-time work for working parents with small children. Accompanying measures for stepping up child care and early childhood education provision are not brought forward though. To support implementation of part time work, an amendment to the labour law for introducing private employment agencies has been prepared, with the potential to improve labour market dynamics. The provision of training for low-skilled workers was further stepped up in 2015; however the number of training courses provided is insufficient for the needs.

The ERP identifies reform priorities for improving labour market effectiveness, basic and occupational skills, and attracting qualified workers, but some measures need to be more clearly described. An additional list includes 12 measures which broadly relate to the reform priorities. They lack details on the content, timing and budget of the measures; the multiannual actions listed under Section 4 are ongoing measures ending in 2016 or 2017.

The measures for improving labour market effectiveness focus on improving the scope and effectiveness of financial and other support to the unemployed, addressing labour market rigidities and gaps in workers' rights. However, informal work is not addressed in this context. The reform measures related to human capital rightly put a two-fold focus on raising basic and occupational skills in the lower/middle skills segment and on attracting highly qualified professionals including from abroad. A new youth employment strategy is announced, which could help to tap unused potential for raising labour market participation and productivity.

Fostering social inclusion, combatting poverty and promoting equal opportunities

Turkey faces significant social challenges in terms of poverty and income/wealth inequality which are structural in nature. The current system of providing social assistance appears to leave a large proportion of poor households outside its coverage; beneficiaries of social assistance represent only one sixth of individuals below the relative poverty rate. The link between social assistance and labour market activation measures is weak. Turkey's advanced economic status contrasts with its very low ranking in international indices on human development and gender equality. The country's commitment to education reforms has not yet delivered tangible improvements.

The two measures in this area rightly focus on improving the delivery and effectiveness of social support measures. The two measures differ in focus. The Family Social Support Programme is already in place and specifically addresses families. The measure on the Effective Social Transfer System aims at a thorough reform of the social protection system to transform it into a universal system. No details are provided about its design, timing and budget.

5.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2015

2015 policy guidance for Turkey	**Summary assessment**
PG 1: Promote domestic saving in view of the persistently large current account deficit. Fiscal policy has an important role to play in this regard by following a sufficiently restrictive stance. Reducing the rigidity of public expenditures would help to make the fiscal policy stance more responsive to macroeconomic needs. The adoption of a fiscal rule would enhance budget transparency, provide an important fiscal anchor and enhance credibility.	Turkey has not addressed policy guidance 1.
PG 2: Continue to take consistent steps to reinforce the focus of monetary policy on the pursuit of price stability, with other policy objectives being pursued with separate measures, and thereby contribute to improving both the functioning and the credibility of the inflation targeting regime.	Turkey has not addressed policy guidance 2.
PG 3: Make sustained efforts to improve the business environment and Turkey's attractiveness as an investment destination, not least for foreign direct investments, in view of the continuing dependence on large capital inflows. This requires wide-ranging reforms, including strengthening the rule of law, making it easier to start businesses, and strengthening competition through continued liberalisation of product and service markets.	Turkey has not addressed policy guidance 3.
PG 4: Accelerate the implementation of a comprehensive structural reform programme. Overall, this is essential to improve the functioning of the markets for goods, services and labour which, in turn, would increase potential growth and international competitiveness on a sustainable basis. In particular, Turkey should upgrade and make better use of its human capital through the pursuit of the education agenda and the deepening and widening of labour market reforms. Specifically, the qualifications of low-skilled workers should be improved through training and female labour force participation should be stimulated through flexible working conditions.	Turkey has partially addressed policy guidance 4: Amendments to the Labour Law were adopted in January 2016, introducing the right to part-time work for parents, with specific rules for female civil servants. Training provisions in VocTest Centres were increased.

5.6. THE 2016 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, 25 May 2016

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

1. Promote domestic saving in view of the persistently large current account deficit. Fiscal policy has an important role to play in this regard by following a sufficiently restrictive stance. Reducing the rigidity of public expenditures would help to make the fiscal policy stance more responsive to macroeconomic needs. The adoption of a fiscal rule would enhance budget transparency, provide an important fiscal anchor and enhance credibility.

2. Reinforce the central bank's focus on price stability in monetary policy by further tightening the policy stance against the backdrop of high (above-target) inflation rates and increasingly unanchored inflation expectations. A simplification of the monetary policy framework in line with the central bank's own forward guidance, published in August 2015, would help to buttress the credibility of the inflation targeting framework in place. Using the main policy rate, rather than a range of other instruments, in the conduct of monetary policy would be more transparent and strengthen the central bank's credibility in fighting inflation in the medium term.

3. Strengthen the rule of law and the judiciary with a view to restoring investors' confidence.

4. Enhance the comprehensive strategy in support of research and development; this should target an increase of total spending on research and development and build closer cooperation between research institutions and economic operators.

5. Enhance further the control capacity of the labour inspectorate and enable tax authorities and the social security institution to ensure a correct declaration of wages in order to reduce informality. Pursue the education agenda and improve the qualifications of low-skilled workers in order to make better use of human capital, in particular of young people.

Annex: Overall assessment of programme requirements

A draft version of Turkey's Economic Reform Programme for 2016-2018 was sent to the Commission on 4 March 2016. The final and formally approved ERP was submitted to the Commission on 13 April, more than two months after the deadline. The programme includes an enhanced description of structural reform priorities. However, the programme's structure does not follow the guidance note provided by the Commission.

Ownership and internal coordination

The ERP was centrally coordinated by the Ministry of Development, but does not provide information on which ministries contributed to the exercise. The ERP is closely based on Turkey´s 10th Development Plan (2014-2018).

Stakeholder consultation

There appears to have been no consultation with external stakeholders on the ERP, in contrast to the 10th Development Plan on which it is based; it therefore contains no written contributions. This should be improved next year.

Macro framework

The programme's medium-term projections are overly optimistic regarding the main macroeconomic indicators (growth, inflation, unemployment, current account). The projections are not all internally consistent. Some key challenges are not sufficiently addressed, particularly the sustainability of the current account deficit, the persistence of relatively high inflation, and the impact of the large inflow of refugees and migrants on the economy. The macro framework is drawn from the government's revised Medium Term Program 2016-2018 from January 2016.

Fiscal framework

Efforts are required to improve fiscal data at general government level on a unified accounting basis according to ESA/international standards. It remains difficult to assess Turkey's public finance situation properly in the absence of regular and consolidated general government budget reports. There is little information about the measures underlying the fiscal projections for the programme period, making it difficult to assess their soundness. Future programmes would benefit from more complete data and from a long-term analysis of public finance sustainability to gain an understanding of the main fiscal challenges in the future, in particular those stemming from demographic and labour market developments.

Structural reforms

The diagnostics per sector should generally be improved. Reform measures appear eclectic at times and the number of structural reforms is unclear. Section 4 does not contain an enumeration of measures. The summary of reform priorities in section 4.3 indicates 18 measures, while table 9 in the annex includes a list of 25 measures. The measures read more like objectives, and no concrete activities are presented. Tables 7 to 9 in the annex are not numbered in accordance with the guidance note and are not properly filled in. Table 7 only references five measures or areas and only contains budgetary information on four of them. Table 8 only contains information on eight of the measures and only a few include detailed timetables. Table 9 provides the only comprehensive summary of structural reforms of the ERP; however, it does not correspond to the information given in section 4 of the ERP.

6. BOSNIA AND HERZEGOVINA

6.1. EXECUTIVE SUMMARY

Economic activity rebounded in 2015, after flood-related damage had kept output growth at a low level in 2014. The recovery in 2015 was mainly driven by stronger private consumption, investment and exports. Stronger growth caused employment to rise by some 1.5 % in 2015. Inflation remained subdued, reflecting low import prices for energy. Between 2016 and 2018, the macroeconomic scenario envisages a marked acceleration of annual output growth, reaching 4 % year-on-year in 2018. This will mainly be driven by private consumption which will increase due to rising employment, and by investment. Overall investment levels are therefore expected to return to historic averages. The external accounts are projected to widen again, reflecting strong domestic demand but also decreasing workers' remittances. The risks to this scenario are mainly on the downside, partly because of unfavourable external developments, but also because of internal factors such as political risks and insufficient implementation of the country's reform agenda.

The programme presents an ambitious, back-loaded fiscal consolidation path, substantially lowering both revenue and expenditure. Fiscal implementation faced a major financing challenge in 2015, as expected external lending could not be realised, requiring increased domestic financing and spending cuts. The 2016 budget is largely in line with the overall strategy of fiscal consolidation. Unfortunately, the programme does not provide a clear rationale for the fiscal tightening approach, nor does it set out how these reductions will be achieved. A particular concern is the disproportionate use of cuts in investment in order to achieve spending reductions. This is in clear contrast to good governance and to last year's joint recommendations.

Improving the standard of living and addressing chronically high unemployment are key policy challenges for the country. A crucial precondition in this respect is to accelerate the implementation of long overdue structural reforms. The following describes the country's main policy challenges:

Bosnia and Herzegovina displays one of the most challenging labour market situations in the region. Inflexible labour legislation, a high tax wedge on labour, widespread skills mismatches and poor outreach of employment services and measures contribute to high youth unemployment and overall long-term unemployment. The lack of active labour market measures and the fact that social assistance is not targeted further act as disincentive to taking up formal work. The pension and healthcare systems display weaknesses as regards both financial sustainability and adequacy and provision of care.

Public spending is heavily biased towards consumption and redistribution, notoriously neglecting investment needs. Besides a high share of public employment, the country's spending structure focuses strongly on social transfers and subsidies. Spending on public investment is projected to drop further, from 3.8 % of GDP in 2014 to 2.2 % in 2018. Given the programme's goal of lowering spending levels in general, the share of public investment in total spending is set to decrease even more sharply.

Fiscal sustainability is impeded by limited access to financing and high roll-over needs. The country's access to international financing is quite limited, while domestic sources are already stretched. This is a major constraint on the country's capacity for deficit financing. Furthermore, roll-over requirements are substantial in some cases, creating additional pressure on the country's public finance management and leaving limited room for manoeuvre. The country's debt management strategy suffers from fragmented responsibilities and an insufficient information flow.

Bosnia and Herzegovina has no clear economic strategy at the country level, based on a comprehensive diagnostic. The Reform Agenda is a good example of a common country-wide diagnostic and cooperation between state and entities, but it is not fully used in the ERP. The lack of a single economic space results in highly fragmented markets at entity or even cantonal level, which in the absence of systematic coordination prevents economies of scale. This is exacerbated by the absence of country-wide transport and energy strategies, complex procedures for exports and an inadequate border infrastructure system that hampers trade and investment.

The poor performance of the business environment is directly linked to a continuing absence of a single economic space and to political and economic instability. Any progress towards the establishment of a real market economy is foiled by the persistence of subsidised state-owned enterprises, the widespread informal economy and corruption and the complex and often contradictory legal and regulatory frameworks across jurisdictions. Compared to peers, the country's state sector absorbs a rather high share of output without generating an adequate value added. Significant resources are consumed by onerous procedures, negatively effecting the business environment and its attractiveness to domestic and foreign investment.

While the ERP's macro-economic and fiscal sections are largely in line with the guidelines, the structural reform section does not provide the required country-wide diagnostic and reform measures. Instead, the text comprises mainly separate inputs for each entity. The entity contributions, which present valuable input for a country-wide ERP, show improvements compared to last year. However, there was no attempt to adjust these inputs and create a country-wide ERP.

Last year's policy guidance was partially addressed. Some measures have been taken to improve fiscal management, while no progress has been achieved with respect to public sector auditing and control. Steps were taken to set up a registry for para-fiscal fees and to adopt new labour market laws. The FBiH set up measures to establish entrepreneurial zones. Little or no action has been taken toward establishing a single economic space in the country, setting up coherent country-wide transport and energy strategies or harmonising the fragmented education sector with competences at entities and canton level.

6.2. ECONOMIC OUTLOOK AND RISKS

The Economic Reform Programme (ERP) envisages a domestic-driven acceleration of output growth. The pace of growth will be moderate in 2016-2017, but more pronounced in 2018. The programme is based on a macroeconomic framework, projecting that growth will increase from 2.5 % in 2015 to 4 % in 2018, bringing average annual growth to 3.4 %. The main sources of growth are forecast to be private consumption, accounting for about half of overall output growth, and investment, contributing another half. Private consumption is supported by solid employment growth and low inflationary pressures, while investment is seen to pick up substantially, resulting from strong investment in infrastructure and the energy sector, catching-up after years of weak investment performance. Government consumption is projected to increase by about one per cent annually during the programme period, resulting in a growth contribution by about one quarter percentage point. Both, import and export growth are expected to remain rather subdued, reflecting assumed progress in import substitution and cautious assumptions on the country's export environment. Overall, the contribution of net-exports to growth remains slightly negative. This is expected to reduce overall GDP growth by half a percentage point in 2016 and 2017 and by a quarter percentage point in 2018. Unemployment is expected to drop from 27.7 % of the labour force in 2015 to 25.6 % in 2018, mainly thanks to an average annual increase in employment by 1.9 %. At the same time, the working age population is forecast to increase by only 0.4 % on average.

The macroeconomic scenario is on the optimistic side with risks tilted to the downside, particularly in the last programme year. The risks related to the external environment are well recognised, while given the country's track record the assumption that investment will grow by some 9 % annually is rather optimistic, given that in the fiscal part public investment is planned to drop (from 3.8 % of GDP in 2014 to 2.2 % in 2018) and the country's track record in improving the business environment is rather poor. The implied import elasticity of final demand is significantly below historic averages, at around 1 during the programme period, compared to 1.6 during the last 10 years. When assuming "historic" import behaviour, import growth would be markedly higher, reducing the annual growth dynamics by about one percentage point. The alternative scenario acknowledges downside risks stemming from a less favourable international environment as well as risks related to domestic political instability, a less favourable labour market performance, and uncertainties related to inflation. Overall, a strong policy commitment towards proceeding with the country reform agenda seems essential if Bosnia and Herzegovina is to achieve the economic outlook presented in the ERP.

Improvements on the labour market remain insignificant. Stronger economic activity during 2015 helped registered employment to increase by 1.5 % on average in 2015. Unemployment declined slightly, but still remains on a high level. The registered unemployment rate (national definition) fell to 42.9 % in January 2016, compared 43.8 % the year before. Among others, a high tax wedge and rigid labour market regulations impeded a more dynamic employment growth. These factors also contribute to the persistence of a large informal economy. Youth unemployment remained above 60 %. The difficult labour market situation is also reflected in broadly stagnating gross nominal wages. The expected performance on the labour market is largely consistent with the underlying macroeconomic outlook, with employment expected to increase on average by some 1.9 % per year. However, achieving this relatively high growth rate strongly depends on addressing key constraints for employment generations, such as inflexible labour legislation and a significant tax wedge on labour. Furthermore, there is a risk that additional employment in the private sector will be partly offset by the need to contain public sector employment.

The programme's inflation scenario is largely plausible, envisaging low inflationary pressures in the coming years. Price increases for imported energy and intermediate goods are expected to remain subdued, while domestic price pressures, in particular on the wage side, are seen to remain moderate, given the high unemployment in the country.

Table II.6.1:
Macroeconomic developments and forecasts

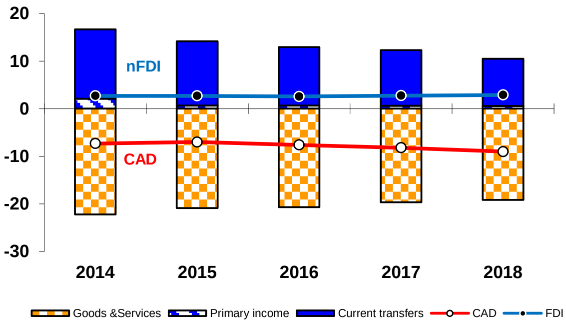
	2014	2015	2016	2017	2018
Real GDP (% change)	0.3	2.5	3.0	3.2	4.0
Contributions:					
- Final domestic demand	3.8	2.6	3.5	4.0	4.2
- Change in inventories	-0.7	-0.2	0.0	-0.3	0.1
- External balance of goods and services	-2.8	0.1	-0.5	-0.5	-0.3
Employment (% change)	-1.2	1.2	1.7	1.9	2.1
Unemployment rate (%), LFS definition	27.5	27.7	27.1	26.4	25.6
GDP deflator (% change)	-0.3	0.5	1.3	1.9	1.7
CPI inflation (%)	-0.9	-0.8	1.0	1.2	1.5
Current account balance (% of GDP)	-7.3	-7.0	-7.6	-8.2	-9.0

Sources: Economic Reform Programme (ERP) 2016

The current account deficit is expected to deteriorate slightly, mainly due to lower transfers. The current account deficit is projected to decline slightly in 2015. This reflects the phasing-out of import-intensive flood repair works but also a somewhat stronger export performance coupled with lower import spending, partly benefiting from lower import prices. For the programme period, the ERP expects the current account deficit to widen gradually to 9 % of GDP by 2018, as expected lower inflows of current transfers are more than offsetting improvements in the trade balance. In the context of investment driven accelerating growth, the expected improvement in the trade balance appears optimistic. Thus, in case of a widening of the trade balance, a sharper than projected deterioration in the country's external balance could further elevate external financing needs.

The financing of the current account deficit is projected to be covered by various sources, such as foreign direct investment (FDI) inflows and other investment flows. FDI, which is characterised by a low sectoral diversification, declined in recent years from an average of 7 % of GDP before the 2009 crisis to 2.5 % of GDP in 2014. The programme envisages increasing FDI inflows to around 3 % of GDP by 2018. Those inflows are expected to focus on energy and infrastructure projects. These investments will therefore have only a limited impact on the necessary diversification of the rather narrow production base and on raising productivity on a broader front is probably quite limited. Unfortunately, the programme does not provide quantitative details on how the substantial current account deficit in the last programme years will be financed.

Graph II.6.1:
Evolution of the current account balance (% of GDP)



Source: Economic Reform Programme (ERP) 2016, ECFIN calculations

The banking system appears broadly stable, but pockets of vulnerabilities remain. It is still well capitalised. The regulatory capital adequacy ratio has declined slightly to 17 % but remains well above the regulatory minimum of 12 %. Profitability remained positive in 2015 and the liquidity of the system remains at comfortable levels. Partly, is is because precautionary motives appear to be keeping deposit growth high, with average deposit levels some 6 % higher than a year before. The banking system's credit risk indicators continue to improve slowly. For example, the share of non-performing loans in total loans continues to decline, reaching 13.9 % at the end of 2015, compared to 14.2 % a year before. However, there are significant differences at a lower level of aggregation, with significantly higher levels of non-performing loans at some, non-systemic, domestically-owned banks. At the same time, the ratio of provisions to non-performing assets has increased, reaching 72.6 % at the end of 2015, compared to 71.4 % a year before. Nevertheless, legislative changes to facilitate loan restructurings have yet to be made and further efforts remain necessary to encourage the clean-up of banks' balance sheets. Furthermore, banking sector supervision and resolution needs to be improved. So far, credit growth remained muted despite greater liquidity in the banking sector. In particular, credit to non-financial corporations remained weak, partly as credit demand from private companies appears to be low. To a certain extent, this probably reflects the unfavourable business environment, which is not supportive for local investment.

Table II.6.2:

Financial sector indicators

	2011	2012	2013	2014	2015
Total assets of the banking system, mEUR	10,987	11,210	11,794	12,299	12,758
Credit growth	-6.3	-0.7	3.1	-1.9	0.8
Bank loans to the private sector	53.0	49.9	48.8	47.9	45.2
Deposit growth	1.5	9.0	5.9	10.0	13.7
Loan to deposit ratio	1.1	1.2	1.1	1.1	1.0
Financial soundness indicators					
- non-performing loans	12.0	12.7	14.5	15.2	13.9
- net capital to risk weighted assets	17.1	17.0	17.8	16.3	16.2 Q3
- liquid to total assets	27.2	25.4	26.4	26.8	25.8 Q3
- return on equity	5.8	4.9	-1.4	5.2	3.0 Q4
- forex loans to total loans	66.7	63.1	62.9	62.3	62.4Q1

Sources: Central Bank, DataInsight, IMF

6.3. PUBLIC FINANCE

The fiscal deficit remained under control in 2015, amid marked changes in the composition of spending and a substantial change in financing. The ERP estimates that the fiscal deficit in 2015 amounted to 1.4 % of GDP. This is below the target set out in the Global Framework for Fiscal Balance and Policies 2016-2018, envisaging an overall fiscal deficit of 2.5 % of GDP. Public expenditure in 2015 remained broadly unchanged at 42.6 % of GDP and was heavily biased towards current expenditures. However, the slight improvement in the composition of expenditure which started in 2013 seems to have been partly offset by pressures on current spending. Increases in spending for transfers led to cuts in expenditure for goods and services but also public investment. On the revenue side, the enduring problem of VAT refunds continues to pose a substantial drag despite measures to improve the collection of VAT revenues. Thus, consolidated fiscal revenues are projected to have remained broadly unchanged from the previous year at 41.3 % of GDP. Due to disagreements on the implementation of requested reforms, previously expected external financing from the International Monetary Fund (IMF) and the World Bank had to be replaced by spending cuts and by largely domestic sources of finance.

The 2016 budgets have still not shifted towards a more growth-enhancing structure of spending. In Bosnia and Herzegovina public accounts are dominated by the activities of two entities, the Federation of Bosnia and Herzegovina, accounting for about 60 % of the state's revenues and spending and the Republika Srpska, accounting for roughly 30 % of public revenues and spending. In contrast to last year, the entity level budgets for 2016 were adopted in time. On a consolidated country level, total revenue as a share of GDP is forecast to decline from an (expected) 41.3 % of GDP in 2015 to 39.7 % in 2016 (-1.5 percentage points), while total spending is planned to decline from an (expected) 42.6 % of GDP to 40.9 % (-1.8 percentage points). As a result, the general government's fiscal position is projected to improve by a quarter of a percentage point, to 1.2 % in 2016. Revenue is expected to drop mainly because social contributions are projected to decline by 0.8 percentage points of GDP and because of other, unspecified revenue items are expected to drop by 0.5 percentage points. The reduction in spending has been mainly driven by a drop in public consumption (-0.7 percentage points) with most savings expected to be realised from public wages, and social transfers (-0.6 percentage points of GDP). Unfortunately, the document does not provide detailed information on the underlying measures, driving those changes. A reduction of both, revenues and spending by more than 1½ percentage points of GDP is quite unprecedented in the country's recent history. More information would have been welcome, in particular regarding the envisaged decline in social security contributions and the planned reductions in social spending.

Box: The budget for 2016

In contrast to last year, both entities adopted their 2016 budgets in line with envisaged procedures, i.e. before the end of 2015. Their budgets are based on the Global Fiscal Framework, expecting real GDP growth of 3.2 % in 2016 and a GDP deflator of 1.3 %. The overall budget deficit is scheduled to drop from -1.4 % of GDP in 2015 to -1.2 % of GDP in 2016.

Both entities envisage a significant fiscal consolidation, lowering both revenues and expenditure. On a country-wide level, total revenues are projected to decline by 1.6 percentage points of GDP, from 41.3 % of GDP in 2015 to 39.7 % in GDP in 2016, while total expenditure is envisaged to decline by 1.7 percentage points of GDP, from 42.6 % of GDP in 2015 to 40.9 % of GDP.

Table: Main measures in the budget for 2016

Revenue measures	**Expenditure measures**
Lower social security contributions: -0.8 % of GDP	Public sector wage and employment measures: -0.7 % of GDP
Direct tax reform: -0.2 % of GDP	Better targeting of social transfers: -0.7 % of GDP
Personal Income Tax reform : -0.1 % of GDP	Subsidy constraints: -0.3 %
Other non-specified measures: -0.6 % of GDP	Public investment measures: -0.1 % of GDP
Total revenues effect: -1.6 % of GDP	**Total expenditure effect: -1.7 % of GDP**

Source: Economic Reform Programme 2016

Over the medium-term, the programme envisages a back-loaded acceleration of fiscal tightening. Between 2016 and 2018, the fiscal balance is planned to improve by 2.4 percentage points of GDP, turning the expected 2015 deficit of 1.3 % of GDP into a surplus of 1.1 % of GDP in 2018. When calculating cyclically-adjusted balances, the degree of fiscal tightening is less pronounced, accounting for 1.2 percentage points of GDP only. Most of the fiscal tightening is scheduled to take place in 2017 and 2018, with the headline fiscal balance improving by 1.1 and 1.2 percentage points, respectively. During the programme horizon, total revenues are expected to drop by 4.8 percentage points of GDP, due mainly to lower income from social contributions (-2.1 percentage points) and lower other revenues (-1.5 percentage points). The fiscal framework foresees an even more marked reduction of the spending ratio, by 7.3 percentage points, across all major spending items: primarily public consumption (-2.0 percentage points) and social transfers (-2.3 percentage points), but also investment (-1.0 percentage point) and subsidies (-0.4 percentage points). Interest expenditure is projected to drop by 0.1 percentage points of GDP. The spending constraint in the area of public consumption will be mainly a result of containing public employment, containing public wage increases and reducing spending on intermediate consumption. The programme provides more detailed data for the two entities, the central government institutions and the Brčko District. However, the ERP contains only very limited information on the various underpinning measures and does not quantify the fiscal impact of those measures. Overall, as in the past, the medium-term strategy for 2017-2018 lacks a description of the underlying fiscal and structural reform measures to support the spending and deficit reductions. Otherwise, the programme refers to some unspecified measures to increase expenditure efficiency. The link to the reform agenda and the overarching policy strategy is not evident.

Table II.6.3:

Composition of the budgetary adjustment (% of GDP)

	2014	2015	2016	2017	2018	Change: 2015-18
Revenues	**41.2**	**41.3**	**39.7**	**38.2**	**36.4**	**-4.9**
- Taxes	21.0	20.9	20.7	20.2	19.8	-1.1
- Social security contributions	15.1	15.1	14.3	13.5	13.0	-2.1
- Other (residual)	5.1	5.4	4.7	4.5	3.6	-1.7
Expenditure	**43.1**	**42.6**	**40.9**	**38.2**	**35.3**	**-7.3**
- Primary expenditure	42.4	41.7	39.9	37.2	34.4	-7.3
of which:						
Public Consumption	13.2	13.3	12.6	11.8	11.3	-2.0
thereof: compensation of employees	12.0	11.9	11.6	11.0	10.5	-1.4
Social Transfers	16.7	16.5	15.8	14.9	14.2	-2.3
Subsidies	1.3	1.5	1.2	1.1	1.1	-0.4
Gross fixed capital formation	3.8	3.2	3.1	2.9	2.2	-1.0
Other (residual)	8.7	8.7	8.4	7.6	6.7	-2.0
- Interest payments	0.7	0.9	1.0	1.0	0.9	0.0
Budget balance	**-1.9**	**-1.3**	**-1.2**	**0.0**	**1.1**	**2.4**
- Cyclically adjusted	-1.2	-0.4	-0.3	0.4	0.8	1.2
Primary balance	**-1.2**	**-0.4**	**-0.2**	**1.0**	**2.0**	**2.4**
Gross debt level	**40.8**	**41.3**	**41.7**	**38.3**	**33.0**	**-8.3**

Sources: Economic Reform Programme (ERP) 2016, ECFIN calculations

The fiscal strategy appears rather ambitious, but the programme does not describe in sufficient detail the concrete measures underpinning the planned fiscal tightening. The programme recognises the need to introduce measures to change the unfavourable expenditure structure. In line with this, public-sector compensation for employees is to fall by almost 1.4 percentage points during 2016-2018, dropping to 10.5 % of GDP in 2018. A revision of social transfers should help to make them more targeted. This should reduce the share of social transfers from the current 16.5 % of GDP to about 14.2 % in 2018. At the same time, however, capital expenditures are projected to decline over the programme horizon. The conservative projection of revenues is not consistent with the macroeconomic scenario. In particular, the underlying economic dynamics should allow stronger growth of indirect taxes in 2017-2018. Furthermore, the strong decline of revenues from social security contributions is surprising given the expected solid growth of employment. Reforms of the social security contribution system might be one explanation. However, the ERP does neither provide sufficient detail on the concrete planned steps nor on the timing of their implementation, nor on their fiscal impact. This part of the programme also remains largely silent on areas with pressing reform needs, for example the pension reform and the public administration reform in the Federation as well as the health reform in both entities.

Box: Debt dynamics

The programme expects the public debt ratio to peak in 2016, reaching 41.7 % of GDP and to decline substantially in the outer two programme years. A key driver for the drop in the debt ratio are primary surpluses and strong nominal growth, while the costs of debt servicing increases the debt level by about one percentage point of GDP. However, this scenario would depend strongly not only on achieving primary surpluses but also on realising additional, not specified measures for debt reduction, accounting for 1.5 % and 2.1 % of GDP in 2017 and 2018.

Table II.6.4:

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

	2014	2015	2016	2017	2018
Gross debt ratio [1]	**40.8**	**41.2**	**41.7**	**38.3**	**33.0**
Change in the ratio	3.6	0.4	0.5	-3.5	-5.3
Contributions [2]:					
1. Primary balance	**1.1**	**0.4**	**0.2**	**-0.9**	**-2.0**
2. “Snow-ball” effect	**0.7**	**-0.2**	**-0.7**	**-1.1**	**-1.2**
Of which:					
Interest expenditure	0.7	0.9	1.0	1.0	0.9
Growth effect	-0.1	-1.0	-1.2	-1.3	-1.4
Inflation effect	0.1	-0.2	-0.5	-0.8	-0.6
3. Stock-flow adjustment	**1.7**	**0.2**	**1.0**	**-1.5**	**-2.1**

Notes:

[1] End of period.

[2] The snow-ball 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 other adjustment positions, such as differences in cash and accrual

Source: Economic Reform Programme (ERP) 2016, ECFIN calculations

Despite the limited size of the country’s public debt, the trend and the structure of public debt continue to raise concern. Bosnia and Herzegovina’s public debt accounted for slightly above 40 % of GDP in 2015. However, the effects of the financial crisis and natural disasters, such as the floods in 2014 have caused public debt to increase sharply by nearly 20 % of GDP within less than 10 years. About 70 % of public debt is foreign owned and is largely provided on concessional terms from various international financial institutions, such as the IMF, the European Investment Bank (EIB) and the World Bank. The drop of IMF and World Bank lending in 2015 caused the share of domestic debt to rise significantly, reaching 11.8 % in 2015. This was mainly due to the issuing of short-term and long-term government securities, which substituted for the non-disbursement of tranches under the IMF Standby arrangement. Domestic public debt is projected to fall to 8.4 % of GDP in 2018 (-3.4 percentage points of GDP) on the back of a steady decrease of verified old currency savings and war claims. Foreign public debt is projected to increase to 31 % of GDP in 2016, but to decline to 24.6 % in 2018. The currency structure of the total public debt could be considered relatively favourable given the country’s currency board arrangement, as nearly 33 % of the outstanding stock is denominated in EUR and 38.4 % in domestic currency. A large part of the debt stock has been contracted on concessional terms, with the average interest rate staying at 1.5 % and about 51.2 % of total debt under a fixed interest rate. Nevertheless, the maturity structure has worsened, with a decline in the average repayment period of the existing loan commitments to about at 8 years.

Roll-over and refinancing risks of public debt continue to be elevated. Public debt servicing, which has more than doubled in recent years, reaching over 5 % of GDP in 2015, is projected to surge further in the programme period to reach 6 % of GDP in 2018. This poses risks for the refinancing of public debt. Moreover, the already substantial refinancing needs following the multiple issue of government securities in 2015 and the limited availability and a partial standstill of other sources of financing could pose risks to the fiscal projections given the tight fiscal space, in particular as the country has only limited access to international capital markets. Furthermore, debt management suffers from decentralised responsibilities and an insufficient information flow among the various stakeholders.

6.4. STRUCTURAL REFORMS

Bosnia and Herzegovina's sustainable economic recovery depends on the implementation of the Reform Agenda (RA) adopted in 2015 in close collaboration with the International Financial Institutes. The adoption of the Reform Agenda is a positive development given its focus on a set of country-wide structural reform measures to tackle key socioeconomic challenges also identified in the recommendations jointly adopted at the Economic and Financial Dialogue with the EU in May 2015. This implies a welcome first step toward improved coordination and cooperation between different government levels, based on a shared country-wide diagnostic of the main structural issues. Implementation commenced in 2015. The Council of the EU has made "meaningful progress in the implementation of the Reform Agenda" a precondition for considering Bosnia and Herzegovina's application for EU Membership submitted on 15 February 2016. In this context it is all the more regrettable that the ERP has not made a similar effort to fully use the RA to present a country-wide diagnostic and strategy to boost growth and competitiveness.

Bosnia and Herzegovina has a small and only moderately open economy with severe structural bottlenecks. The economy is still dominated by a relatively large, inefficient and burdensome public sector. It is particularly important to establish a coherent coordination mechanism to overcome the lack of a single economic space with highly fragmented markets, mostly set at entity or even canton level. The absence of a medium term country-wide economic policy strategy adversely affects all eight key areas of structural reforms. Access to international finance is limited and widespread corruption negatively affects the business environment. The latter is further undermined by a weak rule of law and a large informal economy. Significant labour market challenges, reflected in very high unemployment are exacerbated by the lack of activation measures, disincentives to work and the poorly performing education qualification structure.

Bosnia and Herzegovina has only partially addressed the policy guidance jointly adopted in the Economic and Financial Dialogue with the EU of 12 May 2015 that relate to structural reforms. Both entities have taken first steps to set up a registry for para-fiscal fees and both have adopted new labour laws, although their entry into force remains uncertain. The FBiH has introduced measures to set up entrepreneurial zones while the RS intends to increase business inspections to combat the informal economy. Little or no action has been taken to establish a single economic space in the country by addressing the complex and often contradictory legal and regulatory frameworks across jurisdictions. The same is true of the reforms in the transport, energy and education sectors.

The programme does not provide a comprehensive overview of key challenges and reform priorities within a coherent country-wide common policy framework, despite the joint conclusions of the Economic and Financial Dialogue with the EU of 12 May 2015 and further Commission advice and technical assistance made available during the ERP preparation process. It lists priorities and measures mainly at entity level. However, both entities face similar structural issues and there is a high degree of strong mutual spill-over and interconnectedness. Although more clearly set out than in the previous programme, the proposed measures could be better prioritised, setting out well-defined implementation strategies and indicating the current state of play and clear implementation timelines, including an assessment of challenges and potential risks, budgetary implications, as well as the expected impact on competitiveness and growth. The ERP does in some cases indicate planned cooperation on public finance management or healthcare reform with IFIs such as the World Bank, but specific details are often missing.

Public finance management

The efficiency and effectiveness of the country's public finances are strongly impeded by weak financial management, a lack of medium-term planning, and weak capacities in auditing and monitoring public procurement. Furthermore, tender procedures suffer from high administrative burdens and lack of transparency. Fiscal discipline is low. Public companies are often not viable and accumulate significant arrears to both public and private creditors; these arrears are not monitored, or tackled in a coherent manner, and represent large unfunded liabilities that can have a significant impact on macroeconomic stability and the continuing provision of public services. On entity level the World Bank has started work to identify arrears, although this is not explicitly indicated in the text.

Cooperation and coordination between state and entity levels to address the 2015 joint conclusions on improving the budget management framework appear to have been developed somewhat – mainly linked to the Reform Agenda framework. Some progress has been made in the last few years to improve the quality of government spending. However, the analysis does not detail the impact of these measures on competitiveness. The country has so far addressed public finances on a sub-system basis without explicitly linking different areas and reform measures under a coherent PFM reform programme.

So far, Bosnia and Herzegovina has no country-wide Public Finance Management (PFM) reform programme in place. The measures in this area could have an impact on the quality of public governance. The RS is planning measures to improve the financial control system, slightly reduce the tax burden on labour, combat informalities and reform the health system. The measures to reduce the tax burden and combat informalities are relevant and appropriately developed and include an analysis of the impact on the budget. However, the activities identified concern mostly the formal preparatory process of laws and only relate to one entity rather than taking a coordinated country-wide approach. The ERP seems to underestimate problems with setting up internal audit units, recruitment and the costs of capacity building. The FBiH plans to strengthen public internal financial controls but provides no information on the expected impact. The measures on reforming the health system should not be included in the PFM area.

Infrastructure

Bosnia and Herzegovina has some of the lowest quality infrastructure, particularly in transport, and among the lowest investment rates in the region. It also has a fragmented, inconsistent and weak regulatory and legal framework that hinders investment. The lack of coordination and cooperation between state and entity levels to set up properly-functioning energy and transport markets blocks the required significant upgrades and the considerable growth opportunities for the economy, including as a potential regional transport hub and energy provider. The country's hydropower potential is still largely untapped. A country-wide energy strategy and country-wide infrastructure plans and energy markets with interconnections to the wider regional and EU energy markets would improve the security of energy supply and reduce the wastefully high energy intensity.

The recommendation to develop a transport policy and strategy and an energy strategy at each level of government and to embed them with the regional agenda on connectivity has not been

addressed. The ERP does not mention the adoption of a BiH Framework Transport Policy in July 2015, despite it being an intermediate step towards a country-wide strategy in the transport sector. There is no or hardly any energy sector reform in most areas including electricity, gas, renewable energy, energy efficiency and sustainability. The ERP does not report on the required alignment with the Third Energy package in gas and electricity, or on how obligations under the Energy Community Treaty are going to be met. Establishing such strategies and embedding these within the regional connectivity agenda, in accordance with the TEN-T guidelines amended to contain the core and comprehensive networks of the Western Balkans, will allow project eligibility for co-funding under the Western Balkans Investment Framework (WBIF).

Both the FBiH and RS prioritise restructuring of the railways, while the two measures targeting transport infrastructure and energy infrastructure are only proposed at the level of the FBiH. All three measures seem appropriate in ambition, focus and scope if taken individually. However, they are presented by entity and do not reflect a comprehensive and consistent approach to sector development. The same applies to the energy measures. The FBiH adopted a 'Strategic Plan and Programme for the Energy Sector Development' but provides no further details. The measure entails extending (renewable) energy production.

There are no references to broadband infrastructure and connectivity or to the development of ICT and the digital economy and society, even though infrastructure is particularly weak in these areas. Allowing for more competition between fixed and mobile operators within a proper legal and regulatory framework will enhance the independence of the regulator, require network operators to coordinate and share infrastructure, and to specify conditions for granting aid to ensure an investor-friendly environment for broadband development.

Sector development

Agricultural sector development

The potentially important agricultural sector provides income to a significant share of the population but consists mainly of fragmented small inefficient farm plots. There are no strategic plans to develop the sector at country level, even if both entities often have substantially converging policies in this area. Strategy development is hindered by a lack of actually initiated processes by relevant authorities, consolidated country-wide agricultural data and a country-wide legal framework for implementation of the agricultural census. Moreover, there are no centralised agriculture and rural development registries. The absence of financing, the low overall investment and the insufficiently strengthened capacities, in particular at border controls, are identified as key obstacles to the development of the sector. Although the agricultural sector has considerable growth potential, the absence of progress in agreeing to set up the country’s IPARD operating structure hinders any significant improvements. There is potential for high-quality large scale production of competitive products such as dairy and meat products, fruits and vegetables, cereals and crops, organic produce, and medical and aromatic plants. More investment in standards certification (including ISO and GLOBALGAP) and agribusiness value chains would help achieve this potential.

Only the FBiH tackles the recommendation to develop a comprehensive and strategic approach in the field of EU food safety standards and sanitary and phytosanitary standards to be able to export to the EU. Measures focus on shifting subsidies from production to assets (land, head of cattle) and on sector restructuring, with a view to meeting EU standards. A strategy addressing land fragmentation may be more effective for sectoral restructuring. The observation that veterinary and phytosanitary checks are not aligned with EU standards is no longer true for several sub-sectors, including potatoes and fruits and vegetables. The country was granted EU market access for heat-treated milk and dairy products in June 2015 after a positive assessment of processing standards. Contrary to several remarks on expected EU or reallocated financial support to the agricultural sector, no EU funds were earmarked or reallocated, because of the absence of country-wide strategies and management structures complying with EU standards in agriculture. Creation of such structures and rural development strategy in compliance with EU standards in agriculture and rural development –for which EU support is available- would enable access to IPARD funds.

Overall, the measures lack ambition, especially as regards IPARD operational structures. At the same time, there are implementation risks given a practice of limited budgets without a policy framework and the frequent *ad hoc* budget reallocations and uncertain timeframes. The regular use of "urgent procedures" also increases the risks of failing to properly consult stakeholders. The measure introducing financial support to agricultural producers based on payments per hectare and per head of cattle proposed by FBiH relies mainly on a renewed incentive system for small farmers, while investments in innovation, marketing and business management are quite marginal. The issue of compliance of local products with the requirements of the EU market is not addressed.

Industry sector development

Although the economy is mostly service-dominated, industry accounts for a relatively high share of production. The industrial sector consists of a narrow range of traditional low and medium value-added industries such as mining, metal and wood processing, machinery, textiles, tobacco, ammunition, and domestic appliances, with little or no innovation. By far most industrial enterprises are SMEs. Key issues include the persistent absence of a single economic space as also specifically underlined in the Economic and Financial Dialogue with the EU of 12 May 2015.

The recommendations to take steps towards establishing a single economic space have not been addressed. FBiH proposed measures to address the recommendation to provide support to SMEs and improve their access to finance, to help local governments set up entrepreneurial zones, and support SMEs with tech parks and business incubators to create SME clusters, provide investment support, and to adopt the Law on Factoring.

This area in the ERP only contains a brief contribution from the RS, enumerating the reasons for the disappointing progress in the privatisation process in industry in terms of competitiveness, -foreign-investment and innovation. The measures focus on restructuring the remaining state-owned enterprises including through bankruptcy and liquidation procedures, thereby completing the privatisation process in the RS. It is unclear how this relates to industrial restructuring or growth and competitiveness at a country-wide level.

Services sector development

Services account for the largest share of the economy and the public sector represents a large, inefficient and dominant part of the services sector. Particular growth sectors are tourism and the ICT sector. Tourism is a potentially important services market but sustained growth is impeded by market fragmentation, lack of coordination between different government levels and direct cooperation between public and private stakeholders. The increasing ICT sector has shown production- and export growth, being an attractive sector especially for young people, but it is held back by the lack of skilled workers and low business RDI uptake.

The measures related to the financial, tourism and catering sectors refer to the Reform Agenda and cooperation with IFIs. The FBiH gives an overview of measures addressing the lack of regulatory clarity, conflicting or overlapping institutional responsibilities and the unclear sector policy and strategy. The RS decided to postpone measures in this area to 2017 and thus did not provide any input.

Business environment, corporate governance and reduction of the informal economy

Bosnia and Herzegovina has been structurally lagging behind its peers and continues to rank among the lowest in the region as regards the business environment. This poor performance is directly linked to a continuing absence of a single economic space and to political instability, the absence of country-wide coherent quality infrastructure, weak access to finance for the private sector, especially SMEs, weak rule of law and complex, unclear and sometimes contradictory legal and regulatory frameworks. There are significant costs of business entry and exit procedures, no country-wide recognition of business registration, numerous para-fiscal charges, gaps in contract enforcement and implementation of laws and a sizeable informal economy. Online filing of taxes, e-filing of value-added tax (VAT), and other services such as online filing of social security returns and pensions are limited or not possible. A law on electronic signatures was adopted in 2006 but is yet to be implemented.

The business environment lacks quality support measures for start-ups and export-oriented enterprises. There is no formal coordination with local development partners or a single coordinating body at country level. This results in overlapping and weak budgetary planning for major economic development investments and limited evaluation of the effectiveness of SME support.

The recommendations to set up a registry of para-fiscal fees, reduce business entry and exit costs and simplify the regulatory framework for issuing construction permits have been partially addressed. The FBiH collected an initial listing of para-fiscal charges to prepare a registry of para-fiscal revenues in the first quarter of 2016. The recommendation to advance restructuring and privatisation of state-owned enterprises and to improve their efficiency and corporate governance has been partially addressed. The FBiH approved a plan to privatise 16 companies.

Overall, the measures tend to be rather fragmented and descriptive, instead of specific and coordinated country-wide. There is little analysis of the expected impact on competitiveness and growth, funding or budgetary impacts, and no indication of linkages to the targets in the South East Europe 2020 strategy.

Technological absorption and innovation

Bosnia and Herzegovina's capacity for technological absorption and research, development and innovation (RDI) is low. This is linked to the stagnant expenditure on R&D at a marginal 0.33% of GDP and the low percentage of R&D personnel in the workforce (0.09%), combined with a dysfunctional research, education and innovation environment. There is no country-wide innovation policy or strategy and no or very limited cooperation between academia and the private sector as well as between all levels of government.

Despite the strong correlation between investment in research and competitiveness and growth and the dire situation in BiH, the ERP does not set out any reform measures in this area and there are no budgets committed to R&D and innovation.

Trade integration

The country remains one of the economically least integrated in the region, with an export share of only around 32 % of GDP, down from over 100% before the break-up of Yugoslavia. The areas of concern are a loss of competitiveness due to outdated production facilities, a fragmented domestic market, the non-tariff trade barriers such as complex export procedures, no coordinated border controls and weak border infrastructure systems, and no comprehensive approach to meet EU food safety and sanitary and phytosanitary standards, as already noted in the Economic and Financial Dialogue with the EU of 12 May 2015. The absence of country-wide strategies for exports and quality infrastructure is a further impediment to strengthening the export sector. The recommendation to simplify the complex procedures for exports, ensure coordinated border controls and improve the border infrastructure system has not been addressed.

The measures included in the ERP address some of the bottlenecks, mostly in the framework of CEFTA obligations on trade facilitation. The new Law on Customs Policy simplifies customs procedures, but has not yet entered into force. The text is in line with the provisions of the Stabilisation and Association Agreement (SAA) with the EU, although certain obligations are not taken into consideration (e.g. adaptation of the free trade agreement with Turkey). While the adaptation of the SAA to take account of Croatia's accession is a technical exercise under way, the ERP does not address key structural reforms. The measures to sign and ratify CEFTA Additional Protocol 5 on trade facilitation and to conclude negotiations on CEFTA Additional Protocol 4 on the liberalisation of trade in services are welcome. The statement that WTO accession is hindered by unresolved trade issues with the EU is incorrect as the two are unrelated; the country still failed to meet WTO obligations as also noted in the 2015 Report on Bosnia and Herzegovina.

Employment and labour markets

Bosnia and Herzegovina continues to face significant labour market challenges and has one of the highest unemployment rates in the region, affecting in particular youth and contributing to long-term unemployment. Inflexible labour market regulations and a high tax burden on labour, reflected also by a high incidence of informal work, are key impediments to labour market participation. Recent developments accompanying the adoption of new labour legislation clearly point to the weaknesses in functioning of social dialogue. The widespread skills-mismatches and the insufficient outreach and coverage of employment services and active labour market policies remain key issues. The lack of activation measures and inadequate social assistance targeting further act as disincentives to take up formal work.

The recommendation to reduce labour market rigidities has been partially addressed. The FBiH and RS adopted new labour laws at their entity level, although each has been challenged for being adopted under emergency procedures in the absence of social dialogue in the respective entity's constitutional courts. In the FBiH the law was in the meanwhile re-adopted and the validity of the collective agreement, concluded in the meantime, was extended. A court decision in RS is still pending while the discussions on a new collective agreement have already started. While both laws aim to introduce better labour market functioning and flexibility, the process of social dialogue and stakeholders involvement was inadequate. Both the RS and FBiH plan to lower the contribution rate for employers in 2016, although the question of budget neutrality remains unresolved. In 2015, Bosnia and Herzegovina made initial steps towards developing quality assurance processes for vocational education in line with the European Quality Assurance Reference Framework.

Both entities' ERP reform measures are in line with the implementation of activities in the Reform Agenda and are designed to support employment growth. FBiH plans to reduce labour costs with a view to increasing formal employment and attracting foreign investment. It also plans to introduce a support scheme for first-time job seekers, targeted particularly at youth. There is insufficient focus on cooperation with businesses and linking adequate supplies of skills to labour market needs, for example through measures to help young people make the transition from school to work. RS intends to introduce human resources planning in the public sector, to strengthen employment services and to adopt legislation on employment incentives. The ERP does not contain any information on priority groups and approach of these employment initiatives. To combat the informal economy, RS plans to strengthen inspection capacities and introduce stricter penalties but there is no focus to encourage and incentivise formal employment.

FBiH plans to reform the education system, focusing on students' and teachers' mobility and developing career orientation capacities. While the mobility aspect is relevant, higher priority lies on building teaching capacities and creating links with enterprises in order to support vocational skills development as well as training primary and secondary teachers in order for them to develop basic and transversal skills with students. The development of career orientation services is an important measure, which is expected to benefit both the labour force and people in education.

Social inclusion, combating poverty, promoting equal opportunities

The social situation in Bosnia and Herzegovina remains challenging and there are particular difficulties in rural areas. Despite relatively high spending on social protection, the coverage of social assistance remains weak and poorly targeted, creating disincentives to formally engage in the labour market. Further challenges are child poverty and low coverage of pre-school education, inadequate attention to activation policies, and social exclusion both of disadvantaged groups and single parent families, in particular women. The health and pension systems are not financially sustainable, while they do not provide adequate living conditions and quality care. In response to the 2015 recommendation to take steps to target social expenditures better, the FBiH has initiated a process to establish a single registry of non-contributory cash benefit users. The legislation is planned for Q1 2016 and aims to improve the targeting of social assistance. Increasing participation in early childhood education and care is also relevant for the inclusion of socially vulnerable groups in formal education and would increase their employment and social situation and prospects.

FBiH is planning social protection measures, including introducing minimum social standards and establishing a single registry for social benefits users. The reform measures aim to reduce inequalities and improve social assistance coverage. Extensive legislative revisions are planned, but indicators and milestones are missing. Moreover, aspects relating to gender and protection of minorities are only briefly mentioned. Establishing a single registry of non-contributory cash benefit users is a relevant step, which is expected to provide an overview of social assistance and improve coverage and targeting of benefits at entity level. No link is provided to implementing institutions and budgeting.

While there is no specific ERP reform measure in the area of social protection, RS provides a brief outline of measures to improve pension and social protection systems. The plan is to introduce a voluntary pension scheme and pension fund in 2016 to improve sustainability and pension coverage. Measures to improve the coverage and targeting of social assistance are also planned. This is planned to be achieved through stronger control over social benefits, targeting vulnerable groups and reducing the costs of local and entity budgets. However, there is too little information provided to allow an assessment to be made.

6.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2015

2015 CSR for Bosnia and Herzegovina	Summary assessment
PG 1: Improve the budget management framework by adopting and implementing the Law on Fiscal Responsibility in Republika Srpska, especially including the establishment of a Fiscal council and the adoption of a fiscal rule. Take steps to address obstacles to an efficient implementation of the Law on Budgets in the Federation, in particular the functioning of the Fiscal coordination body. Continue with the improvement of expenditure controls, fiscal discipline, budget reporting methods and the efficiency of tax authorities of lower levels of government.	BiH has partially addressed this PG: RS adopted the Law on Fiscal Responsibility in Republika Srpska. RS plans to establish a Fiscal Council in 2016. FBiH Fiscal coordination body held first meeting in May 2015.
PG 2: Improve the composition of public spending to increase the fiscal space for capital investments by containing current expenditures through curbing the public sector wage bill and more efficiently allocating staff in the civil service at all levels of government. Take steps to better target social expenditures through extensive audits and finalisation of the establishment of the Single Registry of Beneficiaries of Cash Payments without Contribution in the Federation.	BiH has partially addressed this PG: Hiring freeze measures are contained in the Framework Budget Document of BiH Institutions for 2016-2018. The FBiH plans adoption of the Law on the Single Registry of Non-Contributory Cash Benefit Users in Q1 2016.
PG 3: Take steps to advance restructuring and privatisation and improve the efficiency and corporate governance of companies with state ownership, notably in the Federation, to relieve the substantial burden on public finances.	BiH has partially addressed this PG: RS indicated intention to prepare list of sustainable/unsustainable public enterprises and draft a Restructuring and Privatisation Programme in 2016. FBiH approved Privatisation Plan to privatise 16 companies.
PG 4: Take steps to continue with the set-up of registry of para-fiscal fees to relieve burden on businesses without endangering the sustainability of public finances. Continue to reduce costs of business entry and exit and simplify the regulatory framework for the issuance of construction permits, especially in the Federation.	BiH has partially addressed this PG: FBiH collected a first listing of para-fiscal charges to prepare for a Register of para-fiscal revenues in 1st quarter 2016 FBiH formed a Working Group to align legislation to shorten and simplify procedure for permits and ensure greater legal security

PG 5: Reduce labour market rigidities by addressing disincentives to hiring, including taking further steps towards a reduction of the tax wedge while ensuring budget neutrality.	BiH has partially addressed this PG: Both entities adopted new labour legislation in 2015 aiming at greater flexibility, but implementation was delayed or on hold due to constitutional complaints regarding the adoption process (FBiH and RS) and content (RS). RS and FBiH plan to reduce employers' contributions in 2016. Budget neutrality remains unresolved.
PG 6: Finalize the development of a financial restructuring framework including to address the high burden of non-performing loans on bank balance sheets from both a stock and a flow perspective and thus help remove potential supply- and demand-side obstacles to credit extension. In this context, a strengthening of the crisis resolution framework would also appear warranted.	BiH has partially addressed this PG: FBiH proposes legal and regulatory changes to support purchase and sale of NPLs to improve collection and resolution of NPLs, and the adoption of guidelines for out-of-court settlements
PG 7: Take steps toward the establishment of a single economic space by addressing the lack of internal coordination across all government levels.	BiH has not addressed this PG.
PG 8: Improve the business environment and support private sector development, including through the mutual recognition of business registration. Develop measures to provide targeted support for SMEs and to widen their access to finance. Tackle all forms of corruption, fraud and money laundering and informalities in the economy.	BiH has partially addressed this PG. FBiH proposed measures to help local government set up entrepreneurial zones, and support SMEs with tech parks and business incubators to create SME clusters, investment support, and adoption of the Law on Factoring. RS proposes set of laws to increase inspection controls and repressive measures to identify breaches of regulations on business registration.
PG 9: Develop a more strategic approach to tackle the deficiencies in the training and education system by effectively prioritizing measures based on a mapping of the skills gap taking into account the needs of industry, especially SMEs. Harmonise legislation and standards related to education and training at state and entity level, as well as at cantonal level, since the competence on education in FBiH is at cantonal level.	BiH has not addressed this PG. Under the FRAME Skills for the Future initiative, Vision for Skills 2020 has been under preparation, aiming at improving the skills system in BiH, in cooperation with the competent institutions and entities, coordinated by the Ministry of Civil Affairs of BiH.
PG 10: Develop a transport policy and strategy and an energy strategy at each level of government according to competencies, and embed them with the	BiH has not addressed this PG.

regional agenda on connectivity, including through the establishment of a credible planning of prioritized reforms with a timeline and funding mechanism (single project pipeline). The energy strategy should also consider substantial investments in a diversified power generation and on an effective distribution network.	
PG 11: Simplify the complex procedures for exports, ensure coordinated border controls and improve the border infrastructure system. Develop a comprehensive and strategic approach in the field of EU food safety and sanitary and phytosanitary standards to receive accreditation for exporting agricultural and food products to the EU.	BiH has not addressed this PG. BiH proposes the measures it is obliged to follow once it has signed and ratified the CEFTA Additional Protocol 5 on simplification of customs procedures in 2016. Negotiations for the conclusion of CEFTA Additional Protocol 4 on liberalisation of trade in services is expected to be signed by end 2016.

6.6. The 2016 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, 25 May 2016

In light of this assessment, and also taking into account the Reform Agenda, Participants hereby invite Bosnia and Herzegovina to:

1. Improve the quality of public finances: Enhance the growth-friendliness of public spending, among others by increasing public investment, and contain spending for public employment. Improve the targeting of social spending and establish a comprehensive inventory of public sector payment arrears. Furthermore, strengthen the country-wide public debt management capacities, in particular improving cooperation and the flow of information from local data providers to the state level. Set-up of an enforceable rules-based framework to instil discipline at all levels of government.

2. Improve the provision of timely and exhaustive statistics, applying European and international standards, in particular in the area of population statistics, national accounts and government finance statistics. Furthermore, strengthen the provision of data from data providers to producers of official statistics.

3. Develop a comprehensive strategy to foster the resolution of non-performing loans by banks, including all relevant stakeholders with a view to reducing risks to financial stability and the real economy. Follow-up on plans to upgrade the legal infrastructure of the financial system and conduct an asset quality review of smaller banking entities. Establish a bank lending and inflation expectations survey in order to better gauge underlying credit and price dynamics.

4. Set up a common economic space and systematic coordination mechanisms between all government levels. Adopt a country-wide transport strategy and a country-wide energy sector reform strategy in compliance with the country's obligations under the Energy Community Treaty.

5. Introduce e-payment services on taxation and fully implement the law on electronic signature in order to increase transparency and reduce space for tax evasion, corruption and regulatory complexity.

6. Reinforce the capacities of the employment services and target active labour market policies in particular to vulnerable youth, women and long-term unemployed. Reduce the unsupportive tax wedge and disincentives for the unemployed and inactive persons to take up formal work. Improve the co-operation between the education system and labour market institutions.

Annex: Overall Assessment of programme requirements

Bosnia and Herzegovina submitted its 2016 Economic Reform Programme (ERP), covering the 2016-2018 period, on 1 February 2016. The programme, which has been adopted by the Council of Ministers of Bosnia and Herzegovina, is in line with the government's medium-term fiscal strategy.

Ownership and internal coordination

The preparation of the ERP was centrally coordinated by the Directorate for Economic Planning (DEP). Two ERP coordinators were appointed at the level of the two entities, the Federation of Bosnia and Herzegovina (FBiH) and the Republika Srpska (RS), and involved the relevant line ministries at entity level. The contributions to the ERP were prepared at entity level, with measures listed per entity without integrating these in a comprehensive country-wide framework. The ERP input was endorsed by the government at entity level. The role assumed by the national ERP coordinator (DEP) was very weak – it consisted mainly of combining the two entity contributions into one document without any meaningful preparatory consultations or coordination and with no further attempt to consolidate the texts into a single country-wide ERP. Although coordination efforts within entities indeed did improve, there was no national ownership of the exercise and coordination between the entities and with the state level remained insufficient.

In the structural reform part, the ERP rightly refers at numerous instances to the Reform Agenda adopted in July 2015 but it did not fully use the latter to present a country-wide diagnostic and strategy to boost growth and competitiveness. At the same time, linkages to the annual budget and medium-term fiscal framework are still weak.

Stakeholder consultation

At entity level, the RS government held public consultations on the RS contribution to the ERP but the text does not specify which stakeholders were involved or consulted. The FBiH government did not consult any stakeholders or social partners as the FBiH contribution to the ERP text was published after already being adopted. Both entities mainly list procedures and discussions held with OECD, the Commission and line ministries, but there is no mention of consultations with non-government stakeholders. At state level the draft ERP was published on the DEP website but no further consultation process was indicated. Most importantly, there was no consultation on the ERP as a whole. It is essential that the ERP is subject to consultation, offering involvement and shared ownership by the social partners, and all relevant public- and other stakeholders. Stakeholders' involvement needs strong improvements.

In addition, the ERP does not contain written contributions from stakeholders on the ERP as a whole. On these accounts there is significant room for improvement next year.

Macro framework

The programme summarises recent economic developments, but there is a clear issue of data availability and timeliness. Compared to last year, the macroeconomic scenario is slightly more cautious about the country's growth profile. However, the scenario still remains optimistic, particularly in terms of its investment projections, given the poor investment climate and government plans to reduce investment. At the same time, import assumptions appear rather low, given historic trends. The risk analysis is more balanced than last year. The programme complies with the Commission's request to provide an assessment of the medium-term sustainability of the country's external position. The recent macroeconomic performance is adequately described and includes most relevant information available at the time of drafting. Overall, the macroeconomic framework is sufficiently comprehensive. However, some key features should have been explained in greater detail. There is little consistency with other parts of the programme, particularly with the fiscal framework.

Fiscal framework

The fiscal framework is poorly integrated, lacking both, a profile that is consistent with the macroeconomic framework and sufficient references to the structural reform part. The chosen policy approach, namely a significant reduction of revenues and spending, may be consistent with the objective of reducing the role of the state in the economy. However, the reasons for this policy choice are not sufficiently explained. Furthermore, there are hardly any references to any other policy objectives, discussed in other parts of the programme, nor to the Commission assessment in the 2015 Country Report. In addition, the ERP would have greatly benefited from quantifying some of the briefly mentioned measures. The compilation and presentation of fiscal data is not yet fully in line with the methodology of the Government Finance Statistics (GFS methodology), while there are no roadmaps for the introduction of the European System of National Accounts (ESA 2010). Some data inconsistencies and discrepancies show that the quality of budgetary reporting remains low. Additional efforts have been made to broaden the analytical content of the fiscal framework, for example by adding calculations on cyclically-adjusted fiscal balances, based on a largely plausible potential GDP growth rate of 3% annually. Unfortunately, the report did not provide more details on the underlying method and the interpretation of the results.

Structural reforms

The section on structural reform priorities does not follow the guidance note in that it does not contain a country-wide diagnostic and reform measures. Instead, the text comprises mainly separate inputs for each entity.

On the other hand, the entity contributions show an improvement compared to last year as they include a diagnostic per area and report on the implementation of the policy guidance. Although the entity contributions are valuable as input to the ERP, the final ERP should have been presented just one programme for the whole of Bosnia and Herzegovina, with one list of key obstacles and country-wide measures for each area, even if competences and implementation are at lower levels of government.

Details of the implementation of each measure at state or entity level were provided. The structural reform priorities as included in the measures correspond to the key obstacles identified in the diagnostics and in some cases to the policy guidance from 12 May 2015. However, as they do not reflect a country-wide approach they are outside the scope of the ERP exercise. The total number of reforms is 37, while the guidance note limits the number to a maximum of 20. The page limit of 80 pages has been exceeded.

The description of each reform measure should be detailed enough in terms of specific actions and timeline to allow the measures to be easily monitored annually in the coming three years. Some of the measures contain such details while others do not. Tables 10-12 in the annex have been filled in. Table 11 should have contained more detailed timelines and descriptions of activities at least by year if not by quarter.

In addition to explanations given in the one pager on institutional issues and stakeholder involvement, information on the consultation process of external stakeholders, including any written contributions should be included as an appendix.

7. KOSOVO*

7.1. EXECUTIVE SUMMARY

Kosovo's economic growth strengthened in 2015 driven by private demand, following its weakest growth since independence in 2014. The baseline scenario of the Economic Reform Programme (ERP) forecasts an average 4.2% GDP growth between 2016 and 2018. Due to low employment and a narrow production base, stronger private consumption growth will continue to be underpinned by a stable inflow of diaspora remittances. Ambitious investment growth will depend on the relatively volatile inflow of foreign direct investment (FDI), which is sensitive to political stability. The public sector's contribution will remain subdued due to its limited fiscal capacity following recent increase in wages, pensions and other transfers. The main downside risks will arise from possible political and fiscal shocks.

The 2016 budget projections, made in cooperation with the IMF, are broadly realistic and in line with the baseline ERP scenario. No new tax changes are envisaged during the forecasting period. Current expenditure is projected to increase due to the introduction of the new benefits for war veterans, the rise in social transfers and the adjustments to the old age pension system. However its proportion of overall spending should decrease due to an ambitious rise in capital spending, caused by increased expenditure for the construction of the Route 6 highway. The budget deficit is expected to be 2% of GDP which is in line with the fiscal rule. Identified fiscal risks arise from persistent pressure from large interest groups for increases in entitlements and transfers.

Removing obstacles to private sector development is the main challenge facing Kosovo. So far, Kosovo's growth model depended on transfers-driven consumption and large public investments in infrastructure. Changing the pattern towards private-sector-driven growth will require a comprehensive reform agenda and its thorough implementation. Limited fiscal capacity should to be used prudently and efficiently, without endangering the stability of public finances. The main challenges here include the following:

Budget execution monitoring and fiscal rule enforcing mechanisms are weak, and the macro-fiscal framework preparation process is exposed to political influences. With the addition of a new exception to the fiscal rule, setting up related monitoring and enforcement mechanisms becomes even more important. Attempts to limit the rise in current expenditure have been limited to the adoption of the wage rule, limiting the rise of public wage bill to nominal GDP growth, as of 2018, and a temporary discretionary freeze on spending for goods and services. With limited room for further increases, rising pressures from social groups for new transfers, and rising maintenance costs of newly built infrastructure, Kosovo needs to contain the rise in current expenditure and preserve the share of capital spending.

Capital investment budget has been constantly under-utilised (on average by 15%) both on the central and the local government level. When not accounting for the large road building projects capital budget spending is even lower. This shows difficulty in coping with more than one smaller project at the same time, indicating low institutional capacity for project preparation and management.

Poor infrastructure, in particular in the energy sector, is a bottleneck to further private sector development and the general competitiveness of the economy. Unreliable energy supply, distribution losses in the electricity network and low energy efficiency are the main weaknesses. More work should be directed at improving energy efficiency in both the public and private sector. The transport sector is plagued by the weak administrative capacity of the regulatory institutions and the poor state of the

*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.

railway system. The ERP acknowledges these weaknesses and presents an appropriate mix of measures, albeit insufficiently focused on soft measures in the transport sector.

Private sector development continues to be hindered by a complex business environment with a large informal sector. The significant informal economy creates unfair competition, makes access to finance more difficult and hampers SMEs' ability to grow and innovate. Undeclared turnover and work also have negative implications for public revenue collection and the labour market. A changing regulatory environment and weak protection of property rights and contract enforcement are additional obstacles to doing business. The ERP includes several measures to address them, though these are not sufficiently explained

Kosovo's labour market performance is not improving, with most of the working age population inactive and a strong unemployment increase in 2014 and 2015. Labour participation and human capital accumulation are also weak due to distorting effects of large remittances. Social challenges are only partially identified, notably weaknesses in the health care system. The proposed measures are directed towards improving education and training and their alignment with labour market needs, and the functioning of the Employment Agency. Though relevant, they lack definition and a clear sequence of specific steps.

The macroeconomic and fiscal framework of the ERP is coherent, consistent and provides an adequate basis for policy discussions. The structural reform section of the ERP is a considerable improvement compared to last year. The ERP presents a good analysis of the structural obstacles and includes measures that are generally relevant to address them, even though in some cases the description of the measures is not adequately detailed.

Last year's policy guidance jointly adopted in the Ministerial Economic Dialogue of 12 May 2015 has been partially implemented. Public finances have been brought under control under the aegis of the ongoing IMF programme. Revenue and expenditure consolidation measures were taken with positive results, bringing the deficit under the fiscal rule threshold. However, ad-hoc increases in current expenditure in pre-election times are still a possibility. Furthermore, the fiscal framework still needs to be strengthened with sound monitoring and enforcement mechanisms. Although the board of the Privatisation Agency was appointed at the end of 2015, the privatisation agenda was put on hold, and there have been no improvements in the publicly-owned enterprises (POEs) corporate governance. Positive steps include the setting up of the National Investment Committee (NIC), the completion of the energy interconnection with Albania, steps taken to improve judicial efficiency and reduce court backlogs, and the implementation of central procurement. However, there was no significant progress in reducing undeclared work, there is not yet a comprehensive framework for FDI and no measures to increase investor protection have been introduced.

7.2. ECONOMIC OUTLOOK AND RISKS

Economic growth has strengthened recently on the back of investment and construction, while exports remained weak. Available data broadly confirm that the economic recovery took hold in 2015 and the consensus forecast puts real growth at 3.7%. This compares to a growth rate of 1.2% in the previous year. Stronger growth was supported by a recovery of investments mainly resulting from the ongoing construction of the Route 6 highway to Skopje and more than doubled FDI inflows. On the other hand, following strong goods export performance in the first seven months, overall exports finished the year with only marginal 0.7% growth. The substantial decrease in goods exports in the second half of the year is the result of lower crude metals exports. Furthermore, as was evident in 2014, investments in Kosovo react to political turmoil and the ongoing renewed political crisis could therefore have impacted growth towards the end of the year.

Table II.7.1:

Macroeconomic developments and forecasts

	2014	2015	2016	2017	2018
Real GDP (% change)	1.2	3.8	4.0	4.3	4.3
Contributions:					
- Final domestic demand	3.0	5.0	6.1	5.8	5.6
- Change in inventories	-0.5	0.1	0.1	0.0	0.0
- External balance of goods and services	-1.2	-1.3	-2.2	-1.6	-1.3
Employment (% change)	-4.4	2.6	3.0	2.6	2.6
Unemployment rate (%) LFS	35.3	:	:	:	:
GDP deflator (% change)	3.3	0.3	0.5	0.7	0.9
CPI inflation (%)	0.4	-0.2	0.4	0.4	0.6
Current account balance (% of GDP)	-7.9	-9.6	-8.6	-9.1	-9.3

Sources: Economic Reform Programme (ERP) 2016

For the 2015-2018 period, the ERP baseline scenario projects slightly lower economic growth than the previous programme did. Following the weakest growth in ten years in 2014 (1.2%), GDP growth is estimated to have rebounded by 3.8% in 2015 and is expected to remain stable around its long term average of 4.3% by 2018. Private consumption will continue to provide the biggest contribution to GDP, growing by close to 4% on average over 2016-2018, and underpinned by an increasing inflow of remittances and stronger consumer lending. Public consumption is expected to remain subdued under the ongoing IMF standby arrangement. After having rebounded by 9.2% in the first three quarters of 2015 investments are set to continue to grow strongly, by an average of 9.7% per year. Recent changes in the tax system introduced to support domestic production, and announced improvements to doing business, are expected to contribute to a sharp rise in private investments. Budget space for public investment will likely remain limited, and will focus on road infrastructure. However, the newly adopted 'investment clause' of the fiscal rule is meant to allow for additional IFI financed investment spending not to be counted in the fiscal rule adjusted deficit. Owning to the narrow export base, export growth (expected to be 4.9% in 2016-2018) will likely be determined by the external demand for metals, but there are some signs of gradual export diversification in the agriculture, textile production and tourism sectors. Import growth is expected to be 5.2% during this period, and will be underpinned by a strong rise in investments, which usually have a substantial import component. Import substitution, namely of agricultural products, is expected to gradually be strengthened, following rising private investment in domestic production.

On the production side the services sector is projected to grow by 3.9% over 2016-2018, driven by trade, transportation and IT. Both the manufacturing and IT sectors are expected to benefit from the adopted tax and customs exemptions for production line products and IT equipment. However a shortage of high-quality labour force will remain a constricting factor. Expected growth in the agriculture sector (2.6% on average) is not seen as particularly significant, especially following the increases in agricultural subsidies in 2015 and several announced initiatives for improving the sector's competitiveness.

The current IMF programme and the Stabilisation and Association Agreement (SAA) with the EU are important stability anchors. The first review of the standby arrangement was adopted and the government was commended for its work on meeting the programme requirements. Under the ongoing IMF programme, fiscal policy should stay stable at least until the budgetary midterm review in 2017. Furthermore, the recent conclusion of the SAA with the EU will increase Kosovo's profile among investors and facilitate trade and investment.

While broadly plausible, the ERP's growth scenario is subject to a number of risks related to the investment climate, financing conditions and political instability. Throughout the forecast period, domestic risks to growth will arise from an investment climate undermined by an inefficient judiciary, weaknesses in electricity supply, contract enforcement, and an inefficient and unaccountable public administration. The continued restructuring of publicly owned enterprises (POEs), and the privatisation of non-essential ones, is necessary to capture total factor productivity gains and free up resources for new investments. Risk of political instability, reform delay, and backtracking remain prominent.

The low growth scenario foresees a plausible shock to electricity supply and underlines the fragility of the fiscal situation. As growth is slowed to 2% of GDP on account of lower investments, and budget expenditure for energy subsidies increases, the fiscal rule would be breached in the first year without returning to normal throughout the forecasting period. This scenario serves as a warning against further imprudent increases in current expenditure, in particular larger than expected increases in war-related benefits.

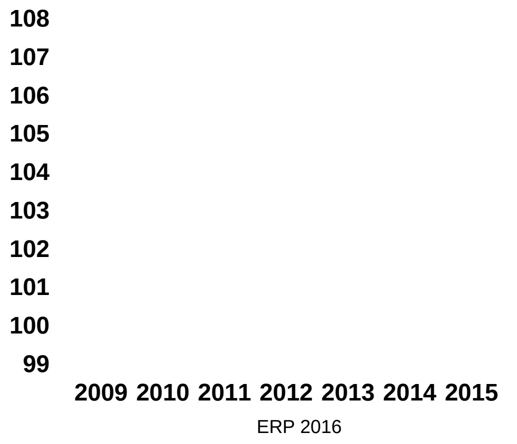
Price developments are outside of Kosovo's control. As a euro-ised economy heavily dependent on external supply, Kosovo price developments are heavily influenced by import prices, especially world food and energy prices. In 2015, Kosovo's CPI inflation was on average -0.5%, due to falling import prices, stagnating food prices, and falling energy prices in the latter part of the year. Core inflation (non-food, non-energy) was negative throughout the year.

Structural external imbalances are a perpetual vulnerability of the economy. A weak and unproductive economic base leaves Kosovo dependent on exporting crude materials and low-value-added products and importing a wide range of consumer and capital goods. The official data for 2015 shows a widening of the current account for the whole year to 9.6% of GDP. Fast growing remittances and a stagnating trade deficit were not enough to either offset or mitigate the large outflow of FDI-related profits and a continuation of the decline in transfers to the government. The ERP predicts that the current account deficit will stabilise at around 9% of GDP over the forecasting period, as a result of growth in FDI-driven investment (8.9% on average). Exports and imports are expected to grow by 6.6% and 5.6%, respectively with gradual export diversification towards higher-value-added products and import substitution in agricultural products and construction material.

Graph II.7.1: External competitiveness and the current account

Evolution of the current account balance
(% of GDP)

Real Effective Exchange Rate
(CPI based, total economy, 2009=100)



The financing side of the balance of payments, with a high proportion of unrecorded flows, remains heavily dependent on volatile FDI inflows. In 2015 net FDI inflow increased to 5.4% of GDP, due to recovery in construction and real estate investments. Since 2009, most FDI has gone to the real estate, construction, and banking sectors. Changing this pattern towards green field investments in tradable production sectors will require broad-based reforms, some of which are outlined in the ERP, aimed at attracting FDI, strengthening property rights protection, improving access to finance, and targeted investment in human capital.

The net international investment position has been positive but has been consistently decreasing since 2013. By the end of 2015, it fell by almost 70% compared to the end of 2014, to 1.7% of GDP. Recovered FDI and new government external debt related to the IMF programme, increased international liabilities, and the asset side, dominated by the central bank, pension and investment funds, kept at a slower pace. Gross external debt remains at a relatively low level of 33% of GDP, with 9.7% of GDP in short-term debt held entirely by the private sector.

Despite optimistic growth forecasts, the effect on depressed labour market conditions remains negligible. Employment is expected to increase on average by 3.1% in the forecasting period, insufficient to absorb the large inflow to the labour force (1.4% annually) and reduce already high unemployment. There are no estimates of unemployment and activity rates in the ERP but there is little chance of a drastic lowering of the two given the structure of the unemployed and inactive population. The proportion of long term and unemployed youth is likely to remain high, as long as the skills mismatch between the available labour force and market needs persists. Furthermore, the 'Dutch disease' effect of the large inflow of remittances increases the wage reservation level, and discourages labour force participation and accumulation of human capital. Labour productivity is projected to grow by a modest 1.1% on average, significantly lower than the 2.5% growth in wages, which raises the possibility of a further loss in competitiveness.

The banking sector remains stable, liquid and profitable, but also heavily under-utilised. Credit growth in 2015 (6.3%) was driven by the supply side as banks lowered lending standards, decreased interest rates and offered products with longer maturities. Despite falling revenue (-2.5%), the banking sector strengthened its profitability due to lower provisioning and safety buffers. The loans- to-deposit ratio and the bank-loan-to-GDP ratio stood at 74.8% and 35.7%, respectively, indicating ample potential space for further financial intermediation. Unfortunately the ERP scenario does not provide specific numbers regarding developments in the financial sector in the forecasting period. It can be assumed that stronger credit growth would resume if banks continued to reduce their lending requirements.

7.3. PUBLIC FINANCE

In 2015, public finances benefited from stronger growth and the ongoing IMF programme. Having inherited the 2015 budget proposal and without enough time to revise it, the new government initially adopted an unrealistic budget. However the budget revision in July 2015 reduced both revenue and expenditure by around 1% of GDP, and brought budget planning to a more realistic level. Nevertheless, budget execution underperformed, both on the revenue and expenditure side, and the deficit remained within the 2% fiscal rule limit. Compared to 2014, budget revenue grew by 8.9%, driven by strong growth in tax revenues. Both VAT and corporate income tax increased significantly (10.3% and 23.1%, respectively) as a result of the increased turnover and profitability in Kosovo's ten largest companies (banks, telecoms and energy production companies). Kosovo customs raised its revenue by 9.1%, through increases in import excise duties, strengthened controls, the introduction of new valuation practices, and improved information sharing. Overall expenditure was 6.1% higher than in 2014. The proportion of spending under current expenditures increased to 74% (71.8 in 2014) due to a full year's effect of public wage and pension increases enacted in April 2014, the implementation of the provisions from the collective agreement which regulates experience premiums for public employees, and increases in agriculture subsidies. Capital expenditure was utilised at 95% of the planned amount, but only thanks to the EUR 25 million advanced payment for construction of the Route 6 highway. Constant underutilisation of the capital investment budget raises questions about institutional capacity for project implementation. The total budget deficit amounted to EUR 117.1 million or 2.0% of GDP. The deficit calculated according to the fiscal rule stood at 1.5% of GDP. Financing of the budget was covered by the issuance of domestic debt with extended maturities. In 2015 Kosovo for the first time issued a domestic bond with a five year maturity. Government bank balances, an additional insurance against fiscal shocks, were increased to EUR 208 million or 3.7% of GDP, through the issuance of domestic treasury bills, financing from the IMF programme and withdrawal of available funding from the privatisation fund.

Maintaining a sustainable fiscal position and improving public financial management are Kosovo's main public finance objectives in 2016-2018. The fiscal rule implemented in 2014 limits the deficit to 2% of GDP and the law on public debt sets the long-term public debt level ceiling to 40% of GDP. To expand the fiscal space in the short run the parliament has adopted an amendment to the fiscal rule which makes it possible to exclude new donor-financed capital projects from the headline deficit. This is in addition to capital investment financed by privatisation proceeds, which is already exempt. To limit the rise in current expenditure as of 2018, a rule governing rises in the budget wage bill has been adopted, limiting its annual growth to nominal GDP growth. Measures to strengthen public finance have also been put in place on the revenue side by changes to the VAT: an increase of the standard rate to 18%, and an introduction of the lower rate of 8% for essential goods and services. To incentivise domestic production and support the nascent IT industry VAT exemptions were introduced for imported production capital goods and IT equipment. To discourage tax evasion the VAT registration threshold was reduced to EUR 30 000 making and additional 1800 enterprises liable to VAT. The direct full year effect of these measures is estimated at EUR 19-35 million. However even more is expected from the secondary effects of increased consumption and domestic production. The ERP fiscal scenario does not foresee any additional tax rate changes. The announced merger of the tax administration and customs is expected to increase productivity and improve service, but the specific mechanisms to achieve thiso remain vague. The merger should be carried out in a transparent way, with a clear action plan, to avoid any political interference.

Table II.7.3:

Composition of the budgetary adjustment (% of GDP)

	2014	2015	2016	2017	2018	Change: 2015-18
Revenues	23.9	25.0	26.2	25.2	24.5	-0.5
- Taxes and social security contributions	22.1	22.0	22.6	22.0	21.5	-0.5
- Other (residual)	1.8	3.0	3.6	3.2	3.0	0.0
Expenditure	26.5	27.1	28.1	27.2	26.6	-0.5
- Primary expenditure	26.3	26.8	27.7	26.7	26.1	-0.7
of which:						
Gross fixed capital formation	7.4	7.0	7.6	7.4	7.6	0.6
Consumption	12.4	12.6	12.5	12.1	11.6	-1.0
Transfers & subsidies	6.5	7.2	7.4	7.1	6.8	-0.4
Other (residual)	0.0	0.0	0.2	0.1	0.1	0.1
- Interest payments	0.2	0.3	0.4	0.5	0.5	0.2
Budget balance	-2.6	-2.0	-1.8	-1.9	-1.9	0.1
Budget balance as per fiscal rule	-2.2	-1.5	-1.6	-1.7	-1.7	-0.2
Primary balance	-2.4	-1.7	-1.4	-1.4	-1.4	0.3
Gross debt level	10.4	13.5	17.3	20.0	22.0	8.5

Sources: Economic Reform Programme (ERP) 2016, ECFIN calculations

The 2016 budget plan appears to be more realistic than in 2015 and tries to limit the growth of current spending. The 2016 budget, adopted by the assembly in December 2015, aims at a fiscal deficit of EUR 95 million([1]) or 1.6% of GDP, in line with the fiscal rule. The budget is based on nominal GDP growth of 4.5% in 2016, and CPI inflation of 0.4%. Total revenue is expected to be EUR 1.6 billion, 9.5%

([1]) Fiscal rule takes somewhat adjusted overall budget deficit.

higher than in 2015. The increase should come from stronger economic growth, the effect of a full year VAT and excise changes, and the repayment of some tax arrears as a result of the new debt amnesty law. Although taxes collected at the border currently account for most of the budget revenue, the implementation of free trade agreements with the EU and Turkey will likely lead to a gradual shift towards domestically collected taxes. Expenditure is forecast at EUR 1.684 billion in 2016, 8.5% higher than in 2015. The budget for wages and salaries will increase by 2.6%, which reflects the implementation of the collective agreement. Subsidies and transfers are planned to increase by 6.3%, reflecting a 25% increase in social assistance, implementation of the law on state-financed pension schemes, provision of pensions to war veterans and other war categories, and maintenance of higher subsidies for agriculture. Increases in transfers have been offset by a rationalisation of expenses in the goods and services category, which will stay at the same level as in 2015. Although the rationalisation of goods and services spending is welcome, further neglect of spending on infrastructure maintenance could yield higher costs in the future. The capital expenditure budget is ambitiously expected to increase by 14.7% compared to 2015. Although 90% of capital spending is allocated to ongoing projects, capacity constraints at the administration level could cause delays and under execution.

The fiscal scenario for 2016-2018 is balanced with few immediate risks. There should not be many fiscal surprises during the IMF programme. However, there could be a period of uncertainty in the second half of 2017. As the IMF programme ends in May 2017 and the newly adopted wage rule does not come into force until 2018, the 2017 budget revision could be under pressure to from groups with a vested interest in increasing wages and entitlements. Government deposits, used as fiscal buffers, are being increased to 4.5% of GDP, a level implied by the fiscal rule; this brings an additional level of insurance against unforeseen financing risks. The incentives of the new privileged pensions for war veterans should be re-examined. Set at the minimum wage level and without any age threshold, they hardly encourage employment; this is evident from the higher than expected number of applications. Political risk remains pronounced. Delay or backtracking in reform implementation due to political instability would affect the compliance with the IMF programme and thus increase the overall instability of the economy. In case of elections, the propensity of political elites to ingratiate themselves with large interest groups (public sector employees, pensioners, war veterans etc.) by means of ad hoc increases of benefits remains a concern. The fiscal impact of the low growth scenario presented in the ERP is substantial. Deteriorating public finances are a result of a 2.4 p.p. drop in average growth, almost unitary budget revenue elasticity to GDP growth,([1]) and an increasing proportion of predetermined spending (current expenditures, and contracted Route 6 spending). In this case, the public debt would rise beyond 26% of GDP in 2018, severely limiting fiscal space made available through the investment clause.([2])

Kosovo's capital investment budget has systematically been underutilised, by an average of 15% of the allocated amount. Underspending seems to be more pronounced at local level. However, central level spending has so far been dominated by large road-building projects which were executed according to plan due to contract obligations with foreign-based contractors. When these projects are excluded, the pattern of underspending is also clearly present at central level. Extremely low levels of utilisation of project financing provided by the international financial institutions (IFI), reflect difficulties in coping with more advanced project preparation and implementation procedures. Furthermore, the local government financing scheme does not incentivise collection of own revenues which could be used for capital investments.

The institutional public finance framework needs further strengthening. A fiscal rule and the Law on Public Finance provide the backbone of public finance management in Kosovo. However, the nascent fiscal regulatory framework lacks enforcement and monitoring mechanisms. Repeated ad-hoc fiscal decision making, with significant fiscal impact, such as commitment to large infrastructure projects and across-the-board increases in wages, pensions and other entitlements, is the main risk to budget credibility

([1]) Estimated total revenue elasticity is 1.05.
([2]) The investment clause is valid until the share of debt to GDP reaches 30%

and fiscal sustainability. It should be legislatively discouraged, especially in election years. Strengthening the fiscal rule with a mechanism governing the increase in current spending would reduce the risk of ad-hoc decision-making. It is recommended that Kosovo sets up a fiscal council of another fiscal rule monitoring and enforcement mechanism with a mandate to evaluate budget outcomes, and contribute to the debate on fiscal issues. Also, strengthening the independence and improving human capital of existing institutions in charge of developing macro-fiscal scenarios and revenue projections would help increase the credibility of government fiscal documents. To improve public finance management, the Ministry of Finance has announced the introduction of mandatory e-procurement and plans to increase the scope of centralised procurement. However, other public procurement reforms should be continued in parallel, to address insufficient administrative capacity, the very weak remedy system, weak enforcement and monitoring etc.

Table II.7.4:

Composition of the budgetary adjustment (% of GDP)

	2014	2015	2016	2017	2018	Change: 2015-18
Revenues	23.9	25.0	26.2	25.2	24.5	-0.5
- Taxes and social security contributions	22.1	22.0	22.6	22.0	21.5	-0.5
- Other (residual)	1.8	3.0	3.6	3.2	3.0	0.0
Expenditure	26.5	27.1	28.1	27.2	26.6	-0.5
- Primary expenditure	26.3	26.8	27.7	26.7	26.1	-0.7
of which:						
Gross fixed capital formation	7.4	7.0	7.6	7.4	7.6	0.6
Consumption	12.4	12.6	12.5	12.1	11.6	-1.0
Transfers & subsidies	6.5	7.2	7.4	7.1	6.8	-0.4
Other (residual)	0.0	0.0	0.2	0.1	0.1	0.1
- Interest payments	0.2	0.3	0.4	0.5	0.5	0.2
Budget balance	-2.6	-2.0	-1.8	-1.9	-1.9	0.1
Budget balance as per fiscal rule	-2.2	-1.5	-1.6	-1.7	-1.7	-0.2
Primary balance	-2.4	-1.7	-1.4	-1.4	-1.4	0.3
Gross debt level	10.4	13.5	17.3	20.0	22.0	8.5

Sources: Economic Reform Programme (ERP) 2016, ECFIN calculations

Public debt is low but remains sensitive to refinancing and fiscal shocks. At the end of 2015, it stood at 13.2% of GDP,([1]) 2.6 percentage point higher than in 2014. Around 49% of the debt is domestically issued, in the form of short maturity treasury bills and bonds, while the rest is mainly held by the IFIs. The average weighted interest rate (3% in 2015) is projected to decrease by 2018. The situation is somewhat confusing in the short term given that Kosovo is progressively issuing domestic bonds with ever longer maturities, and also in the longer term, as Kosovo gradually shifts from concessional loans to market issued international debt. By 2018, the debt level is expected to reach 22% of GDP, with the budget deficit as the main determining factor of debt evolution([2]). The prevalence of short-term debt in is a potential refinancing risk. The government plans to issue EUR 235 million of foreign debt during the forecasting period, most of which will come from the IMF SBA (EUR 116 million). The issuance of domestic bond and treasury bills is expected to amount to 6.3% of GDP on average over the next three years. After the end of the IMF programme, if there is a substantial fiscal shock the government could face financing constraints, given the narrow domestic market, lack of internationally credit rating and

([1]) This figure does not include Kosovo's share of the Paris and London club debt of the former Yugoslavia
([2]) Overall budget deficit according to the ESA methodology. Fiscal rule adjusted deficit omits certain debt funded expenditure

relatively large fixed costs of accessing the international markets. To provide an additional buffer government deposits have been replenished towards the level implied by the fiscal rule (4.5% of GDP) and are expected to reach by the end of 2016. The long-term public debt sustainability analysis presented in the ERP highlights Kosovo's limited room for deviations from the fiscal rule.

7.4. STRUCTURAL REFORMS

Kosovo's structural reform needs are large and cover most sectors with a particular emphasis on access to energy and reducing the widespread informal economy. Tackling these issues will have a significant impact on the budget, the business environment and employment. Kosovo businesses are not yet integrated in global supply chains or the EU single market in a significant way. Although Kosovo's young population provides a great potential, its human capital in general needs development. Labour market imbalances persist, with high unemployment rates of above 35 % particularly among young people (61 %), very low employment rates for women (12 %), and a predominance of long-term unemployment. The weak rule of law has a negative impact on the business environment, which is further undermined by a still weak and unaccountable, albeit improving, public administration and a poor track record for implementing legislation.

The policy guidance jointly adopted in the Ministerial Economic Dialogue of 12 May 2015 were only partially addressed. While the ERP does not report on their implementation in a systematic way, some key follow up actions were taken. The establishment of the National Investment Committee (NIC) is a welcome step towards better assessing future major infrastructure projects, including their fiscal impact. The energy interconnection with Albania has been completed on the Kosovo side, which should improve the security of energy supply in the long-term. However, no significant action to reduce undeclared work has been reported. Steps were taken towards setting up a centralised public procurement system and the board of the Procurement Review Body was recently approved by the Parliament. Overall, Kosovo needs to step up the implementation of the recommendations in the current year.

The ERP correctly identifies most of Kosovo's competitiveness, employment and social inclusion weaknesses and prioritises the reforms accordingly. However, the level of detail provided for the different reform measures is uneven, and many measures would benefit from a more elaborate description of funding sources, budgetary impact for all three years, expected impact on competitiveness and long-term growth, as well as a better analysis of implementation risks and actions planned to mitigate these. The timetable provided for the implementation is very general and does not include a clear operational plan with specific steps to be taken during each projection year. A better differentiation between ongoing and new reform measures would also have been helpful.

Public finance management

The recent PEFA study and OECD assessment on public finance management (PFM) show a certain improvement in this area, yet a number of significant weaknesses remain. The commitment control and asset management continue to be deficient as payments arrears are increased and public spending is financed through unauthorised use of public financial resources. In the specific area of public procurement the key weaknesses are vulnerability to corruption; weak enforcement and insufficient monitoring; insufficient capacity of public procurement bodies and a non-functional remedy system.

The recommendation to improve public procurement has been partially addressed. The law on public procurement has been amended to allow for the introduction of the mandatory e-procurement for all central level budget organisations but implementation is at a very early stage. Central procurement was approved for a list of six products with further scope for broadening. The board of the Procurement Review Body was approved by the Parliament on 30 March 2016 finally making it operational. A broader reform of public procurement will be necessary to address vulnerabilities referred to above.

The planned measure on the launching and application of electronic procurement is relevant but its link with the wider National Strategy on Public Procurement currently being prepared is not explained. Also, a more realistic assessment of the budgetary needs and of the required steps should be carried out. In this context, it would be very important to accompany the proposed measure with awareness raising and capacity building activities that address the possible constraints of SMEs in Kosovo to fully access and use e-procurement. Kosovo is currently developing its PFM reform programme, which should be adopted by the government at the end of May 2016. It will be essential that the measures set out in this reform programme are implemented in accordance with the adopted timetable.

Infrastructure

The main weakness in the transport area is not a lack of physical infrastructure but the poor maintenance and regulatory environment for its management. Therefore, priority should be given to improving traffic management, road safety, border crossing procedures and maintenance systems, rather than to large-scale public investment projects. There are indications that transport links are not a binding constraint for growth at present, but that they require further development to be able to facilitate cross-border trade. Focusing on border crossings should thus help to enable the opening of the market and facilitate trade. There is also a strong need to strengthen the transport regulatory institutions, ensure their independence and improve administrative capacities.

The recommendation to improve government oversight and the assessment of infrastructure projects has been partially addressed. The National Investment Council (NIC) has been set up to assess all strategic public investments according to their cost-benefit and potential impact on the economy. The single project pipeline that will help to strengthen this approach has been approved. Investments in infrastructure are aligned with the regional agenda on connectivity and the core network. However, the recent progress in establishing the NIC and the single sector pipelines has yet to show tangible results. The measure on the construction of the highway to Skopje and rehabilitation of railway line 10 fails to present any solid case for the expected economic impact or contribution to competitiveness, besides some general statements. Taking into account the very large amounts involved in the implementation of this ongoing infrastructure project (EUR 408 million over the next three years), a much clearer cost-benefit and impact analysis would have been expected. Moreover, the project's timeline, monitoring indicators and overall budget should be specified.

The inclusion of the rehabilitation of railway line 10 is relevant as the line is part of the main Kosovo network and connects Kosovo to an international railway corridor. However, the planned activities - it is not clear if they can start before 2018 - are described in only very general terms. The actual implementation timeline and monitoring indicators are too vague, and the project's budgeting is not complete. The risks associated with the implementation of this reform are not sufficiently considered, e.g. the limited capacity of 'Infrakos' for project implementation; competition from the road sector; political risks associated with the segment passing through North Mitrovica; insufficient liberalisation of the railway market; weak capacities of the railway safety authority, etc.

Unreliable energy supply, distribution losses and low energy efficiency have a severe negative impact on private sector development. Moreover, energy tariffs that do not reflect actual costs and the existence of cross subsidies are not fiscally sustainable. Cross subsidies among energy consumer can also represent a disincentive for investment. According to the World Bank, increasing electricity demand coupled with the planned decommissioning of the Kosovo A power plant will create a substantial electricity gap of 3000 gw/h in ten years' time. According to the latest Business Environment and Enterprise Performance Survey (BEEPS), poor access to electricity is the second most important challenge facing the private sector. Commercial and technical losses are high at 28 % (15 % technical; 13 % commercial). The main reason for significant technical losses is the poor condition of the electricity distribution network. The completion of the electricity interconnector with Albania will contribute to the diversification of electricity sources and increase supply reliability, albeit to a limited degree given that both countries' capacity fall short of peak demand and that their demand patterns are concurrent.

The recommendation to advance towards securing a reliable energy supply has been partially addressed through the completion, on the Kosovo side, of the interconnector with Albania. However, to meet this objective, additional generation capacities, a diversification of energy sources, improved energy efficiency and a gradual adjustment of energy tariffs to reflect actual costs are still essential.

The measures on energy are thus pertinent but are presented without links to the broader reform agenda in the sector. The measure on the further development of energy production capacities is indeed a necessary investment. However, the description in the programme leaves out associated risks, such as the dependency on the development of lignite production (mining). Moreover, the deregulation of prices, the need to plan for a gradual adjustment of tariffs to reflect actual costs and the market opening of the electricity sector are also not taken into account. The measure on energy efficiency is also very relevant given the current and future problems of security of supply. However, it is not sufficiently ambitious as it is focused only on existing commitments (loans) targeting public institutions and does not cover the potential energy savings in the residential sector, which represents around 40 % of final energy consumption and 55 % of total electricity consumption. Much more needs to be done to stimulate investments in energy efficiency.

Sector development

Agricultural sector development

Kosovo is one of the biggest importers of agricultural products in Europe on a per capita basis. Many of the imported products could be produced domestically. The agricultural sector is underdeveloped with outdated farming techniques and technologies and fragmented agricultural land plots, illegal changes of agricultural land use and a lack of resources to effectively manage national funds for agriculture and rural development. Improvement of hygiene and food safety standards is also essential to increasing exports of agricultural products.

The two reform measures relating to agriculture are relevant, but the assessment of their impact on competitiveness may not be entirely realistic. The measure on agricultural infrastructure for agro-business plans to establish wholesale markets and expand laboratory capacities, as well as to increase the irrigation system coverage from 15 % to 40 % of arable land by 2020. This would mean an almost tripling of its current coverage in four years, which seems ambitious and unrealistic. Moreover, the budget figures are only presented for 2016. The agricultural sector would benefit from a national strategy for irrigation improvement and expansion, including principles for efficient water use and management. The measure on the consolidation of agricultural land will only be implemented on a voluntary basis. The timeline is not detailed enough and there is a concern that the current process of land consolidation will only cover a number of villages and farms, limiting its impact on competitiveness.

Industry sector development

Kosovo's industry is characterised by a low-value-added and undifferentiated production, as well as weak industry associations and cooperation among companies. The measure to determine the potential for industrial cluster development may be pertinent, but the ERP fails to explain why this is considered the most relevant action in this sector compared to other actions envisaged under Kosovo's industrial policy and the private sector development strategy.

Services sector development

Kosovo's services sector is the largest contributor to employment but it is characterised by small and micro firms that are largely family run, focused on activities with low value-added in non-tradable sectors and by large differentials in earnings across regions. The ERP does not contain a proper analysis of the services sector as a whole but focuses only on the ICT, neglecting other potentially important service areas like retail, wholesale, or those more linked to the diaspora (tourism, real estate, business).

The measure to develop broadband infrastructure in rural areas is relevant for Kosovo's economy. Despite the introduction of VAT exceptions for ICT equipment, a substantial growth in ICT sector will require an adequate supply of educated computer engineers which is lacking. The development of ICT skills for the digital economy is thus especially important, but its potential impact on the economy is limited as activities beyond the pilot phase with the Korean Green Growth Trust Fund are very general and the sources of funding not very clear. Moreover, the development of ICT services requires that in addition to adequate infrastructure, competition among operators and independence of the regulator are ensured.

Business environment, corporate governance and reduction of the informal economy

The large informal sector, together with corruption and poor access to electricity, is one of the top three obstacles to businesses identified by the private sector in the latest BEEPS. In addition, businesses struggle with a complex and changing regulatory framework, notably in customs and trade regulations, multiple state inspections and market surveillance, poor access to finance, weak protection of property rights and contract enforcement, difficult insolvency resolution and the unresolved status of privatisation assets. The informal economy, estimated to constitute around 35 % of GDP, is a key obstacle to competitiveness. A large informal economy damages fiscal revenues and distorts the market by creating unfair competition. Undeclared work also weakens the protection of employees and the systematic evasion of social security contributions hampers building a universal system of social protection.

The recommendation to improve the business environment includes many different elements that have been partially addressed. Kosovo made some partial progress in tackling informalities by easing the process of formalising local businesses. However, no specific incentives were introduced for reducing undeclared work. Progress was much more limited in other areas such as the privatisation of publicly owned enterprises (POEs), although the Privatisation Agency now has a board. No significant progress was recorded in terms of clearing court backlogs, developing cadastre databases or strengthening targeted support for SMEs.

Some of the new measures planned in the ERP 2016-2018 aim to improve the business environment along the lines of the recommendation from 12 May 2015. Streamlining evidence-based policy making through the introduction of regulatory impact assessments, while more linked to public administration reform, can also have a positive impact in the business environment. Strengthening the property rights system and increasing judicial efficiency would address key bottlenecks in the business environment. Strengthening property rights is essential for improving access to finance for SMEs and will help the process of land consolidation. Judicial efficiency reform aims to clear the backlog of court cases that still plague the judicial system in Kosovo. However, neither measure provides enough detail on planned activities, timing or costs, to be able to accurately estimate the quantitative impact on the business environment or the competitiveness of the economy.

The measure on improving the access to finance for Kosovo SMEs is very relevant and addresses one of the key concerns expressed by businesses. If duly implemented and operational, the planned credit guarantee fund has the potential of bringing a tangible benefit to the economy. However, the details provided are very limited and the fund seems to be mostly dependent on not entirely confirmed contributions by external donors.

The measure on improving corporate governance of enterprises with state-owned assets is relevant but does not address the politicisation in the appointments of the management of POEs. POEs do not operate under OECD corporate governance principles nor has the risk they represent for public finances been properly assessed. De-politicisation and professionalisation of the management remain an essential first step in order to enable reforms and modernisation of POEs. The details provided on the reforms related to monitoring, supervision and the centralisation of the Public Enterprise Policy and Monitoring Unit are very limited.

Technological absorption and innovation

Kosovo's capacity for research, development and innovation (RDI) is very low. The public expenditure on R&D is very low (0.10 % of GDP) which shows a low political commitment on the importance of RDI in driving economic competitiveness. Some efforts have been made to update the National Research Programme and to develop an Innovation Strategy but its adoption has been delayed for several years. The main obstacles in the area of RDI include a universities' limited research capacity, a lack of incentives for the private sector and academia, most businesses most businesses very weak financial capacity to invest in RDI, and a lack of infrastructure and networks allowing the integration with regional or global research networks.

The ERP, focussing on the adoption of the innovation strategy as well as implementing measures on fostering business-academia cooperation, is to be welcomed. In particular, the measure on fostering business-academia cooperation through research grants and innovation vouchers is a good initiative that can help address some of the weaknesses in this area. The measure includes important actions to complete the legal and institutional framework for RDI. The envisaged grants and innovation vouchers should include entrepreneurship support for students whose research has clear commercial potential. The Council for Innovation is considering setting up an innovation and entrepreneurship index to benchmark performance in areas such as commercialisation, entrepreneurship and innovation, which would be welcomed. The planned activities on implementing ongoing voucher and grant schemes for SMEs should have been described in more detail in the ERP to make an assessment possible. Awareness raising actions to stimulate participation of SMEs in these schemes and an analysis to understand why SMEs have shown little interest in these schemes so far would be needed. The implementation plans and funding for the Fund for Smart Specialisation are very vague to fully assess its effectiveness, and the fund's link to the obstacles identified and other components of this measure are unclear. Most important, however, is to create the administrative capacity to implement the envisaged actions.

Trade integration

Kosovo faces a number of significant challenges related to its full integration in the global economy. Among the main obstacles in this area are the incomplete regulatory alignment with the EU *acquis*, the poor quality infrastructure, businesses' weak capacity to comply with EU and international standards, and the high costs of, and time needed to, export and import. SMEs in Kosovo face challenges both in developing new products as well as in certifying the products they produce. A lack of experience in marketing and sales also makes it difficult for Kosovo's companies to find contracts in European markets.

The two recommendations related to trade integration have only been partially addressed. The recommendation to amend the Customs Code and adopt new legislation on customs enforcement of intellectual property rights (IPR) has not been implemented. An action plan on trade facilitation has been developed, but the ERP has no information on clear deliverables including a timeline for the Customs Code amendment and the draft law on IPR adoption. The recommendation to adopt a strategic framework for FDI and increase investor protection has not been addressed.

The ERP focuses on one of the underlying structural challenges of the Kosovo economy in exporting its products, namely poor quality standards. The measure on encouraging businesses to improve the quality of their products aims to improve national quality infrastructure systems. To have a real impact, however, the reform should further enhance the direct support to companies to comply with EU standards (access to expertise/financing) and to address the limitations that SMEs face in order to modify their production methods and facilities.

Employment and labour markets

According to available data for 2014 and first indications for 2015, Kosovo's labour market performance is not improving. The labour market participation rate (41.6 % in 2014) still shows that most of the working age population is inactive. Women are particularly underrepresented in the labour force (21.4 %). The employment rate dropped further to 26.9 % in 2014, while unemployment increased strongly to 35.3 % and the data available for 2015 so far point to a further increase in registered unemployment. Aside from women, young people are also particularly affected; youth unemployment rose strongly in 2014 to 61 %. In fact, one third of all young people are not in employment, education or training (NEET), which is of particular concern given the size of the population and the clear risk of further increasing the proportion of the inactive working age population. Tackling the high unemployment rate is hampered by weak labour demand and a wide skills gap as the overall outcomes of the education system are low. The country has great potential to use its youth dividend to increase the workforce and raise productive employment for economic and social development, as long as young people are equipped with the skills expected by employers and potential investors. However, large remittances discourage labour participation and human capital accumulation.

The recommendation to accelerate the modernisation of vocational education, to continue to improve the quality of higher education and improve alignment of the education system to the labour market has only been partially addressed. A review of some vocational education and training (VET) programmes was carried out and a draft law on higher education prepared but not adopted. Rigorous quality assurance measures are still lacking and the accreditation process is not completed. The recommendation on fighting the informal economy included the provision of incentives to reduce undeclared work; this part of the recommendation has so far not been addressed; the government has only adopted a set of recommendations for structural reforms to formalise employment and overcome exclusion and marginalisation.

The measure on better links between education and the labour market identifies the relevant areas for action, but only in fairly general terms. The four areas of activity are presented as ongoing activities for the whole 2016 to 2018 period. Particular attention should be paid to the planned implementation of a pilot VET system combining learning in schools and learning in the workplace. Such a system is welcome and could help improving links with the labour market, but does not replace a more thorough review of the VET provision in Kosovo considering its limited capacity to prepare young people for the demands of the labour market. The measure on implementing a career system for teachers mainly focusses on formal requirements (volume of training) and salary aspects (raising questions about longer-term sustainability), rather than on aspects such as teachers’ competences and further training, which are key to the quality of education.

The measures on the establishment of the Employment Service and the stepping up of active labour market measures are welcome but still underdeveloped. Solid active labour market services and policies are key features needed for a functioning labour market in Kosovo, and the Employment Service's provision of services is not coupled with the new fund’s implementation. The fund’s strategic objectives and the steps for its implementation are not spelled out sufficiently clearly in the ERP, and information about its budget is unclear. Action towards making the Employment Service operational lacks elements on planning, efficient design, implementation and monitoring of labour market policy services and measures on one hand, as well as on providing timely support and advice services to jobseekers. The outstanding administrative steps for establishing the Employment Service as a separate entity outside the Ministry of Labour have not been taken, hampering also the increase of inspection capacities for tackling undeclared work.

Fostering social inclusion, combating poverty and promoting equal opportunities

The multiple social challenges of Kosovo are presented in an analysis which primarily focuses on the weaknesses in the health care system, in particular the quality of care and the system's inability to offer universal coverage to any meaningful extent. There is no indication of follow-up to last year's policy plans on introducing a mandatory health insurance contribution.

Other social policies are only addressed in information on social expenditure. There is no data or analysis of the main challenges related to poverty and social exclusion in the country, or the situation of marginalised groups. The social assistance programme has limited coverage due to the small fiscal envelope.

7.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2015

2015 country policy guidance for KOS	Summary assessment
PG1: Sustain the commitment to fiscal discipline and improve transparency of public finances by considering establishing an independent fiscal council, or fiscal agency, with a clear mandate to preserve sustainability of public finances, and reduce deficit bias, and by better coordination between government and parliamentary bodies responsible for budgetary processes. Improve the budget process by legislatively strengthening the role of the Medium Term Expenditure Framework and enshrine principles of cost-benefit analysis as the basis of the policy planning process. Take steps to increase government deposits to the threshold implied by the fiscal rule (4.5% of GDP) to provide additional financing buffer.	• Kosovo has partially addressed PG1: There have been some discussions between stakeholders on possible modalities for the establishment of the fiscal council/ institution but the discussion has not yet moved to the technical level. All policy initiatives are required by law to be accompanied by a fiscal impact assessment but in practice it is rarely the case. Government deposits have been increased to 3.6% of GDP and are projected to reach the desired target of 4.5% of GDP by the end of 2016.
PG2: Address immediate fiscal risks with necessary measures aimed at reducing unsustainably high current expenditures while preserving growth enhancing capital spending. Develop a legal framework for maintaining a sustainable public wage bill and strengthen targeting and means testing of transfers. Ensure planned increases in agricultural subsidies are directed exclusively at productivity increasing initiatives. Advance public administration reform with special attention on improving productivity and reducing costs. Take further steps in strengthening public finance management practices.	• Kosovo has partially addressed PG2: With the 2015 budget revision expenditure targets have been reduced. Savings have been found namely among the current expenditure. However issues of capital investment budget under-spending and rising political pressures for new entitlements persist. Wage bill has been regulated with the new Wage rule, starting in 2018. Annual rise in the wage bill will be limited to the latest available growth rate of the nominal GDP. Means testing and targeting of transfers have not been strengthened. Furthermore the 2016 budget foresees introduction of the new untargeted war veterans pension. Agriculture subsidies still show weak link to productivity gains and should be re-examined, supported by other structural policies and phased out with time.
PG3: Modernize revenue collection to reduce reliance on customs receipts by improving property tax collection and strengthening the legal framework for collection of tax and municipal tax arrears. Revisit local government grant financing scheme to incentivise better collection of municipal	• Kosovo has partially addressed PG3: Reform measure 14# from this year's ERP envisages the establishment of a common revenue agency by merging the Kosovo Tax Administration and Kosovo Customs which will should improve

revenues. Further broaden tax base by introducing the planned mandatory health sector contributions, and reassess planned tax exemptions.	efficiency of tax collection and reduce tax avoidance. Recommendations from the EU funded project analysing the system of municipal finances have been discussed by the interinstitutional working group on fiscal decentralisation and will be considered for adoption by the ministry of finance in 2016. Introduction of the mandatory health contribution has been postponed.
PG4: Advance restructuring and restart the privatization of non-essential Publicly Owned Enterprises (POEs). Take steps to improve the efficiency and corporate governance of strategic POEs. Address the lack of quorum of the board of Privatization Agency of Kosovo (PAK) and accelerate privatization of Socially Owned Enterprises still in PAK's portfolio.	• Kosovo has partially addressed PG4: Privatization Agency of Kosovo board has been approved in December 2015. No new privatisations or restructurings have been started. No improvement in efficiency and corporate governance of POE. Recent management appointments were done along clear political lines and in contrast with OECD corporate governance principles, and are in breach of Kosovo's law on public enterprises, article 17(2).
PG5: Address the underlying causes for high costs of bank-based financing, reduce the duration and cost of insolvency procedures by adopting the new bankruptcy law and further improve contract enforcement with a view to increase overall financial intermediation in the economy.	• Kosovo has partially addressed PG5: Cost of financing in Kosovo has been somewhat reduced as the banks lowered their financing criteria. Contract enforcement is strengthened by the introduction of private enforcement agents.
PG6: Strengthen government oversight and consider setting up an advisory body to contribute to the assessment of future major infrastructure projects, including their fiscal impact and make sure they align with the regional agenda on connectivity (core network). Advance towards securing a reliable energy supply while ensuring the compliance with the EU environmental standards in the production of energy.	• Kosovo has partially addressed PG6: The National Investment Committee (NIC) has been established. The interconnection with Albania has been completed on the Kosovo side.
PG7: Improve the quality of education by continuing to roll out teacher licencing and training as well as improving quality assurance and strengthening related incentives; improve access to pre-primary and primary school education;	Kosovo has partially addressed PG7: A review of five VET programmes was undertaken and is about to be finalised.

accelerate modernization of vocational education, continue improve quality of higher education and improve focus on aligning the education system so as to make it more responsive to the labour market. Assure the timely operationalisation of the recently established Public Employment Service and its effectiveness in lowering the high unemployment rate.	Preparatory steps were taken for making the Employment Service operational as a separate entity outside the Ministry of Labour, but the process is not yet completed since the Director of the Employment Service still needs to be nominated. A draft law for reforming Higher Education has been prepared. The rolling out of the new curricula for primary and secondary education has started.
PG8: Continue to improve the business environment and continue with the clearing of court backlogs, strengthening capacities of judicial system, and developing cadastre databases. Advance measures to tackle informality in line with the strategy for the prevention and fight against informal economy, including incentives to reduce undeclared work. Reduce the administrative burden for business by implementing the Better Regulation Strategy and the Law on Permits and Licences. Develop measures to provide targeted support for SMEs and to widen their access to finance. Step up the fight against corruption and efforts to improve public procurement, by enhancing administrative capacity, increasing efficiency and effectiveness of the Public Review Board, and implementing central procurement.	Kosovo has partially addressed PG8: The strategic plan for Kosovo's judiciary and the national strategy for reducing court backlogs are being implemented. There was some tax reform easing the tax burden and the process of formalising local businesses. There was liberalisation of the market for fiscal devices. There were some measures for collection of fiscal receipts. No specific incentives were introduced for reducing undeclared work. The Law on Normative Acts was approved by the government. The Voucher Counselling Scheme was introduced. No specific measures adopted yet to widen access to finance. The Public Procurement Law was amended and e-procurement introduced. Central procurement approved for list of 6 products (tenders launched, 1 contract signed). The board of the Procurement Review Body was recently put in place.
PG9: Facilitate trade by amending the Customs Code and adopting new legislation on customs enforcement of IPR.	Kosovo has partially addressed PG9: Laws on Patents, Trademarks, Industrial Design and GEO Indications and Designation of Origin were adopted.
PG10: Adopt a holistic approach to Foreign Direct Investment that anchors supportive policies in a strategic framework and focus on removing existing obstacles. Increase investor protection by developing an investor after-care program and establish an investor grievance mechanism.	Kosovo has not addressed PG10.

7.6. THE 2016 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, 25 May 2016

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

1. To improve forecast accuracy enhance technical capacities of the services preparing the macro fiscal framework, strengthen parliamentary oversight capacities in evaluating budget planning and execution as well as fiscal risks and take first steps towards establishing an independent fiscal body.

2. Identify offsetting measures for recent increases in categorical benefits while preserving the share of capital spending and address persistent under spending of the capital budget by improving project preparation and management capacities at central and local administration levels.

3. Further address the underlying legal and institutional factors responsible for both high cost of credit and difficulties in access to finance so as to increase financial intermediation in the economy, while establishing a reliable measure of private sector inflation expectations so as to better gauge price developments.

4. Implement the action plan of the strategy for the fight against the informal economy. In particular, speed up the risk assessments focusing on the sectors and branches most vulnerable to informalities in order to identify and apply appropriate corrective measures.

5. Increase energy security by reinforcing the planned energy efficiency measures to include incentives for the private sector and households and by adopting a plan for the gradual adjustment of energy tariffs to reflect actual costs.

6. Set up an action plan for tackling youth unemployment based on an assessment of the challenges and focussing on improving education outcomes including through improved teacher training and supporting school-to-work transitions. Ensure that the Employment Agency has sufficient capacity. Take measures to increase labour market participation of women.

Annex: Overall Assessment of programme requirements

The Kosovo Economic Reform Programme (ERP) for 2016-2018 was submitted on time. The government approved it following a roundtable discussion with representatives of NGOs and business associations. It is in line with the previously approved medium-term fiscal strategy and national development strategy. This is the second iteration of the programme submitted to the European Commission and there has been some improvement over the first iteration. Overall the document is of good quality in terms of content, structure, and analytical approach. The analysis of the impact of the proposed structural reforms on the macro-fiscal framework has improved compared to last year's document. Estimates have been made for all measures most of which were already planned and budgeted for before the development of the 2016 budget.

Ownership and internal coordination

The ERP was jointly coordinated by the office of the Prime Minister and the Ministry of Finance. It was formally endorsed by the government. An inter-ministerial working group involving 11 ministries worked on its preparation. The coordination of the costing exercise between the office of the Prime Minister and the Ministry of Finance could be improved.

There is a strong correlation between the ERP and the recently adopted National Development Strategy, which is positive. On the other hand, the link to the annual budget and medium-term fiscal framework is still weak. The programme is linked to the European Commission’s annual report in several ways and corresponds well to the requirements of the recently concluded Stabilisation and Association Agreement.

Stakeholder consultation

The government held two public consultations with social partners, business associations, civil society organisations and academia, as well as the Association of Kosovo Municipalities. The draft was also presented to the National Committee on Economic Development. It is unclear whether trade unions were involved in the consultations. It is indicated that the draft will be presented to the Parliament for information. The ERP does not contain any written contributions from stakeholders, no information on the time allowed for comments and no indication of whether feedback was integrated in the final draft. This should be improved next year.

Macro Framework

The presented macro-fiscal framework in the 2016 ERP is broadly plausible. External assumptions have been taken from the IMF October World Economic Outlook and the Commission's autumn forecast. Credibility of the fiscal framework has been greatly improved on the account of more realistic revenue projections. Developed low growth alternative scenario is useful to showcase the fragility of Kosovo public finance and should be used to highlight the importance of prudent fiscal behaviour.

Fiscal Framework

The fiscal framework was prepared in cooperation with the IMF and is in line with the MTEF 2016-2018 and the 2016 budget. It envisages plausible revenue projections due to renewed growth and several policy actions taken in 2015. On the expenditure side the risk remains of capital spending under-execution and the further increase of current spending.

Structural reforms

The sections on structural reform priorities follow the guidance note, present a diagnostic per area, and report on the implementation of the policy guidance from last year. However, the reporting should have been included in the overview on pages 2-5 of the ERP. Moreover, more detailed and up-to-date information on the implementation should have been provided. The structural reform priorities included in the 20 measures correspond well to the key obstacles identified in the diagnostics and in many cases to the policy guidance from 12 May 2015. The number of reforms is limited to 20. However, the page limit of 80 pages has not been respected.

The description of each reform measure in terms of specific actions and timeline should be made in such a way that it can be easily monitored annually in the coming three years. Some of the measures contain such details while others do not. Tables 10-12 in the annex have been filled in. Table 11 should have contained more detailed timelines and descriptions of activities at least by year if not by quarter. The summaries in table 12 are very helpful and sufficiently detailed.

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