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2023 Economic Reform Programmes of Albania, Bosnia and Herzegovina, Montenegro, North Macedonia, Serbia, Türkiye and Kosovo*

The Commission's Overview & Country Assessments

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EUROPEAN ECONOMY

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Directorate-General for Economic and Financial Affairs
Directorate-General for Neighbourhood and Enlargement Negotiations
Directorate-General for Employment, Social Affairs and Inclusion

2023 Economic Reform Programmes of Albania, Bosnia and Herzegovina, Montenegro, North Macedonia, Serbia, Türkiye and Kosovo*:

The Commission's Overview and Country Assessments

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

EUROPEAN ECONOMY

Institutional Paper 252

CONTENTS

LIST OF TABLES

LIST OF GRAPHS

INTRODUCTION

Economic governance has become one of the three key aspects of the EU enlargement process over recent years, mirroring efforts in the EU to strengthen economic policy coordination and multilateral surveillance under the European Semester. In its 2013 and 2014 enlargement strategies, the Commission outlined a new approach to economic governance. It involved clear guidance on the reforms needed to foster macroeconomic stability, ensure fiscal sustainability and support long-term growth and competitiveness. Focus on fundamental reforms, including those related to the economy, was further re-inforced in the revised enlargement methodology adopted by the Commission in February 2020. In the same vein, the Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye has since 2015 provided jointly agreed and targeted policy guidance for each candidate country or potential candidate.

This Dialogue is based on medium-term Economic Reform Programmes (ERP) submitted annually by all candidate countries and potential candidates ([1]). The ERPs include a macroeconomic and fiscal policy framework as well as structural reform plans to boost competitiveness and long-term growth. The ERP exercise also aims to help candidate countries and potential candidates develop their institutional and analytical capacities and to prepare them for participation in the EU's multilateral surveillance and economic policy coordination procedures once they become Member States of the EU.

In early 2023, Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, Serbia and Türkiye submitted their ninth annual Economic Reform Programmes covering the period 2023-2025 ([2]). The programmes were assessed by the European Commission and the European Central Bank. Based on these assessments, joint conclusions with country-specific policy guidance ([3]) were agreed and adopted at the Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye, held on 16 May 2023.

This paper contains the Commission staff's assessments of the ERPs for 2023-2025, preceded by a horizontal overview summarising the key findings from a cross-country perspective, and taking stock of the implementation of the country-specific policy guidance adopted in 2022. The cut-off date for the assessments was 12 April 2023.

The 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.

Comments would be gratefully received and should be sent to:

Directorate-General for Economic and Financial Affairs
Economies of candidate and pre-candidate countries
European Commission
B-1049 Brussels

or by e-mail to Uwe.Stamm@ec.europa.eu

([1]) Further to the 23 June 2022 European Council decision to grant the status of candidate country to Ukraine and to the Republic of Moldova and to recognise the EU membership perspective of Georgia, the dialogue will be extended to Ukraine, Moldova and Georgia in 2024.

([2]) The Economic Reform Programmes can be found at https://ec.europa.eu/neighbourhood-enlargement/enlargement-policy/policy-highlights/economic-governance_en

([3]) This paper includes at the end of each country assessment the country-specific policy guidance adopted in May 2023.

Part I

Horizontal Overview of the 2023 Programmes

1. HORIZONTAL OVERVIEW OF THE 2023 PROGRAMMES

1.1. INTRODUCTION

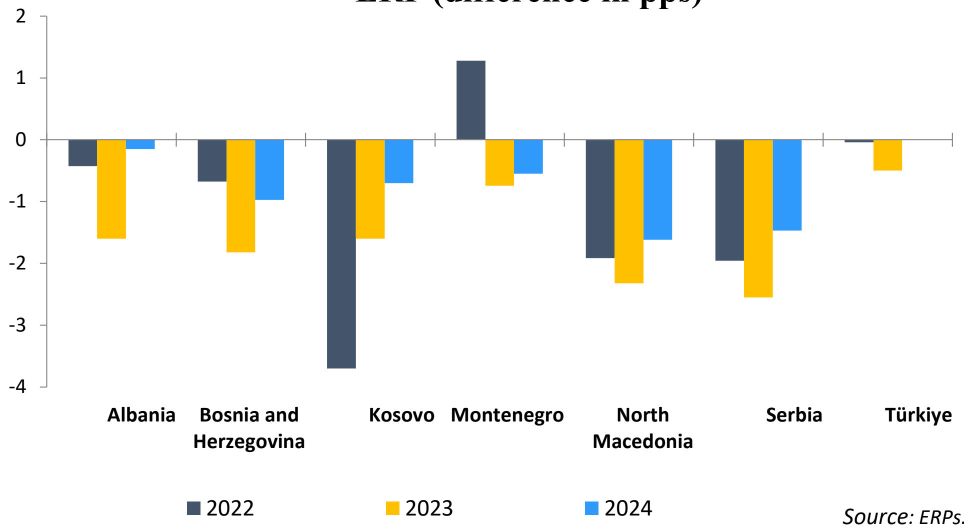
This section is based on the Commission's assessments of the 2023 Economic Reform Programmes (ERPs). It provides an overview of the economic situation and outlook and discusses the main challenges that the Western Balkan and Türkiye ([4]) are facing. The note serves as a background to the Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye taking place in spring 2023.

1.2. MACROECONOMIC AND FISCAL DEVELOPMENTS AND OUTLOOK

Following a very strong rebound in 2021 from the downturn caused by the COVID-19 pandemic, economic growth decelerated across the region as a whole in 2022 (substantially in the eastern part of the Western Balkans) but remained relatively solid in the western part of the Western Balkans and in Türkiye. Economic activity weakened especially in the second half of 2022, due in particular to the economic fallout from Russia's war of aggression against Ukraine. Based on preliminary estimates, average annual GDP growth varied from a moderate 2.1% in North Macedonia and 2.3% in Serbia to a still robust expansion in Kosovo (3.5%), Bosnia and Herzegovina (4.0%) and Albania (4.8%), and to strong output gains in Türkiye (5.6%) and Montenegro (6.1%). Food- and energy-driven inflationary pressures dampened the growth of real disposable income, but private consumption generally remained the main growth driver across the region, while government consumption and investment made mostly neutral contributions to growth. In some countries (particularly Serbia and North Macedonia) the contribution of net exports became significantly more negative due to the increased cost of energy imports and decelerating external demand.

([4]) Türkiye's ERP was prepared and submitted before devastating earthquakes hit the country in February 2023, causing a tragic loss of human life and significant destruction of capital assets. The full economic impact of the earthquakes is yet to be assessed. A preliminary damage assessment, which covered 11 of the 17 provinces declared as earthquake-stricken zones (accounting for around 16.5% of Türkiye's overall population and around 10% of its GDP), estimated the direct costs of the disaster at USD 103.6 billion. This figure may be revised upward as a result of further, more detailed assessment. The resulting impact is likely to dampen economic growth somewhat in 2023, but reconstruction could boost growth in the following years.

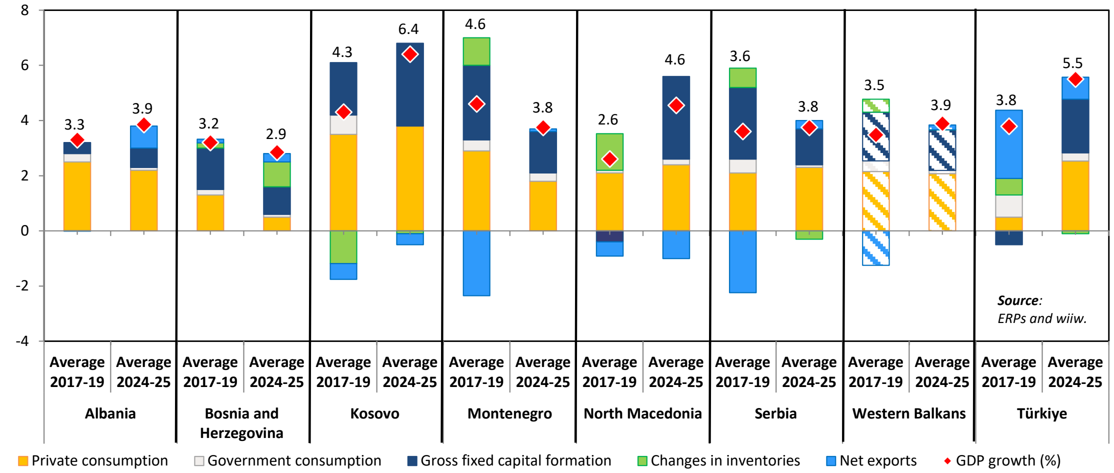
Graph I.1.1: **GDP growth: divergence from previous ERP (difference in pps)**



Source: ERPs.

The ERPs expect GDP growth to stabilise or decelerate further in 2023 before picking up again in 2024-2025 to reach or exceed pre-pandemic rates of expansion. Russia's war of aggression against Ukraine is having a negative impact on the Western Balkans and Türkiye mainly through indirect channels, including higher energy and food prices, tighter financing conditions and lower growth prospects in the EU (their main trading partner). Growth projections have therefore been revised downwards compared with last year's ERPs, especially for 2023 (see Graph I.1.1). Albania, Bosnia and Herzegovina and Montenegro expect some further significant deceleration in their GDP growth rate in 2023 while North Macedonia, Serbia and Türkiye expect that their growth rate will remain broadly constant. Only Kosovo forecasts reacceleration already in 2023, due mainly to a major increase in public investment. For 2024-2025 most ERPs project the rate of growth to pick up significantly, especially in 2024 (by around 1 percentage point) followed by a more moderate increase in 2025. Only Montenegro expects a further slight deceleration in GDP growth in 2024-2025 and Türkiye expects a broad stabilisation. With the exception of Bosnia and Herzegovina and of Montenegro, the Western Balkans and Türkiye project economic growth to reach or even exceed pre-COVID-19 rates of expansion in 2024-2025 (see Graph I.1.2). Economic growth is projected to be strongest in Kosovo, North Macedonia and Türkiye, with average annual growth rates in 2024-2025 of around 2 percentage points (pps) above the levels in the three pre-pandemic years. The key growth driver in both the Western Balkans and Türkiye is projected to be domestic demand (primarily private consumption and gross fixed capital formation). The contribution of investment to growth is expected to be especially strong at 3 pps a year on average in 2024-2025 in North Macedonia and Kosovo, reflecting the authorities' plans to significantly increase public capital spending. Net exports are projected to reduce GDP growth in Kosovo and North Macedonia in 2024-2025, but they are expected to contribute positively to growth in Albania, Bosnia and Herzegovina, Serbia and Türkiye, and to have a broadly neutral impact on growth in Montenegro.

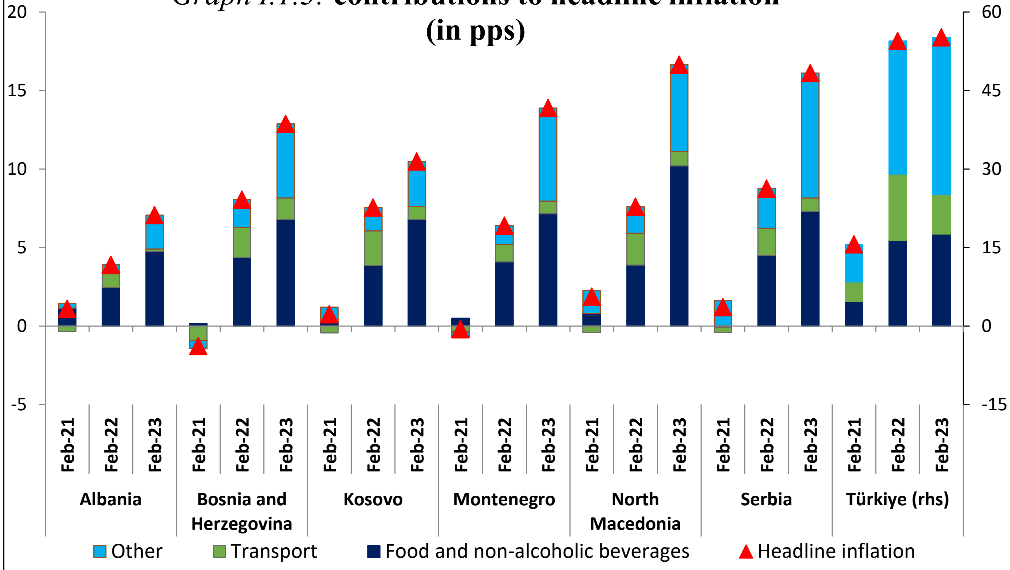
Graph I.1.2: **contributions to real GDP growth (in pps)**



The ERPs' growth projections are still subject to significant downside risks in a context of sizeable adverse shocks and higher-than-usual uncertainty. The Western Balkans and Türkiye have shown remarkable resilience in the face of successive shocks stemming from the COVID-19 pandemic and Russia's invasion of Ukraine. Even so, in an uncertain economic environment, their growth outlook is (as elsewhere) heavily impacted by the further economic fallout of Russia's war of aggression against Ukraine. Risks to the global outlook have also increased due to the recent banking sector stress in some countries outside the region. In particular, additional increases in energy and food prices, persistently high core inflation and the resulting further tightening of monetary policy could weaken the growth outlook of the region's main trading partners in the EU, weighing on external demand and remittances to the Western Balkans and Türkiye. Moreover, baseline growth projections for Kosovo and North Macedonia rely heavily on substantial increases in public investment that may be challenging to achieve in view of persistent weaknesses in public investment management and a poor record of implementing the capital budget. In Türkiye, the continued overly loose and unorthodox monetary policy stance creates additional uncertainty which might, in combination with the country's vulnerability to changes in investor sentiment, further weigh on its economic outlook. Recognising the prevalence of downside risks, most ERPs (except Türkiye's) include at least one lower growth scenario, although these are not always well-developed.

Inflation has reached double digits in most of the Western Balkans and Türkiye continues to face much larger price pressures in the context of an overly loose monetary policy. Following an initial increase to high single digits in the second half of 2021, inflation accelerated further until the autumn of 2022 throughout the Western Balkans, bringing average annual inflation to double digits (between 10% and 15%) with the sole exception of Albania (6.9%).

Graph I.1.3: **contributions to headline inflation (in pps)**

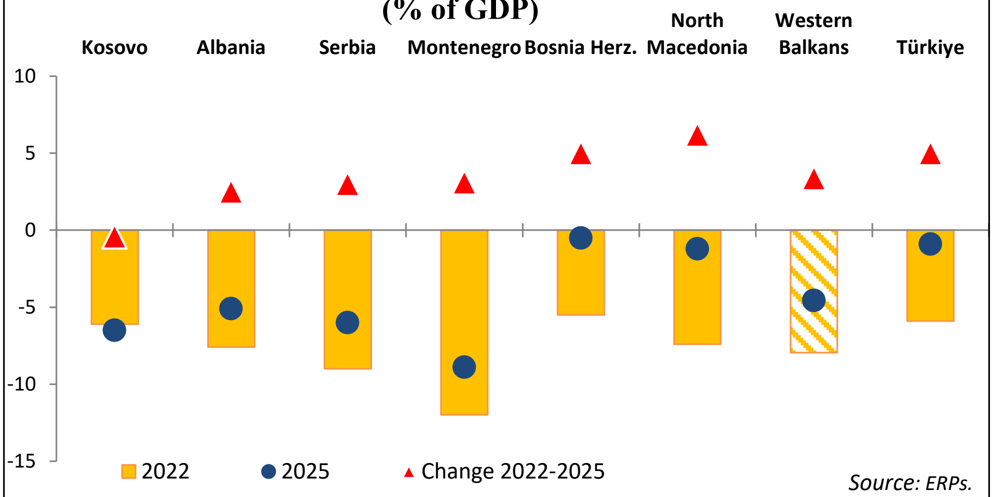


Source: National authorities and EC staff calculations.

The surge in inflation was particularly driven by food and energy prices (reinforced by the relatively high weight of food and energy in the consumer price baskets in the Western Balkans), but the contribution of items other than food and transport has gradually increased (see Graph I.1.3). Central banks with monetary policy autonomy (in Serbia, North Macedonia and Albania) have reacted to above-target inflation by embarking on a tightening cycle. Most of the Western Balkans ERPs expect average inflation to fall sharply in 2023 to around half of the 2022 level (with the exception of Serbia, which projects average annual inflation to remain broadly unchanged in 2023, partly due to scheduled increases in regulated energy prices). Persistent international price pressures and domestic second-round effects on core inflation mean that the sharp drop in average annual inflation in 2023 projected in most Western Balkan ERPs appears optimistic. The ERPs project a further gradual fall in inflation across the Western Balkans to average annual rates in the range of around 2% to 3% by 2025. In Türkiye, the effect of global price pressures has been aggravated by continued unorthodox monetary policy decisions which resulted in further cuts to the policy rate to deeply negative levels in real terms. This contributed to the weakening of the lira and drove annual inflation up to a peak of 85.5% in October 2022, denting disposable incomes and eroding consumer confidence. On the back of sizeable base effects, inflation decelerated sharply to a still very high level of 50.5% in March 2023. Türkiye's ERP forecasts that the inflation rate will fall steadily to 24.5% by the end of 2023 and below 10% in 2025, but this appears too optimistic unless the policy stance tightens substantially. A series of regulatory and macroprudential measures (to reduce dollarisation, support the lira, lower inflationary pressures, ration and direct credit, and limit interest rates) have achieved some short-term results but have failed to address the fundamental drivers of high inflation (i.e. the deeply negative real interest rates, the lack of an effective policy anchor and the weakened institutional independence of the central bank and key agencies). Inflation is therefore likely to remain high at above 40% in 2023 due to unanchored expectations, inertia and exchange-rate volatility.

The terms-of-trade shock led to a substantial deterioration in the current account balance in most of the Western Balkans and Türkiye in 2022, but the ERPs mostly forecast that the external deficit will narrow in 2023-2025. The energy-balance-induced surge in the goods trade deficit, which tended to be only partially offset by increases in exports of services and higher remittances, caused the current account balance to deteriorate very significantly in 2022 in most of the Western Balkans and Türkiye.

Graph I.1.4: **projected evolution of current account balances (% of GDP)**



Source: ERPs.

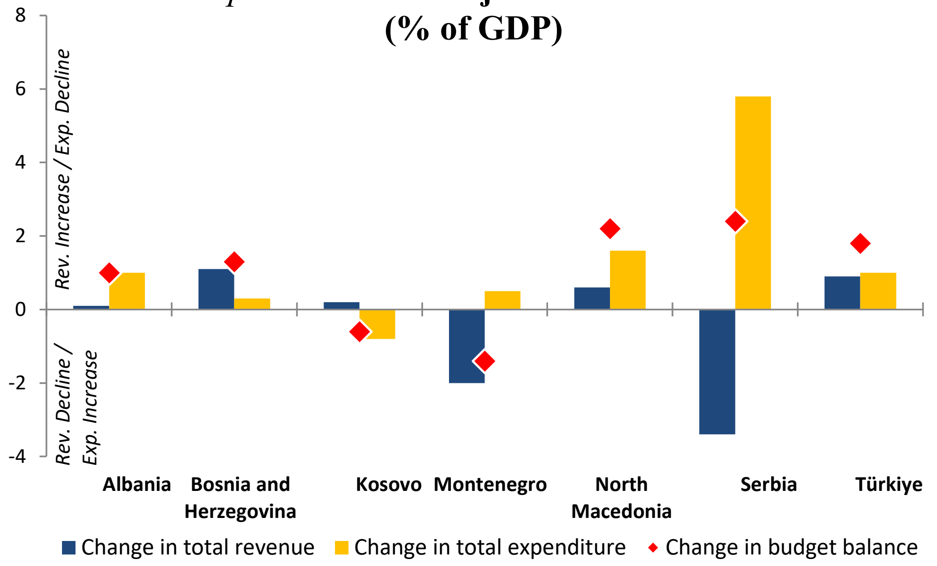
Note: Western Balkan countries are presented in increasing order of the change 2022-2025

Albania was the only exception because its higher surplus in services trade fully offset the increase in the merchandise trade deficit. For 2023-2025, most programmes project a gradual narrowing of the current account deficit, mainly as a result of an improving goods trade balance helped by the expected normalisation of import prices (see Graph I.1.4). These projections are subject to major uncertainties (particularly the further development of energy and food prices). The Western Balkans ERPs expect that foreign direct investment inflows will continue to be the main way of meeting external financing needs, but these inflows might be vulnerable to increased uncertainty and lower growth prospects. Serbia and North Macedonia successfully tapped the international markets by issuing sizeable Eurobonds in early 2023. They also agreed disbursing financial assistance programmes with the IMF at the end of 2022, and North Macedonia also requested macrofinancial assistance from the EU. Foreign reserves at the end of 2022 were able to cover at least 5 months of imports in Serbia, Montenegro, Albania and Bosnia and Herzegovina, and 4 months in North Macedonia, thereby providing a certain safeguard against adverse shocks.

Helped by the effects of high inflation supporting revenues and containing real expenditure growth, most budget balances improved in 2022 despite substantial ad hoc fiscal support. In most of the Western Balkans, strong revenue performance (driven by high inflation) and contained real expenditure growth (including some underexecution of capital spending) broadly offset substantial expenditure on discretionary fiscal support measures to mitigate the impact of the energy crisis, which often did not target those most in need. This led to a slight year-on-year decrease in fiscal deficits across most of the Western Balkans in 2022, with the budget balance improving by an estimated 0.6 pps in North Macedonia, 0.7 pps in Albania and Kosovo and 1.0 pp in Serbia. However, it is estimated to have deteriorated by around 1.5 pps in Bosnia and Herzegovina and by as much as 2.9 pps in Montenegro, reflecting in the latter case the sizeable effect of the abolition of mandatory health contributions and the introduction of a tax-free band for wage income. The general government deficit thus ended up at around 5% of GDP in Montenegro and North Macedonia, 4% in Albania, 3% in Serbia and close to balance in Kosovo as well as Bosnia and Herzegovina. Türkiye's general government deficit is estimated to have declined by 1.8 pps to 0.8% of GDP as buoyant tax revenues boosted by rampant inflation and good corporate profits, as well as the inflation-induced suppression of real personnel expenditure and social transfers, have only been partially offset by a significant increase in transfers and lending to mitigate high energy prices and support the liraisation strategy.

Fiscal plans differ across the region, but most ERPs project a gradual improvement in the budget balance over the programme horizon. With the exception of Montenegro, the budget deficit is planned to fall below 3% of GDP in all of the Western Balkans and Türkiye by 2025 (and substantially lower in many cases), assuming significant fiscal adjustments. Bosnia and Herzegovina's ERP projects that its budget surplus will increase further.

Graph I.1.5: **fiscal adjustment 2022-2025 (% of GDP)**

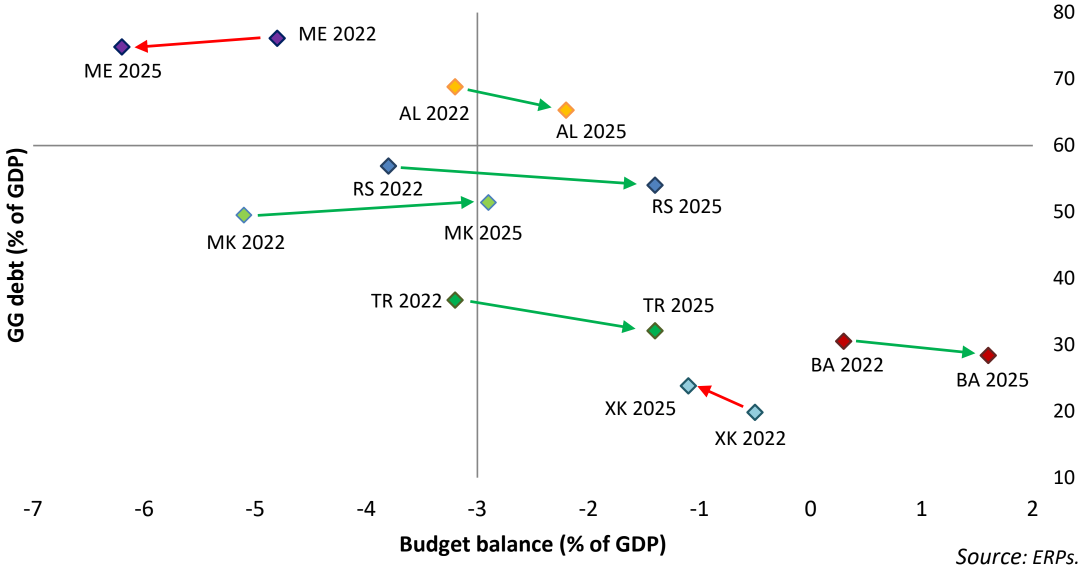


Source: ERPs.

This is surprising given the country's moderate growth, high investment needs and low public debt levels. In the case of North Macedonia, the planned fiscal consolidation path is somewhat backloaded and it is expected that the pre-crisis primary balance will only be achieved in 2027. In Kosovo, after 2 years of strong consolidation, the ERP envisages a sizeable fiscal impulse in 2023 while still expecting compliance with the fiscal deficit rule over 2023-25. The budget balance improvements across the region are projected to be achieved mostly by keeping spending growth below nominal GDP growth (see Graph I.1.5) – except for Kosovo, where a surge in public investment is forecast to more than offset the expected decrease in transfers and subsidies as a share of GDP. In addition to containing spending, Bosnia and Herzegovina, North Macedonia and Türkiye also project that the revenue-to-GDP ratio will rise, whereas Serbia expects a substantial decrease in the revenue ratio (although this will be more than offset by the decrease in expenditure as a share of GDP). Only Montenegro projects a deterioration in its budget balance in both 2023 and 2024 due to a further fall in the revenue ratio and sustained high spending resulting from mandatory allocations for public wages, social transfers, pensions and the health insurance fund. This would result in continued large budget deficits which are projected to rise from 5.9% of GDP in 2023 to 6.2% in 2025 (this implies a procyclical fiscal stance which appears unwarranted because inflation remains high and fiscal risks are mounting). Montenegro's sharply rising debt repayment needs (especially in 2025), coupled with tightening financing conditions, creates vulnerabilities and calls for a more prudent fiscal position. In all countries, further potential fiscal measures to mitigate the impact of adverse shocks (particularly high energy and food prices) and a further adverse economic fallout from Russia's war against Ukraine could disrupt or decelerate fiscal consolidation plans. Continuing underexecution of capital spending compared with budget plans is an upside risk for the fiscal balance but a downside risk for potential growth.

Most ERPs project that the debt-to-GDP ratio will broadly stabilise or decrease between 2022 and 2025, with only Kosovo and North Macedonia expecting their debt ratios to increase in this period (see Graph I.1.6). After broadly stabilising across the Western Balkans and Türkiye in 2021 (but falling sharply by 21 pps in Montenegro), public debt-to-GDP ratios fell more substantially in 2022 – largely due to the impact of high inflation on budget balances and nominal GDP. The debt ratio is estimated to have fallen particularly significantly (by almost 8 pps) in Montenegro, mostly due to substantial growth and a significant draw-down on the government's cash buffer to pay back maturing debt. Going forward, the main driver of the expected moderate debt decrease is in most cases the favourable snowball effect, as the rate of nominal growth is projected to exceed the effective interest rate for all Western Balkan economies. In Albania and Bosnia and Herzegovina, the projected primary surplus is expected to contribute most to the decrease of the debt ratio. Except for the strongly negative contribution in the case of Montenegro and a broadly neutral impact in Albania, stock-flow adjustments are in most cases expected to push up the debt ratio, thereby decelerating the overall downward trend (particularly in Türkiye, Serbia, and Bosnia and Herzegovina).

Graph I.1.6: **projected changes in budget balance and general government debt, 2022-25**

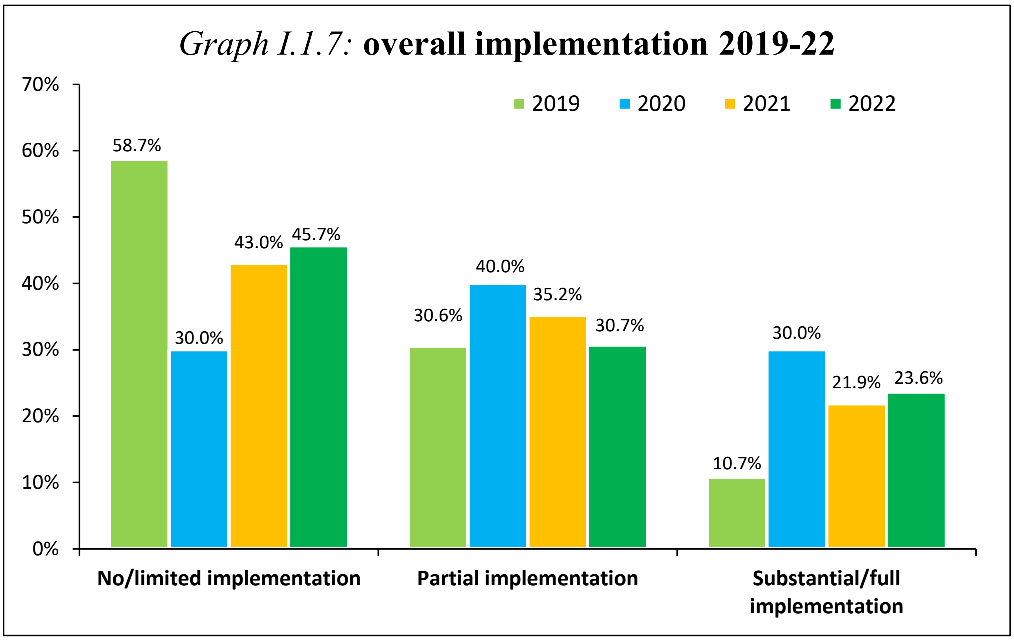


Source: ERPs.

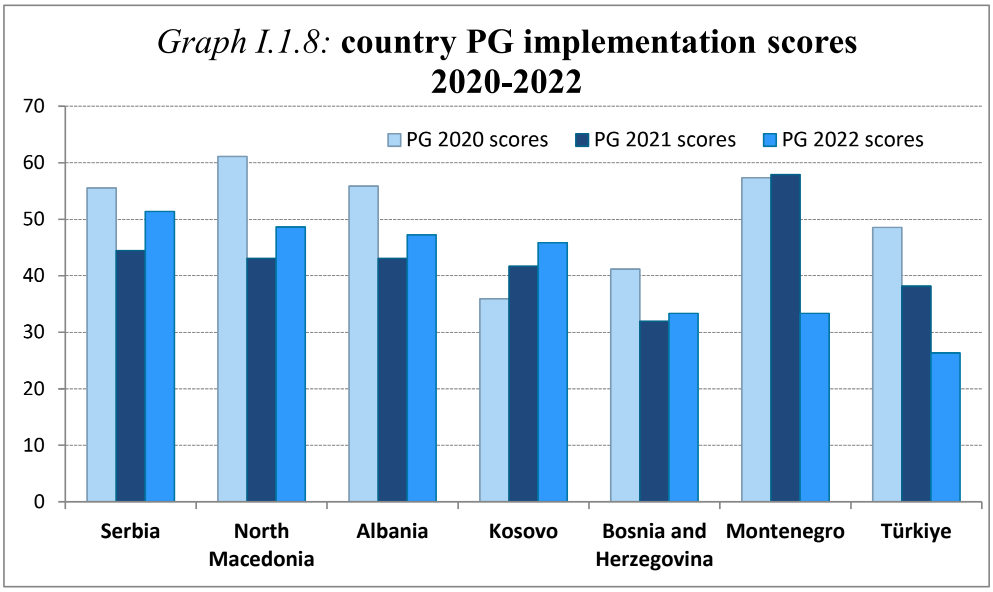
1.3. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED IN 2022

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye has adopted targeted policy guidance (PG) for all partners in the enlargement region. The PG represents the participants' shared view on the short-term policy measures that should be implemented in order to address macrofiscal vulnerabilities and structural obstacles to growth. The PG's underlying rationale is similar to that of the country-specific recommendations usually adopted under the European Semester for EU Member States. Implementation of the PG is evaluated by the Commission in the following year's ERP assessments (5).

(5) The detailed evaluation of individual PG items can be found in Section 5 of the Commission's ERP assessments.



The level of implementation of last year's PG remained broadly stable when compared with that for 2021. The average score across the Western Balkans and Türkiye has slightly decreased (from 42.9 out of 100 for the implementation of the PG adopted in 2021 to 40.9 in 2022 ([6]). 45.7% of the policy recommendations saw no or only limited implementation, which is a slight deterioration compared to last year. Less than a quarter of the PG (23.6%) has been substantially or fully implemented, but this is still the second best performance since 2017 – after the exceptionally high score for the implementation of the COVID-19-focused PG from 2020 (see Graph I.1.7).



([6]) For a detailed description of the methodology used to assess PG implementation, see Section 1.3 of the Commission's Overview and Country Assessments of the 2017 Economic Reform Programmes. This is available at https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en.

Compared with last year, most of the Western Balkans have managed to improve their performance, but the overall implementation level was reduced by a deteriorating score for Türkiye, Bosnia and Herzegovina and especially Montenegro. These three countries had the lowest level of implementation of the 2022 PG. This is especially striking for Montenegro because it had achieved the highest score among the Western Balkans and Türkiye last year (see Graph I.1.8). This result is probably due to protracted political instability in Montenegro and underlines the importance of a stable government with a strong sense of ownership of the ERP and the jointly adopted PG for fostering a strong reform performance.

Graph I.1.9: **PG 2022 individual scores**

The scores vary to some extent, but 4 out of 7 exceeded 40 (see Graph I.1.9). Overall, the implementation of the policy guidance adopted in 2022 is assessed as ‘partial’ (7) for most partners, with Serbia achieving the highest score (above 50), while the implementation of the PG has been limited in Türkiye, Montenegro and Bosnia and Herzegovina (with scores at or below 33.3).

1.4. MAIN CHALLENGES

First, while standing ready to provide targeted and temporary support to vulnerable households and companies affected by adverse shocks, fiscal policy should avoid amplifying the inflationary effects of ongoing supply shocks and a broad-based fiscal impulse to the economy is not warranted in 2023. In later years, differentiated medium-term fiscal consolidation strategies should help achieve prudent medium-term fiscal positions and rebuild largely depleted fiscal buffers. The economies of the Western Balkans and Türkiye proved resilient in 2022, but the economic fallout from the Russia’s war of aggression against Ukraine has caused a significant slowdown in growth throughout the region (including through higher energy and food prices, and decelerating trade and investment). In view of the substantial negative impact of adverse economic shocks in most of the region and the

(7) The assessment categories are as follows: limited (0-37.5), partial (37.5-62.5), substantial (62.5-87.5) and full (87.5-100) implementation.

devastating earthquakes in Türkiye, it appears appropriate for fiscal policy to provide support, where needed, to the most vulnerable households and businesses through well-targeted, temporary and transparent fiscal measures. At the same time, fiscal policy in 2023 should avoid amplifying inflationary pressures. This is even more important in countries with no monetary autonomy and therefore limited tools to manage aggregate demand and achieve price stability. A well-calibrated return to a more prudent fiscal position appears warranted in the medium term in order to gradually reduce the debt burden and rebuild fiscal buffers.

Second, continuing efforts should be made to make budgets more growth-oriented in order to better support the economic recovery. All Western Balkan partners (except Serbia) are planning to increase public capital spending as a share of GDP in 2023 (as compared with the actual 2022 outcome). Kosovo, Montenegro and North Macedonia expect to broadly keep the 2023 public investment ratio constant over the remaining programme period, but Albania, Bosnia and Herzegovina and Serbia project a slight decrease in 2024-2025. All partners need to maximise the growth-enhancing effect of increased capital allocations by supplementing them with higher expenditure efficiency and a proper cost-benefit analysis of investment projects. This includes improving investment management (e.g. project planning and selection) and potential reprioritisation (after crisis-induced structural changes and in view of green and digital adaptation needs and energy security concerns) as well as ensuring that the full benefit is gained from EU funding. Appropriate resources also need to be allocated to develop human capital and mitigate the scarring effects of recent adverse shocks by investment in education, training and health.

Third, given the considerable crisis-induced deterioration of fiscal positions in the early 2020s, fiscal-structural reforms should be prioritised in order to strengthen medium-term debt sustainability. This should include increasing the capacity to mobilise public revenue by improving tax administration and reforming distortive, inefficient and costly tax exemptions. Failure to contain current spending (especially on public wages, pensions and social transfers) has been a persistent problem across the Western Balkans and could hamper fiscal adjustment efforts. It is therefore important to put in place or reinforce fair, transparent and sustainable public wage and pension systems as well better target social transfers. Efforts should also continue to monitor and address fiscal risks stemming from public guarantees, inefficient state-owned enterprises and public-private partnerships that are often not transparent. These fiscal risks may have become more acute following recent crises and the policy response to them. Finally, fiscal governance needs to be improved by reinforcing or introducing fiscal rules (with the necessary escape clauses to allow for exceptional circumstances), setting up independent fiscal councils and strengthening medium-term budgeting. This would send a strong signal that the authorities are committed to returning to a more prudent fiscal position, thereby lowering the country risk premium and sovereign borrowing costs. Some recent encouraging steps include the adoption of North Macedonia's new Organic Budget Law, which provides for the introduction of fiscal rules and a fiscal council; the adoption of a new set of fiscal rules in Serbia; and progress in Montenegro on plans to set up a fiscal council.

Fourth, the Western Balkans and Türkiye need to closely monitor and address inflation developments and the impact of adverse shocks on the financial sector. Persistent price pressures mean that price developments need to be carefully monitored and monetary policy tightened further (if needed and if monetary policy tools are available) to ensure price stability in the medium term. Macroprudential indicators have remained sound overall and capital adequacy ratios are well above the minimum requirements in the Western Balkans, but there may be pockets of vulnerability, and some delayed impact of recent price shocks and tightened financing conditions. The ratio of non-performing loans (NPLs) decreased slightly throughout the enlargement region in 2022, but the economic slowdown triggered by Russia's war of aggression against Ukraine and tightening financing conditions may lead to some deterioration of banks' asset quality that needs to be closely monitored and addressed by strengthening legal and regulatory frameworks for NPL resolution. In line with high inflation, average credit growth accelerated further in nominal terms across the Western Balkans (except for Montenegro) but slowed in real terms (particularly in the second half of 2022). Annual credit growth also picked up strongly in Türkiye to 56%, the NPL ratio remained low and the banking sector is adequately capitalised, but high dollarisation poses a particular challenge.

Fifth, all seven economies face challenges with their business environments and a high share of informal economic activity that prevents them from achieving their full potential. For most, the regulatory and institutional environment remains a key challenge that hampers private-sector development and competition because it is unable to ensure a level playing field. Several economies also face problems with still sizeable and unprofitable state-owned enterprises, which lead to a misallocation of resources and unfair competition. All enlargement partners struggle with corruption, legal unpredictability and slow legal procedures that make their economies less attractive to foreign and domestic investors. These challenges should be overcome with effective and well-coordinated structural reforms to improve the business environment and the investment climate. These should include significant efforts to strengthen the rule of law and institutions in order to fight corruption. Widespread informal economic activity undermines competition, hinders the efficient allocation of state and private resources, and reduces tax revenues and the funding of social security systems. For most economies, the informal economy is driven by the overall weak institutional and regulatory environment, the insufficient enforcement capacity of the public authorities, corruption and low awareness of the negative social implications of informality. Low levels of trust in government and the perceived low quality of public services further discourage tax compliance. Undeclared work leads to reduced job security and safety at work. In order to overcome these challenges, there is a need to incentivise tax compliance (e.g. through public awareness measures, simplification of administrative procedures and lower maximum limits for cash transactions) and to strengthen law enforcement in this area.

Sixth, Russia's war of aggression against Ukraine has had – and continues to have - significant spill-over effects for the Western Balkans and beyond, thus underlining the need to enhance energy and food security. Energy dependence, supply insecurity and higher and more volatile prices for fossil fuels (including gas) have affected the affordability and availability of energy for both households and businesses. This has triggered emergency short-term responses, including the EU's Energy Support Package (approved at the end of 2022). Securing access to natural gas remains a concern in several Western Balkan economies and particularly Serbia, North Macedonia and Bosnia and Herzegovina, which import between 85% and 100% of their gas supply from Russia. The disruption in supply chains continues to negatively affect food prices, and the supply of wheat as well as necessary fertilisers. The war's continuation has increased real and perceived risks for investors and this has in turn created challenges in mobilising private-sector finance. It remains crucial to reduce vulnerability to external shocks and to increase food and energy security, and accelerating the clean energy transition is key to securing a sustainable energy supply that is resilient to external shocks. This can be achieved by promoting energy efficiency measures, accelerating the deployment of renewable energy and diversifying the energy and electricity mix.

Seventh, the lack of regional economic integration in the Western Balkans prevents the region from realising its full growth potential. All Western Balkan partners have made a commitment to boost regional economic cooperation and create a common regional market based on the EU's four freedoms (free movement of goods, services, capital and people) but also covering aspects of digital, investment, innovation and industrial policy. This should stimulate competition and allow economies of scale and productivity gains. Such a regional market based on EU rules and standards would provide a stimulus for intra-regional trade and investment, increase the benefits of big infrastructure projects and make the Western Balkans a more attractive investment destination. It would also be an important stepping-stone to integrating the region more closely with the EU Single Market even before the countries' EU accession, further contributing to the economic growth of the region.

Eighth, low labour-market activity rates (especially among women and young people) and poorly targeted active labour-market policies remain key challenges. Despite positive labour-market developments and rising employment rates in most economies recovering from the COVID-19 pandemic, the enlargement partners continue to have generally low activity rates as well as high unemployment. Structural challenges remain, including under-utilisation of labour resources and lower integration of women, young people and less represented ethnic groups in the labour market. The gender employment gap in 2021 ranged from 11-16 pps in Montenegro, Serbia and Albania to around 33 pps in Kosovo and 38 pps in Türkiye. This was well above the EU-27 average of 10.8 pps. The small progress seen in recent years was reversed in 2021 in several economies. The outreach and coverage of support services for jobseekers are limited. Active labour-market policies are not sufficiently targeted at categories that are most in need (e.g. the long-term unemployed and people from ethnic or minority background) and only a limited range of measures is on offer. The Western Balkan partners undertook in July 2021 to gradually establish and implement Youth Guarantee schemes and established interministerial expert groups to develop Youth Guarantee implementation plans. North Macedonia is a front-runner, implementing the Youth Guarantee countrywide since 2019 and has, together with Albania and Kosovo, adopted Youth Guarantee implementation plans. The remaining plans are under development. From around 20% to more than 30% of the workforce is engaged in undeclared work. No comprehensive strategies have yet been implemented to address the issue. Social partners are not regularly consulted on the design and implementation of economic, employment and social policies. Social dialogue between employers and workers (including collective bargaining) remains weak.

Ninth, social spending is not well targeted towards the poorest segments of the population. Despite positive economic trends after the COVID-19 crisis, high levels of poverty remain a problem in all partners and are set to be exacerbated by the recent soaring food and energy price inflation. Means-tested social assistance schemes are underfunded and there are gaps in the coverage of those most in need. The low levels of support are ineffective in reducing poverty. However, relatively generous non-means-tested social benefits (for instance to war veterans) might serve as a disincentive to work. Income inequality is higher than the EU-27 average but has shown a downward trend in most cases. People in vulnerable situations also have difficulties in accessing social care services, whose coverage is weak and sometimes non-existent in remote and rural areas.

Tenth, structural skills mismatches persist due to underinvestment in human capital and weak education systems, including the low labour-market orientation of vocational education and training (VET). The education systems in the Western Balkans and Türkiye face challenges from early childhood education and care (ECEC) until the transition to the labour market and adult education. Enrolment in ECEC is particularly low compared with the EU and this potentially affects long-term education outcomes, especially for children from a less favourable economic background. Efforts to increase pre-school education (especially in remote areas and for marginalised communities) are a first step in the right direction. Increasing the inclusion of vulnerable groups in education systems is also key and some economies are already making progress here. New curricula are being introduced in pre-university education, but social partners and the private sector need to be more involved. There remains a significant mismatch between the provision of secondary and tertiary education and the needs of the labour market, and this often impedes a smooth transition from school to work. VET schools do not adequately teach skills that match employers' needs and work-based learning is rather limited. Furthermore, the low level of participation in adult learning and lack of awareness in the general population of the need to acquire qualifications in lifelong learning both remain issues. The training of teachers at all levels of the education system (including in the new curricula) remains a challenge for most economies.

Eleventh, universal coverage and equal access for all to the essential healthcare services remain a challenge. Public expenditure on healthcare as a percentage of GDP in the Western Balkans and Türkiye is well below the EU-27 average. Health insurance coverage is generally lower than in the EU, with the exception of Serbia. Unmet needs for medical care are higher than the EU-27 average (1.8% in 2020) in all enlargement economies and significantly higher in Albania and Kosovo. The main barrier to accessing healthcare is the high out-of-pocket expenditure rate, which is more than twice the EU-27 average (except for Türkiye, where it is close to the EU-27 average) and creates an additional burden for low-income households. The availability and number of medical staff is an additional challenge because many doctors emigrate to higher-income countries. Some economies are addressing this problem by making the medical profession more attractive and thus retaining doctors and nurses. Vulnerable groups (e.g. Roma, women, persons living in rural areas and persons living in poverty) experience significant barriers in accessing healthcare. This increases inequalities and reduces the productivity of the population in the long run. Investment in healthcare from the earliest age (starting with pre-natal and maternal care) would offer economic benefits by reducing future treatment costs and boost human capital. Overall, there is a need to strengthen the financing of the healthcare sector in the Western Balkans and Türkiye, as well as to improve access to, and the affordability of, high-quality healthcare.

1.5. CONCLUSIONS

As presented above and in the individual Commission staff working documents, there are many macrofiscal and structural challenges in the Western Balkans and Türkiye. These are to some extent similar to challenges that EU Member States are facing. They are compounded by the current context of a global economic slowdown and high inflation aggravated by the economic fallout from Russia's war of aggression against Ukraine, which requires governments to stand ready to take appropriate policy responses to mitigate adverse shocks for vulnerable households and businesses while also managing aggregate demand to encourage disinflation. Against this background, the ERP-based Economic and Financial Dialogue has become an even more important forum for sharing experiences, discussing policy strategies and jointly agreeing on priority reforms to foster sustainable public finances, price stability and resilient growth. Confronted with growing instability, strategic competition and security threats, the EU has decided to take more responsibility for its own security and to take further decisive steps towards building EU resilience, reducing dependencies and designing a new growth and investment model for 2030 (including building a more robust economic base). This also implies the need for greater energy diversification and fostering green and digital investment. These objectives of good governance and economic prosperity are also relevant for the Western Balkans and Türkiye, and can be best achieved by addressing the challenges outlined above. Moreover, most of these challenges are best addressed simultaneously in order to obtain the best possible outcome.

Table I.1.1:
Economic Reform Programmes 2023 – key indicators

	2019	2020	2021	2022e	2023	2024	2025
Real GDP growth (% change)							
Albania	2.1	-3.5	8.5	3.7	2.6	3.8	3.9
Bosnia and Herzegovina	2.8	-3.2	7.6	2.7	1.7	2.7	3.0
Montenegro	4.1	-15.3	13.0	7.7	4.4	4.0	3.5
North Macedonia	3.9	-4.7	3.9	2.7	2.9	4.1	5.0
Serbia	4.3	-0.9	7.5	2.5	2.5	3.5	4.0
Türkiye	0.9	1.8	11.4	5.0	5.0	5.5	5.5
Kosovo	4.8	-5.3	10.7	4.1	5.5	6.1	6.7
Unemployment rate (% LFS)							
Albania	12.0	12.2	12.0	11.2	10.7	10.2	9.8
Bosnia and Herzegovina	15.7	15.9	17.4	15.7	15.3	14.4	13.1
Montenegro	15.4	18.4	16.6	15.5	14.5	13.7	12.9
North Macedonia	17.5	16.6	:	:	:	:	:
Serbia	11.2	9.7	11.4	9.9	9.5	9.0	8.3
Türkiye	13.7	13.1	12.0	10.8	10.4	9.9	9.6
Kosovo	25.7	25.9	20.7	:	:	:	:
Current account balance (% of GDP)							
Albania	-7.9	-8.7	-7.6	-7.6	-6.9	-5.6	-5.1
Bosnia and Herzegovina	-2.6	-3.3	-2.3	-5.5	-1.3	-0.6	-0.5
Montenegro	-14.3	-26.1	-9.2	-12.0	-10.5	-9.9	-8.9
North Macedonia	-3.0	-2.9	-3.1	-7.4	-5.6	-2.1	-1.2
Serbia	-6.9	-4.1	-4.3	-9.0	-8.5	-6.7	-6.0
Türkiye	1.4	-4.5	-0.9	-5.9	-2.5	-1.4	-0.9
Kosovo	-5.7	-7.0	-8.7	-6.1	-5.4	-6.2	-6.5
Inflation (CPI annual % change)							
Albania	1.4	1.6	2.0	6.7	3.6	3.0	3.0
Bosnia and Herzegovina	0.6	-1.1	2.0	13.1	6.7	3.1	2.2
Montenegro	0.5	-0.8	2.4	13.0	5.0	3.0	2.2
North Macedonia	0.8	1.2	3.2	14.3	8.5	2.4	2.0
Serbia	1.8	1.6	4.0	12.0	12.5	5.3	3.0
Türkiye	15.2	12.3	19.6	72.3	31.6	19.7	11.9
Kosovo	2.7	0.2	3.3	11.6	4.3	2.2	1.2

e: estimate.
LFS: labour force survey.
Sources: Economic Reform Programme (ERP) 2023 for 2021-2025, CCEQ for 2019 and 2020.

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

Table I.1.2:
Economic Reform Programmes 2023 – fiscal indicators

	2019	2020	2021	2022e	2023	2024	2025
Total revenue * (% of GDP)							
Albania	27.2	25.9	27.0	28.2	29.5	28.3	28.3
Bosnia and Herzegovina	42.5	42.1	40.4	40.4	41.1	41.3	41.5
Montenegro	43.4	44.6	44.3	39.8	39.3	38.0	37.8
North Macedonia	31.5	30.5	32.4	31.8	32.8	32.5	32.4
Serbia	42.0	41.0	43.3	43.0	40.9	40.4	39.6
Türkiye	29.7	29.6	30.9	29.5	30.8	30.5	30.4
Kosovo	26.8	25.4	27.7	27.8	29.3	28.1	28.0
Total expenditure * (% of GDP)							
Albania	29.1	32.6	31.6	31.4	32.1	30.5	30.4
Bosnia and Herzegovina	40.6	47.4	38.6	40.2	41.1	40.7	39.9
Montenegro	45.4	55.7	46.2	44.5	45.2	44.2	44.0
North Macedonia	33.7	38.9	37.8	36.9	37.4	35.9	35.3
Serbia	42.2	49.0	47.4	46.8	44.2	42.5	41.0
Türkiye	32.9	32.5	33.5	32.8	34.3	32.9	31.8
Kosovo	29.7	33.0	28.9	28.4	32.8	30.4	29.2
General government balance (% of GDP)							
Albania	-1.9	-6.7	-4.5	-3.2	-2.6	-2.2	-2.2
Bosnia and Herzegovina	1.9	-5.3	1.8	0.3	0.0	0.7	1.6
Montenegro	-2.0	-11.1	-1.9	-4.8	-5.9	-6.2	-6.2
North Macedonia	-2.2	-8.3	-5.4	-5.1	-4.6	-3.4	-2.9
Serbia	-0.2	-8.0	-4.1	-3.8	-3.3	-2.2	-1.4
Türkiye	-3.2	-2.9	-2.6	-3.2	-3.5	-2.4	-1.4
Kosovo	-2.9	-7.6	-1.2	-0.5	-3.4	-2.2	-1.1
General government debt (% of GDP)							
Albania	65.8	74.5	73.2	68.8	67.5	66.3	65.3
Bosnia and Herzegovina	32.7	36.6	32.0	30.5	30.2	29.5	28.4
Montenegro	76.5	105.2	84.0	76.1	73.6	74.8	74.8
North Macedonia	40.5	51.9	52.0	49.5	51.0	51.8	51.4
Serbia	52.0	57.0	57.1	56.9	56.1	55.1	54.0
Türkiye	32.6	39.7	41.8	36.7	35.2	33.6	32.1
Kosovo	17.6	22.4	21.5	19.8	22.6	23.0	23.8

e: estimate.
* 2019 and 2020 data from Ministry of Finance.
Sources: Economic Reform Programme (ERP) 2023 for 2021-2025, CCEQ for 2019 and 2020.

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

Part II

Country analysis

1. ALBANIA

1.1. EXECUTIVE SUMMARY

Although economic growth in Albania will slow in 2023, the economic reform programme (ERP) expects it to firm up in 2024 and 2025. In 2022, the economic recovery slowed, but GDP growth remained strong at 4.8%, driven by private investment and consumption. Inflation rose to an annual average of 7%, prompting the central bank to start tightening monetary policy by raising its policy rate. The ERP projects economic growth to slow to 2.6% in 2023 due to a less favourable external environment that is set to dampen exports. In addition, the tighter financing conditions and increased uncertainty about the impact of Russia's war against Ukraine affect private consumption and investment. In 2024, growth is expected to rebound to 3.9% and stay close to this rate in the medium term, mainly supported by private consumption and investment and exports. The main downside risks are related to overly optimistic projections for net exports and private investment growth. As the impact of high import prices looks set to fade, inflation is expected to meet the 3% target in 2024. Moderate employment growth in 2023-2025 is projected to reduce the unemployment rate gradually to 9.8% by 2025.

Fiscal consolidation has accelerated, and the ERP aims to achieve a positive primary balance from 2023. Following strong revenue growth, considerable savings on interest and personal expenditure and lower-than-planned execution of foreign financed public investment, the 2022 budget deficit was 3.7% of GDP. This is lower than originally envisaged despite additional expenditure to shelter households and small businesses from the high energy and food prices. Supported by increasing revenue, including the EU's budget support for energy, the budget deficit is set to fall in 2023 to 2.6% of GDP. At the same time, the primary balance is set to reach a small surplus, in line with the new fiscal rule. In the medium term, a decreasing expenditure-to-GDP ratio is projected to lower the budget deficit to just above 2% of GDP and to further increase the primary surplus. In 2022, the public debt ratio fell much more than expected in the ERP, by 8.6 percentage points (pps) to 64.6% of GDP, which is below the 2019 pre-crisis level. The reduction is expected to continue by about 1 pp per year.

The main challenges Albania faces are the following.

- **The planned fiscal consolidation is set to gradually rebuild fiscal space, but this should be complemented by a tighter control of fiscal risks and greater transparency of budget revisions.** The gradual reduction of the public debt ratio and a return to a positive primary balance should be implemented to rebuild fiscal space in the medium term. This should be accompanied by a steady reduction of public-sector arrears throughout the fiscal year. Applying the budget revision process provided for in the budget law for all budget amendments would make fiscal planning more transparent. Furthermore, a systematic risk assessment would help inform decisions on state guarantees and on-lending to public bodies and contribute to debt sustainability and limit fiscal risks.

- **A higher tax revenue ratio based on well-prepared tax reforms, coupled with more efficient spending, is crucial for financing the necessary investment in human and physical capital to boost productivity.** The planned fiscal consolidation needs to be supported by increasing the tax revenue ratio, including by broadening the tax base, reflecting the results of the consultation with civil society stakeholders to ensure the quality, applicability and acceptance of tax reforms. A higher tax revenue ratio is crucial for ensuring that human capital development, including social protection, education and health, is adequately financed. To monitor public expenditure on R&D, the respective data has to be collected first. In addition to increasing expenditure on measures that boost growth, steps should be taken to make public investment spending more efficient. This can be achieved by strengthening the approval process for investments and advancing the necessary legal amendments to fully integrate public-private partnerships (PPPs) into this process.

- **There is a need to increase funding and capacity for skills and training, social protection, and healthcare to improve employability and social inclusion.** 30.7% of the population aged 15-64 are economically inactive (not currently working or looking for work). Participation in vocational education and training (VET) is growing but level remains relatively low compared to its regional peers and economic demand – only 17.7% of upper secondary students enrolled in VET schools in 2021. Skill mismatches and quality issues in education and vocational training persist, as schools have yet to develop curricula that attractive for students or that are relevant to the needs of the labour market. The fact that few adults participate in lifelong learning hinders the matching of skills supply and demand. Even growing sectors such as ICT struggle to recruit staff, so providing digital skills training and promoting work-based learning in the digital sector could yield substantial benefits. High inactivity rates are reflected in the high percentage of people living at risk of poverty or social exclusion (45% in 2021, compared to 21.6% in the EU-27). The social protection system relies heavily on cash transfers, which have low adequacy, but efforts are under way to establish a systemic review and increase of the benefits. Social services are limited and unevenly distributed around the country, and local governments have limited capacity to provide them. To tackle these issues and improve access to and availability of social services, a Social Fund mechanism has been set up.

- **Albania should step up efforts on connectivity, the green transition and adapting to climate change.** The country remains a net importer of electricity, which contributes to its trade imbalance. The energy sector also remains unstable and ineffective, with insufficient supply security due to a heavy dependency on hydroelectricity, which is vulnerable to climate change. Russia's war against Ukraine has led to higher and more volatile energy prices, increasing costs and charges for households and businesses. Albania needs to manage water resources better, and tackle waste and waste-water issues addressed. Smart and sustainable mobility could help address business needs and energy challenges.

- **Further efforts are needed to nurture competitiveness, and tackle the informal economy and the digital transition.** Micro and small businesses, which account for a far higher level pf employment and added-value than the EU average, still struggle to access finance. Diversification of production and exports is also low. Albania could improve competitiveness by further improving digital skills, by addressing infrastructure and property issues, and by introducing prevention policy measures. Research and innovation funding remains below the regional average. The informal economy remains an obstacle to business development and competition, despite some results of "fiscalisation" (the obligatory electronic recording of sales subject to VAT) and other measures to combat it.

The policy guidance jointly adopted at the Economic and Financial Dialogue of 24 May 2022 has been partially implemented. Fiscal consolidation progressed, control of arrears and fiscal risks improved, and the reform of public investment management began. Some tax measures planned in the draft medium-term revenue strategy (MTRS) were implemented, but the formal consultation and adoption of the strategy were dropped. Although the share of expenditure on social protection increased, the share on education decreased, and health expenditure stalled. No data was available on R&D expenditure. The Bank of Albania began normalising monetary policy and ended the provision of unlimited liquidity to banks. It prepared a draft regulation for data collection on the real estate sector but had not conducted asset quality reviews of the major systemic banks. The longstanding dispute over bailiff tariffs was resolved but the government introduced no measures to promote the use of the national currency.

The key challenges identified in the 2023-2025 ERP partly correspond to those identified by the Commission, but the proposed policy response is not sufficiently reflected in the fiscal framework.

The programme's macro-fiscal framework is based on optimistic projections for net exports and private investment above historical averages. In addition, although the planned pace of fiscal consolidation adequately supports the policy mix, the composition of the fiscal adjustment does not sufficiently reflect the identified expenditure needs for improving the availability of the public goods that are needed to increase productivity. The analysis of structural obstacles fails to examine key sectors of the economy, notably industry and services (except tourism). While the analysis of the green transition does look at some of the challenges facing Albania, on which a specific measure is included, the shared European growth model on the green and digital transition needs to be further improved, especially in the current geopolitical context. In line with the EU strategy for the digital agenda in the Western Balkans, the reform of the development of the broadband infrastructure is expected to benefit the economy. The reform measures largely address the identified key challenges. However, the ERP does not include any measures to improve the quality of higher education.

1.2. ECONOMIC OUTLOOK AND RISKS

GDP growth decelerated but was still robust at 4.8% in 2022 ([8]), higher than the ERP estimate ([9]), driven by private investment and consumption. The increase in private investment remained solid and private consumption grew even faster than in 2021, leading to higher-than-expected economic growth despite shrinking public investment and consumption and a negative contribution of net exports. The robust rise in private consumption was supported by continued strong employment growth, which brought the unemployment rate down to 11%. Real private wages grew by about 5%. On the production side, construction and services were the main growth driver, partly due to buoyant tourism.

The ERP expects growth to slow further to 2.6% in 2023 before recovering to almost 4% in 2024-2025. The slowdown in 2023 is due to a less favourable external environment that is dampening exports of services, tighter financing conditions, and increased uncertainty holding back private consumption and investment. These factors are expected to be only partly compensated by an increase in public consumption and investment. As import growth is forecast to decelerate sharply, net exports are projected to have a slightly positive contribution to growth. From 2024, private consumption and investment and exports are expected to return as the main drivers of growth, which is estimated to stay close to 4% in the medium term. Despite assumed average private investment growth of 4.2% per year, total investment is projected to fall from an average of 23.4% of GDP in 2020-2022 to 22.3% in 2023-2025 as post-earthquake reconstruction should end in 2023. Real growth of exports of goods and services is expected to average 4.3% per year in 2023-2025, whereas imports of goods and services are projected to grow by 2.2% on average. This should result in an average positive growth contribution of 0.6 pps per year from net exports. Employment is expected to rise by an average of 0.5% per year in 2023-2025, gradually reducing the unemployment rate to 9.8% in 2025. The mobilisation of the inactive population is expected to remain the main driver of labour supply, given the shrinking population (caused by high emigration and low fertility rates). The ERP projects the output gap to turn slightly negative in 2023 and to gradually close by 2026.

The main downside risks are related to overly optimistic projections for net exports and private investment growth and a lack of focus on policies that can boost productivity. The growth projections for 2023 and 2024 were lowered by 1.6 pps and 0.1 pps respectively compared with last year's ERP, which reflects the expected impact of the external situation on the Albanian economy. However, the forecast for 2025 and beyond remains the same. For 2023 and 2024, the economic growth projection is still above international and Commission forecasts. In particular for 2024, the projected growth

(8) Macroeconomic and fiscal estimates and forecasts covering the period 2022-25 have been taken from the ERPs themselves; if available, preliminary macroeconomic and fiscal outturn data for 2022 have been taken from the relevant national sources (national statistical office, ministry of finance, central bank).

(9) The tables of this assessment reflect the ERP estimates, not the preliminary 2022 outturn published by the statistical office.

contribution of net exports and private investment exceeds historical averages as well as international projections, but the ERP presents no policies to support this forecast. On the production side, the ERP expects the contribution of agriculture, mining and services to growth to exceed historical averages but does not explain why. The composition of the fiscal plan, in particular from 2024, does not fully reflect the expenditure needs of the ERP policies to support the projected growth scenario, namely investment in human and physical capital to increase productivity. Furthermore, the ERP does not consider the possible impact of the shrinking working-age population, which is a further downside risk to the growth projections because businesses are already suffering from a lack of skilled workers.

Table II.1.1:
Albania - Comparison of macroeconomic developments and forecasts

	2021		2022		2023		2024		2025	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	8.5	**8.5**	3.2	**3.7**	2.6	**2.6**	3.4	**3.8**	n.a.	**3.9**
Contributions:										
- Final domestic demand	9.1	**9.0**	4.0	**3.6**	2.4	**2.3**	3.2	**2.8**	n.a.	**3.3**
- Change in inventories	0.5	**0.8**	0.0	**:**	0.0	**:**	0.0	**:**	n.a.	**:**
- External balance of goods and services	-1.2	**-1.2**	-0.7	**0.0**	0.3	**0.3**	0.1	**0.9**	n.a.	**0.6**
Employment (% change)	-0.8	**-0.4**	1.2	**4.6**	0.9	**0.5**	0.9	**0.5**	n.a.	**0.4**
Unemployment rate (%)	12.2	**12.0**	11.4	**11.2**	10.9	**10.7**	10.5	**10.2**	n.a.	**9.8**
GDP deflator (% change)	5.9	**5.9**	6.6	**5.1**	4.3	**3.0**	3.6	**1.2**	n.a.	**1.1**
CPI inflation (%)	2.0	**2.0**	7.1	**6.7**	4.3	**3.6**	3.4	**3.0**	n.a.	**3.0**
Current account balance (% of GDP)	-7.7	**-7.6**	-8.3	**-7.6**	-7.9	**-6.9**	-7.4	**-5.6**	n.a.	**-5.1**
General government balance (% of GDP)	-4.1	**-4.5**	-3.4	**-3.2**	-3.0	**-2.6**	-1.9	**-2.2**	n.a.	**-2.2**
Government gross debt (% of GDP)	73.2	**73.2**	69.4	**68.8**	67.5	**67.5**	66.4	**66.3**	n.a.	**65.3**

Sources: Economic Reform Programme (ERP) 2023, Commission Autumn 2022 forecast.

Inflation climbed to an average of 6.8% in 2022 but looks set to fall back to the 3% target in 2024. The inflation rate peaked at 8.3% in October 2022 but has since declined as price increases in food, energy and transport have decelerated and financial market conditions have tightened. Some of the foreign price pressures have been absorbed by the 2.5% average appreciation of the lek against the euro. This was mostly due to significant external inflows from tourism and foreign direct investment (FDI), and the unchanged regulated electricity price for Albanian households and small and medium-sized businesses (SMEs). In response to the inflation rate overshooting its 3% target and the broadening of demand-driven price pressures, the Bank of Albania (BoA) stopped the provision of unlimited liquidity to banks in February 2022 and began to tighten its accommodative monetary policy stance in March 2022. It raised the policy rate in several steps by 2.75 pps to 3% in March 2023. The ERP expects average inflation to fall to 3.6% in 2023 before converging to the 3% target in 2024 as international price pressures fade and domestic inflationary pressures become more muted in line with the slightly negative output gap. The inflation forecast for 2023 seems optimistic considering persistent foreign price pressures, including in the EU. Amid the overall increased uncertainties, the European Central Bank and the Bank of Albania have agreed to extend until January 2024 Albania's liquidity line for the amount of EUR 400 million, which has been in place since 2020 without ever being used. The ERP does not include projections for the inflation rate in the EU, but it is assumed that the effective lek exchange rate will appreciate slightly and external interest rates will rise in 2023.

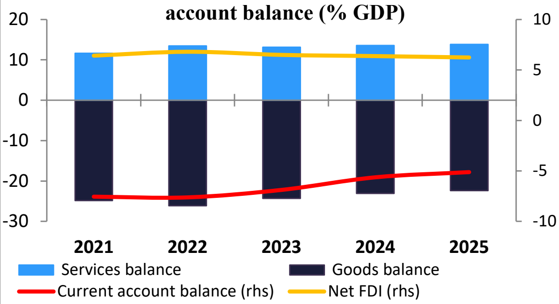
Despite the terms of trade shock, the current account deficit decreased in 2022, and the ERP expects it to fall further in the coming years. Sharply increased import prices widened the nominal goods trade deficit despite the strong growth of goods exports. However, high nominal GDP growth resulted in the trade deficit decreasing by about 1 pp. to 23.7% of GDP. At the same time, the services trade surplus surged by 30%, to 13.3% of GDP, which has contributed to a 1.6 pps decrease in the current account deficit to 6% of GDP. The ERP expects the current account deficit to fall further in 2023 and

2024 reaching 5.1% of GDP in 2025. This improvement is based on the assumption of a gradually decreasing goods trade deficit and an increasing services surplus. These are set to more than offset the projected increase in the primary income deficit and a gradually decreasing contribution of remittances as a share of GDP. The forecast growth of the services surplus and the primary income deficit are higher than in last year's ERP. The expected improvement of the goods trade deficit might be limited if import needs and prices are higher than projected, e. g. for electricity and investment goods.

Foreign direct investment (FDI) inflows are forecast to gradually decrease as a share of GDP but still finance the current account deficit. Following a strong growth of almost 19% year-on-year, FDI inflows reached 6.7% of GDP in 2022, but they are expected to gradually decline in the medium term to 6.2% of GDP in 2025. FDI inflows fully financed the current account deficit in 2022 and should continue to cover the bulk of the expected current account deficit in 2023-2025. The FDI projections appear plausible in light of the recent completion of two very large energy projects that boosted inflows in 2016-2019 and large investment projects currently in the pipeline. These projects are likely to generate inflows that are more evenly spread over the coming years. External debt is estimated to have dropped by some 10 pps to 54.6% of GDP in 2022. The BoA's risk analysis shows that the external debt ratio is more sensitive to currency depreciation than to an increase in interest rates. However, the appreciation trend of the lek indicates that such a risk is limited. Moreover, this risk is sufficiently safeguarded against by foreign exchange reserves, which have consistently increased over recent years and exceeded EUR 5 billion at the end of 2022, covering 7 months of imports of goods and services and over three times the short-term external debt.

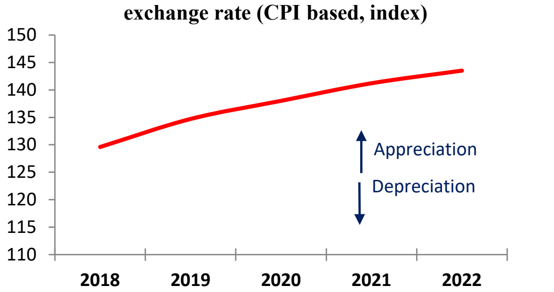
External competitiveness and current account

Graph II.1.1a: **Albania - Current account balance (% GDP)**



Source: Economic Reform Programme (ERP) 2023.

Graph II.1.1b: **Albania - Real effective exchange rate (CPI based, index)**



Source: Economic Reform Programme (ERP) 2023.

The financial sector remained stable, but there could be more credit risks in the wake of rising interest rates. Bank profitability (return on equity) improved strongly in 2021 to 12.9% but fell to 12.3% in 2022. Overall banking sector capital in relation to risk-weighted assets remained unchanged and well above the regulatory minimum, but not all banks fulfil the macroprudential requirements adequately. Liquidity declined in 2022 but was still above the regulatory limit set by the Bank of Albania. The ratio of non-performing loans to total loans continued to slightly decrease, falling to 5.1% from 8.4% in 2019. However, there are concerns that the interest rate risk could transform into credit risk as bank loans, about 75% of which carry variable rates, are being repriced. In light of this, the recent resolution of the dispute over the private bailiff services' fees is well timed, and the government should ensure that all other parts of the insolvency and resolution framework are fully operational. Another remaining source of vulnerability is banks' exposure to sovereign risk given the high share of government securities among their assets. The growth of credit to the private sector ([10]) accelerated from 6.9% in 2021 to 11.2% year-on-year in 2022 although commercial lending fell at the end of the year as interest rates increased in line with the usual monetary policy transmission lags following the policy rate hikes. Both the share of foreign

([10]) Adjusted for written-off loans and exchange rate impacts.

currency denominated loans and foreign currency deposits grew in the banking sector, partly reflecting high inflows from tourism and FDI (foreign currency deposits, in particular, increased strongly to 55% of total deposits). The BoA reconfirmed its commitment to strengthen the regulation and supervision of the banking sector; the Bank updated its stress testing methodology and continued to improve the availability of data to monitor the real estate sector. Given its progress in aligning its supervisory and regulatory frameworks with EU standards, BoA applied for an equivalence assessment by the European Banking Authority. However, Albania remained under increased monitoring by the Financial Action Task Force (FATF) to address strategic deficiencies in its regime to counter money laundering and terrorist financing. There appears to be scope to increase the financial sector's role in reaching climate and energy targets in line with European and international commitments by adopting policy measures in the area of sustainable finance (such as sustainability disclosures, sustainable finance taxonomies etc.).

Table II.1.2:
Albania - Financial sector indicators

	2018	2019	2020	2021	2022
Total assets of the banking system (EUR million)	11 398	12 380	13 156	14 980	16 598
Foreign ownership of banking system (%)*	83.4	77.1	76.0	75.1	:
Credit growth (%, aop)	-1.7	3.0	6.1	6.9	11.2
Deposit growth (%, aop)	-1.2	2.5	5.8	8.5	8.0
Loan-to-deposit ratio (eop)	53.9	55.6	54.7	54.8	56.1
Financial soundness indicators (%, eop)					
- non-performing loans to total loans	11.1	8.4	8.1	5.7	5.0
- regulatory capital to risk-weighted assets	18.2	18.3	18.3	18.0	18.1
- liquid assets to total assets	14.8	15.1	13.6	13.3	11.0
- return on equity	13.0	13.5	10.7	12.9	12.3
- forex loans to total loans	55.1	50.1	48.5	48.8	49.3

* foreign equity ownership of total banks' equity
Sources: Economic Reform Programme (ERP) 2023, IMF, Bank of Albania.

1.3. PUBLIC FINANCE

Strong revenue growth coupled with some expenditure savings and a high GDP denominator lowered the fiscal deficit to 3.7% of GDP in 2022. The government introduced four budget amendments outside of the regular revision process in 2022 (January, March, July, December). As in previous years, they were not all triggered by unexpected events. The budget amendments: (i) significantly raised expected revenue (+2.5 pps of GDP); (ii) increased support to the state-owned electricity utilities to keep the regulated electricity prices for households and SMEs unchanged (1.4% of GDP); and (iii) allocated direct support worth 0.9% of GDP to vulnerable households facing difficulties in meeting higher food and fuel costs. Based on the new GDP estimate ([11]) in the ERP and the budget implementation data, tax revenue ended up at 26.3% of GDP in 2022. This was 1.1 pps above the 2021 value and 8.3% above the original target in the 2022 budget. Total expenditure was up 0.2 pps year-on-year at 31.6% of GDP, 2.2% below the amended target. This included central government capital expenditure of 5.4% of GDP as well as direct support of 1.4% of GDP to the publicly owned energy utilities. Tax revenue grew by 13.8% year-on-year in 2022 and was driven by strong growth across all tax categories except national taxes and excises. In particular, profit tax (+33.9%) and import-related revenue (VAT and customs duties) saw an exceptional rise. Overall expenditure increased by 9.2% compared with 2021. Current spending rose by 8.4% while capital expenditure turned out 14.6% higher than in 2021, only because it was used to clear

([11]) The budget law requires Albania to use a projected nominal GDP not higher than the latest available IMF forecast for fiscal purposes. However, nominal GDP growth in 2022 is expected to have been 8.9%, about 3.4 pps above the original estimate used for the budget preparation.

arrears in December. Sizeable savings compared to the original budget were achieved on interest costs, personnel expenditure and foreign-financed capital spending. The budget deficit of 3.8% of GDP was about 1.2 pps lower than projected in the original budget and 0.7 pps below the 2021 deficit.

The ERP envisages a moderate pace of fiscal consolidation mainly driven by a decreasing spending ratio. Following an exceptional increase in revenues in 2023, the revenue ratio is projected to fall back to its 2022 level in 2024-2025. The planned reduction of expenditure as a share of GDP, which looks set to see the biggest fall (1.6 pps) in 2024, should underpin the budget balance's gradual improvement in 2023-2025. In 2024 this is mainly related to ending the exceptional support to the electricity sector and the completion of the post-earthquake reconstruction. From 2025, this reduction is due to the gradually decreasing spending on personnel and operation and maintenance as a share of GDP. Capital spending is also expected to decrease by about 0.6 pps of GDP, while interest costs are projected to rise significantly, reflecting tighter financing conditions. The primary balance is forecast to turn positive already in 2023, one year earlier than has been expected in the previous ERP. The cyclically adjusted primary balance shows the largest improvement in 2023, which implies a pro-cyclical tightening given the estimated negative output gap. However, this fiscal stance would support monetary policy in reducing inflation towards the target.

Table II.1.3:
Albania - Composition of the budgetary adjustment (% of GDP)

	2021	2022	2023	2024	2025	Change: 2022-25
Revenues	27.0	28.2	29.5	28.3	28.3	0.1
- Taxes and social security contributions	25.2	26.5	27.0	26.7	26.7	0.2
- Other (residual)	1.9	1.7	2.5	1.6	1.6	-0.1
Expenditure	31.6	31.4	32.1	30.5	30.4	-1.0
- Primary expenditure*	29.7	29.4	29.3	27.4	27.1	-2.3
of which:						
Gross fixed capital formation	7.7	6.6	6.7	6.1	6.2	-0.4
Consumption	8.7	8.5	8.7	8.5	8.2	-0.4
Transfers & subsidies	12.2	11.7	11.9	12.0	11.9	0.2
Other (residual)	1.1	2.6	2.0	0.8	0.9	-1.7
- Interest payments	1.9	1.9	2.8	3.1	3.3	1.4
Budget balance	-4.5	-3.2	-2.6	-2.2	-2.2	1.0
- Cyclically adjusted	-6.1	-3.3	-2.3	-2.2	-2.2	1.1
Primary balance	-2.6	-1.9	0.3	0.9	1.2	3.1
- Cyclically adjusted	-4.2	-1.3	0.5	0.9	1.1	2.5
Gross debt level	73.2	68.8	67.5	66.3	65.3	-3.5

* Excluding arrears clearance
Sources: Economic Reform Programme (ERP) 2023, Commission calculations.

Windfall tax revenue and one-off grants are set to help Albania achieve a positive primary balance in 2023. The 2023 budget and the medium-term macro-fiscal framework, which serves as a basis for the ERP, are based on the latest fiscal outturn data available at the time (November 2022). This marks an improvement over the previous years' practice. The budget deficit is expected to fall to 2.6% of GDP while the primary balance is set to improve substantially to 0.3% of GDP from -1.2% estimated for 2022. Exceptional energy-related EU budget support and one-off revenue from retroactively taxing exceptional profits of private electricity producers ([12]) are expected to lift total revenue by 1.3 pps to 29.5% of GDP. Total expenditure is set to grow by 0.7 pps to 32.1% of GDP, mainly to cover the increase in public sector wages and interest costs. Budget support to the electricity sector is set to decrease by 0.8 pps to 0.6% of

([12]) According to its legal basis, this exceptional revenue has to be used for social expenditure.

GDP. Capital expenditure (including local governments) is set to increase marginally by 0.1 pps to 6.7% of GDP, mostly related to foreign-financed investments, while post-earthquake reconstruction is set to end in 2023. The planned income tax reform, which was postponed to 2024, would broaden the tax base as self-employed people and freelancing professionals would be subject to the personal income tax regime instead of the profit tax, from which most of them (with a turnover below ALL 14 million) have been exempted since 2021.

Box II.1.1: **The 2023 budget**

Following the presentation of the draft budget on 25 October, the 2023 budget was adopted by the Albanian Parliament on 25 November 2022. Two months later, Parliament approved the last amendment of the 2022 budget, which the government had introduced on 1 December 2022 by a normative act. The 2023 budget aims to achieve a fiscal deficit of 2.6% of GDP and a positive primary balance of 0.3% of GDP.

The budget provides for a 6% salary increase for health and education employees, funding for the local elections in May 2023, subsidies for electricity prices, and contingencies for foreign grant projects and unplanned expenditure needs.

Total revenue is expected to reach 29.5% of GDP due to a higher disbursement of grants (1.4% of GDP, mostly from EU budget support), a retroactive tax on exceptional profits of private electricity producers, the effect of the increase of the minimum wage on social contributions, and an increase in VAT from higher import prices. In addition to the inflation indexation of pensions, the end-of-year pensioners' bonus was changed from a one-off item to a regular expenditure item. While this regular bonus makes the budget more predictable, it remains an untargeted action that is not integrated into the social insurance system. The birth bonus is also a regular untargeted payment. As in 2022, most of the support to the state-owned electricity producers is budgeted as direct budget support instead of being provided via loans or guarantees, which increases transparency.

Main measures in the budget for 2023:

Temporary/permanent Revenue measures	**Temporary/permanent Expenditure measures**
• 33% tax on private electricity producers' windfall profits in 2022 (0.38% of GDP) • EU energy-related budget support (0.4% of GDP) • New gambling tax and harmonisation of excises (0.1% of GDP) • Vehicle and fuel sales tax (0.28% of GDP)	• Salary increases in health and education (0.1% of GDP) • Support to state-owned electricity producers (0.5% of GDP) • Increase of the reserve fund to cover elections costs and unplanned support needs due to the volatile external environment (0.7% of GDP)

After a larger-than-expected fall in the public debt ratio in 2022, the ERP projects a continued trend of moderate debt reduction by about 1 pp. per year. The debt ratio fell by 8.64 pps to 64.6% of GDP in 2022, more than 4 pps below the level projected by the ERP. This marked improvement, which was mainly due to a lower-than-planned deficit and the much larger than expected growth in nominal GDP, has brought the debt ratio below its pre-Covid-19 level, which the ERP expected only for 2025. The ERP projects a moderate pace of debt reduction of about 1.1 pps per year on average in 2023-2025, slightly slower than in the previous ERP (average of 1.4 pps per year). Guaranteed debt, which is fully accounted for in the public debt stock, increased from 2.9% of GDP in 2020 to an estimated 3.3% of GDP in 2022 and is set to remain at around 3% of GDP in the medium-term.

The maturity of public debt lengthened, but there are still risks related to the shallow domestic market and the rising share of foreign currency debt. Although the share of short-term securities in the domestic debt portfolio fell to about 30%, the tightening financing conditions and the shallow domestic market for government securities pose risks. The yield for 12-month bonds increased by about 3.25 pps from its average level in 2019-2021 to 5% in January 2023 in response to the monetary policy tightening. Similar increases were observed across all maturities, and the slope of the yield curve has remained unchanged. In addition, the exchange rate risk has increased due to the share of foreign currency denominated debt rising over the last 2 years to 48.5% of total public debt and the share of debt owed to private foreign creditors climbing to about 30% of the foreign public debt, caused by the annual issuance of large Eurobonds in 2020-2021. To mitigate the exchange rate risk, the medium-term debt strategy limits foreign currency denominated public debt to 50% of the total public debt stock, and 0.7% of GDP has to be earmarked in the budget for fluctuations in the exchange rate. There will be high refinancing needs for foreign debt when a Eurobond and a private loan guaranteed by the World Bank are due in 2025 and another large Eurobond repayment is due in 2027. To meet these refinancing needs, the government is prepared to issue a new Eurobond in 2023-2024 if financial conditions improve and may combine it with a liability management transaction.

Box II.1.2: **Debt dynamics**

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

	2021	2022	2023	2024	2025
Gross debt ratio [1]	**73.2**	**68.8**	**67.5**	**66.3**	**65.3**
Change in the ratio	-1.3	-4.4	-1.3	-1.2	-1.1
Contributions [2]:					
1. Primary balance	**2.6**	**1.2**	**-0.3**	**-0.9**	**-1.2**
2. "Snowball" effect	**-7.5**	**-3.9**	**-0.9**	**-0.1**	**0.1**
Of which:					
Interest expenditure	1.9	1.9	2.8	3.1	3.3
Growth effect	-5.5	-2.5	-1.7	-2.4	-2.5
Inflation effect	-3.8	-3.4	-2.0	-0.8	-0.7
3. Stock-flow adjustment	**3.5**	**-1.7**	**-0.1**	**-0.2**	**0.0**

[1] End of period.
[2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).
The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other effects.
Source: Economic Reform Programme (ERP) 2023, Commission calculations.

The debt dynamics are based on slightly optimistic growth expectations and assume: (i) a stable exchange rate; (ii) a drop in the inflation rate to 3.6% in 2023 and to 3% in 2024-2025; and (iii) an increase in the implicit interest rate. The debt ratio recorded a large fall in 2022, driven by a strong snowball effect due to high inflation and growth and a sizeable stock-flow adjustment related to the use of deposits from the 2021 Eurobond issue. In 2023, a much smaller snowball effect is expected as interest expenditure climbs by almost 1 pp. of GDP while the debt-reducing impact of both inflation and real growth moderates. From 2024, the snowball effect is set to diminish further because rising interest costs and decelerating inflation are projected to outweigh the rising impact of higher growth. Overall, it is the increasing primary surplus that is expected to drive the moderate reduction of the debt ratio in 2024-2025. The table is based on the values provided in the ERP. However, due to the much larger than expected debt reduction in 2022, the debt path will shift to a lower level.

The main sources of fiscal risks remain the state-owned hydroelectricity providers and the financial governance of public sector utilities. The state-owned energy utilities' dependence on regular public guarantees and loans is a source of fiscal risks. This situation is aggravated by the hydropower sector's vulnerability to fluctuations in rainfall and to climate change risks, for which mitigation measures still need to be developed. About two thirds of public guarantees are issued to the energy sector, including for foreign borrowing. In 2022, adverse weather conditions caused a decline in domestic electricity production, and import costs surged. As a result, the government provided direct on-lending of 0.4% of GDP and budget support of 1% of GDP to the sector. Until now, no payments have been made under the guarantees provided to the private sector as part of COVID-19 support, which amount to 0.6% of GDP. In future, the government intends to base decisions on guarantees and on-lending to public bodies on criteria such as the recipient introducing reforms to strengthen financial performance and management and the intended use of the funds. As part of the energy sector reform, the Ministry of Finance and Economy now monitors the financial performance of public sector bodies. This has helped identify a rise in mutual arrears in the public sector.

Box II.1.3: **Sensitivity analysis**

The sensitivity analysis in this year's ERP extends to 2026 and provides some detail on the expenditure and financing categories. However, there is no information provided on the revenue side, except for the total revenue, which includes grants and non-tax revenue. Although the ERP refers to the effect of automatic stabilisers, their impact is likely to be limited given the large number of informal and agricultural self-employed people and the low social security benefits. The particular economic circumstances in 2023 are integrated into the baseline and assumed to continue somewhat in 2024, leading to only minor deviations between the scenarios. However, assuming a return to a normal environment in 2025-2026, it is expected that shocks will create larger deviations from the baseline. The real GDP growth rates for the optimistic and pessimistic scenarios deviate by +0.5 pps and -1.5 pps, respectively, from the baseline growth scenario of 2.6% in 2023 and its average rate of 3.8% in 2024-2026. Foreign borrowing is kept unchanged across all scenarios.

In the pessimistic scenario, the revenue ratio is assumed to be 0.5 pps below the baseline, current expenditure is about 0.2 pps above the baseline, and capital expenditure is on average 0.5 pps below the baseline. Domestic borrowing and interest expenditure (in nominal terms) is assumed to be lower in the pessimistic scenario compared to the other scenarios, leading to a lower primary surplus. The fiscal deficit is set to be about 0.2 pps higher than in the baseline scenario, except in 2025 when it is lower. The fiscal adjustment under the pessimistic scenario is set to comply with the neutral or positive primary balance rule but not with the rule of a decreasing debt ratio in 2023 and 2024. From 2025 on, the debt ratio should decrease incrementally to 68.4% mainly due to reduced domestically financed investment (by 0.5 pps to 1 pp.) and lower operational and maintenance expenditure.

The optimistic scenario is close to the baseline scenario in terms of revenue (0.1 pps above the baseline in 2023-2024) or the same as the baseline (2025-2026). Nominal expenditure does not change and, in terms of GDP current expenditure, is only 0.1 pps lower in 2023-2024. However, the difference increases by 2025 when it is 0.5 pps lower. Similarly, the difference in the fiscal deficit is 0.2 pps lower in 2023 and gradually decreases to 1.1% of GDP or by 0.6 pps in 2026.

Overall, the public debt-to-GDP ratio would decrease by less than 1 pp. in the pessimistic scenario. This is considerably lower than the baseline and the optimistic scenario in which the reduction would accelerate to about 1.8 pps per year. While the baseline projection for the revenue ratio, which averages 28.3% of GDP, seems realistic, the assumption under the pessimistic scenario of just 0.5 pps lower would still be higher than the ratios observed between 2015 and 2021.

Given the low revenue targets, the burden of fiscal consolidation is to be borne by reducing expenditure, which prevents more investment in physical and human capital. The improvement of the fiscal balances is set to be mainly achieved by a 1.5 pps reduction of the expenditure ratio while the envisaged incremental increase in the tax revenue ratio is significantly below the estimated 2 pps that could be achieved with more decisive reforms and a broader tax base. A public consultation on the draft medium-term revenue strategy (MTRS), which aimed for a simpler tax system and a more predictable tax policy, remained suspended, and it seems the strategy's formal adoption is no longer planned. Albania included specific measures in the 2020-2022 fiscal packages to raise revenue by broadening the tax base and simplifying the tax system but not to the extent proposed by the IMF. In addition, other measures were introduced that reduced the tax base. Furthermore, the credibility, quality and applicability of tax policies continue to suffer from the lack of a meaningful consultation with stakeholders. The gradual reduction of the expenditure ratio prevents significantly increasing public investment in human and physical capital, which the country needs. The ERP also acknowledges that expenditure efficiency should be improved to ensure that such investment needs can be met within the available fiscal space. However, despite the announcement of reforms to public investment management and increased managerial accountability, the potential gains are unlikely to have any impact in 2023-2025 and are hard to quantify. Therefore, the ERP's fiscal framework is not conducive to accelerating productivity growth.

Recent steps to reform public investment management are promising but do not fully cover public-private partnerships (PPPs). The 2021 ERP already identified significant shortcomings in the public investment management system. These included inadequate project design, lack of clear criteria for including projects in the medium-term budget, and weak and fragmented management, including of PPPs. A decision of the Council of Ministers in December 2022 on public investment management procedures ([13]) strengthens and aligns the evaluation procedures of strategic projects for the National Single Project Pipeline (NSPP), managed by an agency under the Prime Minister's office (SASPAC), with the processes required by the medium-term budgetary framework but the NSSP has yet to be established. The improved appraisal procedure also includes a screening for climate impact and is planned to be used for all projects of a certain size, including PPPs. However, other legal amendments, to be launched in 2023, are necessary to align PPPs fully with the revised procedure.

Monitoring fiscal risks continued to improve but could benefit from a broader mandate, and arrears remain a concern while **the new public finance management strategy is not yet in place.** At the end of 2022, the government started to prepare a new public finance management (PFM) strategy with EU-financed assistance, which should guide PFM reforms from 2023 on. Fiscal risk statements, which regularly accompany the budget proposals and have covered PPPs and concessions, were expanded to include disaster risks and the financial assessments of an increasing range of SOEs and utilities. Such assessments proved useful for forecasting the financing needs of the energy sector in 2022. An instruction issued in December 2022 introduced additional reporting requirements of all public bodies on potential fiscal risks, including those related to PPPs, based on a reporting template and the financial data of the entities. If all public bodies report as required, the information available to assess fiscal risks will improve. At the same time, increasing the capacity of the fiscal risk unit and broadening its mandate remains essential. Public sector arrears persist: the ratio of arrears to expenditure rose to 3.7% during the year. However, using the unspent capital budget to clear arrears helped bring this ratio down to 2.2% at the end of 2022. The persistence of arrears even as some spending categories remain under-executed signals problems with fund commitment and contract management. There is little transparency on possible interest due on arrears, and there is no systematic approach to sustainably prevent arrears reoccurring, including those related to court cases.

1.4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

Drawing from Albania's ERP and other sources, the Commission conducted an independent analysis of the Albanian economy. This analysis aims to identify the key structural challenges to mitigating the impact of Russia's war of aggression against Ukraine in order to boost competitiveness and inclusive growth. The results show that Albania continues to experience several structural weaknesses across many sectors. The main challenges to mitigating the impact of war, the ongoing impact the COVID-19 pandemic and support recovery in terms of boosting competitiveness and long-term sustained and inclusive growth are:

(i) increasing funding and capacity for skills and training, social protection and healthcare to improve employability and social inclusion;

(ii) speeding up connectivity, the green transition and adaptation to climate change;

([13]) For details, see structural reform measure 10.

(iii) increasing competitiveness, in particular by improving business support services, funding research and innovation, continuing to address the informal economy and implementing reforms to facilitate the digital transition.

The three key challenges identified by Albania did not correspond to those identified by the Commission. Instead, they were more closely related to those identified by the Commission in 2022, rather than the 2023 ones. For key challenge 1, the focus differs as Albania only included increasing innovation and skills. It did not include funding, social protection, or healthcare, which it kept in key challenge 2. Albania did not have a key challenge on connectivity, the green transition and adaptation to climate change. For key challenge 3, the country focused on business support and tackling the informal economy, but it did not include the digital transition.

To promote competitiveness Albania also needs to tackle corruption, improve the rule of law, and strengthen its institutions. Addressing these fundamental challenges is a prerequisite to successfully transform economy. The Commission is closely following the issues on strengthening the rule of law, including the ongoing justice reform, and those related to corruption, in its annual Albania country report.

Furthermore, the country should proactively implement the Energy Community's Decarbonisation Roadmap to achieve the agreed climate and energy targets, and strive towards establishing a carbon pricing instrument compatible with the EU ETS.

Key structural challenge 1: Increasing funding and capacity for skills and training, social protection, and healthcare to improve employability and social inclusion

Albania's labour market indicators show a stable continuous improvement in the last several years, which also indicates resilience to economic shocks. There was an increase in both the employment and activity rates: according to the Labour Force Survey, in Q3-2022 the total number of employees had grown by 3.8% compared to Q3-2021, with the participation rate (population aged 15 to 64) standing at 73.4% compared to 70.1% in Q3-2021. The level of unemployment had decreased by 0.7 pps compared to Q3-2021, standing at 10.6% in Q3-2022 (population aged 15 to 64), which was even below pre-pandemic levels.

The share of the active population with low educational attainment remains high and participation in lifelong learning is low. In 2021, a high share (41.4%, compared to 24.9% in the EU-27) of the labour force (aged 25-64) and the majority of registered jobseekers had at most a primary education, indicating a need for investment in reskilling and upskilling. However, opportunities for lifelong learning are still very limited in number and scope – there are not enough opportunities to respond to the needs of the labour market. Participation in adult training remains low, as identified in the Adult Education Survey conducted in 2016. In 2016, only 9.2% of adults (aged 25-64) participated in lifelong learning, which is significantly lower than the EU average (43.7% in the same year). LFS data on participation in education and training in the past 4 weeks confirm very limited access to lifelong learning opportunities (only 0.8%, 2019, last data available).

Investment in human capital, ranging from education and training to healthcare and social protection, is still underfunded and needs more targeted investment and prioritisation. The rate for young people aged 15-29 not in education, employment or training (NEET) is 26.1%, which, combined with a persistent problem of skills mismatches and low wage levels, results in significant brain drain.

Skills mismatches and quality of education are still highlighted as key areas for improvement by social partners, especially employers' and youth organisations. These findings are also confirmed by regional surveys on labour migration, showing that 30% of respondents consider that skills learned in the education system do not match the needs of their job, and 45% of surveyed companies identify applicants' lack of skills as a reason for unfilled vacancies (2022). These issues contribute to the high inactivity among young people and high emigration. Both are key challenges to be addressed through the Youth Guarantee and by adopting curricula based on labour market needs and investing in career support and quality jobs.

Reform measure 1: Increasing the quality and access to VET

The measure**,** rolled over from the two previous ERPs, aims to address many of the existing challenges in the sector. It plans to do this by adopting and implementing the 2023-2030 national employment and skills strategy, implementing the plan for optimisation of public VET providers, investing in VET infrastructure, and training of VET teachers.

The measure is one of the strategic priorities in the new 2023-2030 strategy for employment and skills, which continues the momentum of the government's increased investment in human capital. One of the big challenges is implementing of the optimisation plan for VET providers, for which the Ministry of Finance and Economy needs to increase investment in the sector. The description of activities and plans under this measure are well described, however, a stronger focus has to be put on VET service providers to stimulate and encourage their engagement to provide VET.

This reform measure is still necessary, as participation of students in VET remains low – only 17.7% of upper secondary students enrolled in VET schools in the 2021-2022 school year. Skill mismatches and quality issues of vocational training persist, as schools have yet to develop curricula with enough work-based learning that attract students and are relevant to the labour market needs. At the same time, career guidance and counselling services should be further expanded to match the variety of needs and expectations of young learners and graduates. Even growing sectors, such as ICT, struggle to recruit staff, so providing digital skills training and encouraging work-based learning in the digital sector could yield major benefits. The ongoing reforms of the VET system have yet to show results.

The private sector's involvement in VET schools is improving. This has been helped by the requirement for a representative of an employers' organisation to be appointed as the head of the governing board of all VET schools. This move has allowed for a closer involvement of the private sector in school management and has strengthened links. The role of employees' organisations in VET needs to be similarly boosted, ensuring an equal focus on decent work, safe working conditions and career support. One of the actions planned under this reform measure, the establishment of the National VET Council, has been rolled over from previous ERPs because the Council is still not operational. Along with the Council, setting up sectoral skills committees is important so that both the private sector and employers' organisations get to shape VET policy design from the beginning.

Albania started developing tools to regularly monitor the labour market and skills needs. In 2021-2022, the National Agency for Employment and Skills (NAES) , with the help of RISI Albania, piloted a regional labour market analysis in Elbasan and Durrës to improve the planning of short-term training. This analysis facilitates an understanding of the main characteristics of jobseekers, the regional job offers and the potential to develop it further. In turn, this can help target the employment promotion programmes and vocational training better. It is planned to progressively deploy this labour market analysis across the country. NAES is also developing a Labour Market Information Observatory, which will build on existing administrative and survey data, aiming to become the primary mechanism for fetching and disseminating labour market information and intelligence.

Reform measure 2: Improving the employability of the most vulnerable unemployed jobseekers

This reform measure is newly proposed as part of the 2023-2025 ERP. It brings together the adoption and implementation of the new 2023-2030 Employment and Skills Strategy, creates the crucial strategy to support the exit from the economic aid scheme ([14]), and includes the gradual roll-out of the Youth Guarantee scheme.

The measure is essential as vulnerable groups require the government's support to enter the labour market. These include specific groups, such as people with disabilities, Roma and Egyptian minorities, people living in poverty and the long-term unemployed. More diverse groups are also supported, such as women and young people.

The above-mentioned challenges of supporting education and training affect these groups: among unemployed jobseekers registered with the Public Employment Service, 45.3% of Roma jobseekers and 13.9% of Egyptian jobseekers had not completed basic education. Two thirds of unemployed jobseekers receiving the economic aid benefit also had the same characteristic.

Albania has taken steps towards setting up a Youth Guarantee scheme based on the EU model to help young people integrate into the labour market. With EU-funded technical assistance, Albania has conducted a mapping of NEETs and a review of the legal framework. A multi-stakeholder group and a technical expert group were set up, and they have developed a Youth Guarantee implementation plan. However, with the gradual implementation of the plan, an increase in the number of staff in employment offices is needed to meet the expected rise in the number of young jobseekers. Investing in social and child care services, especially early childcare and daily centres, is also key to support the active inclusion of mothers and carers in the labour market.

The planned activities to improve of the quality and effectiveness of labour market institutions and services are essential. To achieve this, sufficient staffing of both the Labour department of the Ministry of Economy and the National Agency for Employment and Skills is crucial, as well as training and capacity building of employment offices staff. This will ensure the successful implementation of all labour policies, and in particular the Youth Guarantee and the economic aid exit strategy. It will also help to support vulnerable groups more efficiently overall. A review of the current employment promotion programmes and their effectiveness is also a good step to ensure better quality offers that result in longer-term and more sustainable employment. The National Agency for Employment and Skills (NAES) still needs to accelerate the implementation of employment promotion measures and increase outreach work to people who are economically inactive and those most in need. It is also recommended to consolidate skills development opportunities for the unemployed and inactive to build up skills sets and raise the levels of education attainment. The integrated case management approach of the exit strategy has to be further consolidated. Collaboration with education, social services and other complementary services also has to be further strengthened to build an integrated approach to supporting the most vulnerable jobseekers.

Overall, the ERP presents a good analysis of the challenges in the area and presents a robust plan of action, which now needs to be implemented efficiently. There is sufficient funding planned in the mid-term budget for this measure. More detailed indicators on vulnerable groups could be selected to improve monitoring and evaluating the measures' impact and effectiveness.

Reform measure 4: Increasing the coverage and adequacy of integrated social care system to reduce the share of the population at risk of poverty

The measure is rolled over from the previous ERP, and aims to increase the availability, inclusiveness and effectiveness of social services. It remains very relevant as Albania has a very high percentage of people living at risk of poverty or social exclusion (45% in 2021, compared to 21.6% in the EU-27). The

([14]) The economic aid scheme is the main non-contributory social programme, consisting of cash payments to persons and households living in poverty and persons with disabilities. The exit strategy from the scheme is a tool to support the beneficiaries to join the labour market and exit the cash benefit scheme.

situation has improved since 2019, but the country continues being an outlier with a rate of material and social deprivation of 56.5% in 2020. Income support to socially vulnerable groups (roughly 65 000 families or 10% of the population) helps lower the percentage of people living at risk of poverty to 21.8%, but is not enough to bring those groups above the poverty threshold. The ad hoc increase in benefits has partially addressed the issue of inadequacy, but has not solved structural issues. Therefore, a system for the annual indexation of the economic aid benefits and disability benefits is still needed to guarantee a minimum income based on set benchmarks to measure the cost of living.

Overall, spending on social protection programmes is one of the lowest in Europe, at around 9.2% of GDP (2022). Additionally, the social protection budget is largely focused on cash assistance. There is a need to redirect the budget towards the Social Fund and support deinstitutionalisation and community-based care further to ensure more effective results and sustainable action. In the existing plan, the budget allocations for social care and deinstitutionalisation of residential care are also not clearly indicated and need to be more targeted.

Drafting a new social protection strategy will be a key deliverable to plan the long-term strategy for investment in better social protection for Albania's citizens. The extension of Social Fund coverage beyond the third year of the establishment of a new social service is a significant development and crucial to ensure the sustainability of new social services. However, there still is a risk of local government not having and, therefore, not allocating enough financial resources to support and increase the availability of social services, which are under their direct responsibility. Monitoring to see if the services continue being offered beyond the third year is important in order to inform potential corrections of the Social Fund rules. Two points that require further attention are ensuring a shock-responsive social protection system built, in particular, on the lessons learnt from the recent crises; and ensuring the sustainability of funding and clear arrangements for implementing the Social Fund at local and central levels.

The reform of the disability assessment is a very welcome development, and the planned implementation measures are key to ensure it is applied throughout the country and effectively linked through a referral mechanism to social services on offer.

Reform measure 5: Increasing access to health care

This measure is rolled over from the previous ERP and demonstrates the continuous commitment of the government to take measures to strengthen the primary healthcare sector. Significant steps have been taken to: (i) ensure uninsured people have access to healthcare services; (ii) increase availability of screening programmes; (iii) support immunisation; (iv) make dental and ophthalmological screenings more easily available to children. Moreover, the government has taken action to retain more medical personnel in Albania.

Albania has reportedly has the highest out-of-pocket health expenditure per capita in Europe, and only a part of the population has health coverage. Therefore, the proposed measures are relevant, but their success will depend on sustained political support, predictable and increased financing, and effective implementation. Inequalities in access to healthcare still persist, especially among people living in poverty, Roma and Egyptian minorities, and people in remote areas. Of all WB6 economies, Albania still has the: (i) lowest health expenditure per GDP, (ii) highest percentage of out-of-pocket expenditure (as % of health expenditure), (iii) lowest number of physicians (per 1k people); and (iv) lowest number of nurses and midwives (per 1k people). The Universal Health Coverage index was 62 in 2019 (SDG Dashboard), which indicates significant challenges. There are major differences in coverage depending on geographical location, educational attainment and personal income.

The large informal sector and low percentages of health insurance coverage mean that a high proportion of the population are uninsured: only 46% of women and 37% of men benefit from public health insurance coverage. Out-of-pocket payments are still high: in 2021, Albanian households paid on average

5.4% of their households' budget on health-related expenditure. These factors result in high self-reported unmet need for medical care (10.6% of the population in 2020), five times higher than the EU average (2% in 2021).

There are still obstacles across the country to the right to health and to sexual and reproductive health services, particularly for vulnerable groups. Greater focus on maternal and new-born care is also needed: maternal and infant mortality rates (15 per 100 000 live births and 7.8 per 1 000 live births respectively) are twice as high as in the EU.

The budget allocated to healthcare as a share of GDP has been steadily increasing, from a low of 2.5% of GDP in 2008 to 3.28% of GDP in 2023. However, this is still below the allocation rates of regional peers except Kosovo and significantly below the EU-27 average of 8.0%.

Box II.1.4: **Monitoring performance in light of the European Pillar of Social Rights ([15])**

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights concerning equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion for the benefit of citizens in the EU. The European Pillar of Social Rights Action Plan, adopted on 4 March 2021, aims at rallying all relevant forces to turn the principles into actions. Since the 20 principles provide a compass for upward convergence towards better working and living conditions in the EU, they are equally relevant for candidate countries and potential candidates (CC and PC). The new reinforced social dimension for the Western Balkans includes an increased focus on employment and social reforms through greater monitoring of relevant policies (EC, 2018). The Western Balkans Ministers' Declaration on improving social policy in the Western Balkans (6 November 2018) confirms that they will use the Pillar to guide the alignment of their labour markets and welfare systems with those of the EU.

Albania has steadily improved employment and unemployment rates and has shown good resilience in face of the post-COVID-19 and energy crises. Further improvement in employment results is hindered by a high NEET share.Although it is slowly but steadily decreasing, Albania remains one of the worst performers among CC and PC. Another obstacle is the gender employment gap. There was a slight improvement noted in recent years, but this reversed in 2021. The gap is now wider than the gap in the EU-27 in 2021 (16.3 pps vs 10.8 pps). This is partly driven by the low provision of early childhood education and care, especially for children below the age of 3. Unemployment, especially long-term, is still far from the EU average, which is partly due to low provision and effectiveness of active labour market measures. Albania is a medium performer in the region as regards the income quintile ratio.

ALBANIA		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Worse than EU avg., no change
	Individuals' level of digital skills (basic or above basic)	Worse than EU avg., improving
	Youth NEET (% of total population aged 15-29)	Worse than EU avg., improving
	Gender employment gap	Worse than EU avg., improving
	Income quintile ratio (S80/S20)	Worse than EU avg., improving
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-64)	Worse than EU avg., improving
	Unemployment rate (% of population 15-74)	Worse than EU avg., improving
	Long term unemployment rate (% of population 15-74)	Worse than EU avg., improving
	GDHI per capita growth	N/A
Social protection and inclusion	At risk of poverty or social exclusion (in %)	Worse than EU avg., improving
	At risk of poverty or social exclusion rate for children (in %)	Worse than EU avg., improving
	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU avg., deteriorating
	Disability employment gap	Better than EU avg., improving
	Housing cost overburden	Better than EU avg., improving
	Children aged less than 3 years in formal childcare	Worse than EU avg., trend N/A
	Self-reported unmet need for medical care	Worse than EU avg., improving

Albania has a very high rate of low-skilled adults and high but decreasing rates of early school leaving. There are significant rural-urban and socioeconomic differences in access to education and the early school leaving rate remains the highest among CC and PC after Türkiye. Participation in adult learning over the past 12 months is very low (9.2%, 2017) compared to the EU (45.1% in 2021), and more up-to-date data is missing. The overall level of digital skills (23.80%) is the lowest among all CC and PC and far below the EU average (53.92%).

Risks of poverty and social exclusion are very high and the capacity of the social protection system to reduce them is low. This is documented by the low and deteriorating impact of social transfers (excluding pensions) on poverty reduction which was only 11.88% in 2021 compared to 32.38% in the EU. Albania has the highest rate of poverty and social exclusion (46.2% in 2020) among all EU Member States and CC and PC for which data are available. Although there is a social assistance scheme, the allowances have low adequacy. However, the government increased allowancesin 2022 and embarked on a process leading to a systemic increase in the benefits. The capacity of local governments to provide social care is very low, but the situation is receiving more attention from the central government, which is funding new services. The pension system has almost universal coverage, albeit with low pensions. Around 600 000 adults, maily informal workers, do not have health insurance, but access to universal healthcare has been improving in recent years. In 2020, 10.6% of people reported an unmet need for medical care. While this value has improved over the last 4 years, it is still five times higher than in the EU (2% in 2021).

([15]) The table in this box includes 16 headline indicators of the Social Scoreboard, used to compare performance of EU Member States (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators). The indicators are also compared for the Western Balkans and Türkiye. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2021 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). For data see Annex B. NEET: neither in employment nor in education and training; GDHI: gross disposable household income.

Data availability improved in 2021. However, some headline indicators of the Social Scoreboard are still not measured, or data for the most recent years is not available. Employment data are regularly measured both by the Labour Force Survey (LFS) and by National Agency for Employment and Skills (NAES), including through the newly established Labour Market Information Observatory, which is however not yet publicly accessible. LFS data are not yet available in Eurostat, but INSTAT has been transmitting LFS microdata to Eurostat since 2017 and has been working on its quality, timeliness and validation.

Key structural challenge 2: Speeding up connectivity, the green transition and adaptation to climate change

Albania remains a net importer of electricity and this that contributes to its trade imbalance. Russia's war against Ukraine has led to increased and volatile energy prices, increasing costs and changes for businesses and the population in general. Better energy efficiency could help to alleviate these problems; however Albania also continues to be hampered by other energy issues, including insufficient security of supply. The energy sector is also affected by unstable and non-transparent fiscal liability, which existed even before the recent energy price increases.

Most of Albania's electricity is produced by hydropower - although this is a renewable source, it creates a dependency that is affected by unpredictable rainfall, and exacerbated by climate change. This means that the country's electricity import needs fluctuate, leading to calls for more efforts to diversify electricity sources, which is particularly important due to the impact of Russia's war of aggression on Ukraine. The government often involves private investors to do this, such as with the two new photovoltaic parks agreed on in 2022, selected under well organised auctions supported by EBRD. While the government adopted a draft 2020-2030 national energy and climate plan in 2021, it has yet to substantially address the comments of the Energy Community Secretariat. According to the Secretariat, the plan does not link between the targets, policies and measures, lacks a public consultation and is not based on a sound cost-benefit analysis. Alongside making energy use and energy generation more efficient, it is crucial to reform water resource management to help develop Albania's economy. This is particularly important for the tourism and agriculture sectors to mitigate the effects of climate change, which Albania is vulnerable to.

On security of supply, Albania's electricity distribution losses in the power grid increased to 20.62 % in 2021, down from 21.48% in 2020, corresponding to an increase of about 155 GWh, due to an increase in electricity consumption. No new energy efficiency funding mechanisms have been put in place, and the implementation of the 2017-2020 national energy efficiency action plan, extended to 2021, did not met its target of 6.8% energy saving. Furthermore, the Energy Efficiency Agency, set up in 2018, is still not fully operational. Albania is a net importer of electricity at a rate of 30% per year, as its hydroelectric production is not enough to cover its needs. Its electricity system is connected with systems in Greece and Montenegro, and construction work on the interconnector with North Macedonia is expected to start shortly. The Albanian Power Exchange (ALPEX) has not yet been created or is operational yet. The country intends to connect the Vlora thermal power plant with the Trans Adriatic Pipeline (TAP) through a natural gas pipeline and a new LNG terminal. This should boost the country and the region's energy security. Albania's oil stock legislation is not in line with EU *acquis*, and its emergency oil stock model has not yet been amended.

Albania's electricity prices are not fully liberalised. Since 1 January 2021, all distribution customers connected to 35kV benefit from an unregulated market. From 1 January 2022, 7 358 customers connected on 20/10/6 kV, after meeting the technical conditions of installation of metering system. They therefore entered the liberalised market and have the right to find their own suppliers. If they do not find another supplier, based on the provisions of the power sector law (no. 43/2015, as amended), for two years they will continue to be supplied by FSHU as a last resort supplier. At the end of this period, the system operator will interrupt the power supply to the customer. The next step of de-regulating supply at all voltage levels, except the 0.4 kV level, has yet to be completed. Albania's small hydro-electricity power plants have a significant impact on biodiversity and local communities, notably in protected areas where around 100 concessions are located or planned.

Albania's potential for renewable energy production is promising, but the market is still not fully liberalised, the energy supply relies on hydropower and energy efficiency remains low. However, by improving energy demand management, including further measures to stimulate investment in energy efficiency and renewable energies (notably solar energy), Albania could boost the economy's competitiveness and energy security. The power sector law was amended to comply better with EU *acquis* on energy. This allowed for the effective separation of the electricity distribution system operator from the production operator. However, the compliance officer has still not been appointed, and functional unbundling is not yet completed. Albania was ranked 25th in the World Economic Forum's energy transition index (WEF) in 2021, the highest in the Western Balkans. In October 2020, the Albanian Power Exchange (ALPEX) was established as a shareholder company. It is jointly owned by the Transmission System Operators of Albania (OST) and Kosovo (KOSTT). The power exchange company will operate the short-term electricity markets in Albania and in Kosovo. In February 2022, ALPEX selected the winning bidder for the service provider, and a union of three companies (the Hellenic Energy Exchange S.A., ENEX Clearing House S.A. and Hellenic Exchanges – Athens Stock Exchange S.A.) and signed the agreement that will provide the electronic trading platform for the day-ahead and intraday market and services required for the operation of the organised market in Albania and Kosovo. The Albanian power exchange should be made fully operational, as it could be key to an integrated organised electricity market agreed with the energy community.

Smart and sustainable mobility (including trams, electric buses, digital platforms, alternative fuels infrastructure, and charging stations) could help to tackle business needs and energy challenges. It could also be a key component in a new growth strategy that could support Albania's decarbonisation efforts and improve mobility in its larger cities. Albania also needs to make significant efforts in implementing and enforcing waste management and improving water and air quality. Waste is also a major issue – closing non-compliant landfills and dumpsites and tackling littering are still big challenges. There are still not enough separate collections of waste streams or economic instruments to promote recycling and reuse and prevent waste generation. Any planned water and wastewater reforms should include a thorough analysis of what is preventing development in these sectors. However, neither smart mobility nor waste management measures were included in the 2023-2025 ERP.

In October 2021, Albania along with other Western Balkan partners endorsed the action plan for the Green Agenda for the Western Balkans. This aims to align with the European Green Deal and contribute to the sustainable socio-economic development and the green recovery of the region after the pandemic. However, despite this endorsement and a reportedly good level of support, notably among female Albanian entrepreneurs, for sustainable and green transformation, in the OECD's 2022 SME policy index, Albania had the second-lowest score in the region for its framework for environmental policies targeting SMEs. It also had the lowest score for incentives and instruments for greening SMEs. Albania needs to ensure capacity building to improve the completeness, quality and consistency of data collected on greening SMEs, access to finance, innovation and public procurement. However, the government needs to make Albanian businesses more aware about the circular economy. According to the 2022 Balkans barometer, Western Balkan economies are far behind in their efforts to shifting towards a circular economy, and Albanian businesses are the second-least prepared for and inclined to a circular economic model in the region. An Albanian Circular Economy Roadmap is being developed with the OECD, funded by the EU, foreseen to be launched in 2024. The lack of government subsidies to help on this is an impediment.

The ERP's analysis of energy market reforms is well developed, identifying the main obstacles in the energy sector -to hydro power generation. Power generation in Albania remains vulnerable to the hydrological situation; this has an effect on electricity import needs to secure an uninterrupted power supply in the country, and increases the financial burden for the state-owned power generation company. Electricity prices for households and SMEs remain highly subsidised, which creates disincentives for energy efficiency measures and affects fiscal accounts. Albania has good potential for developing photovoltaic power, and this is included in the measure-. This is important, as diversifying energy sources is necessary to alleviate hydrological crises caused by climate change, such as those the country suffered to a degree in 2022. As part of the efforts to improve connectivity and security of supply, the power line interconnecting Albania and Kosovo has become operational. In addition, it is important for Albania's fiscal sustainability to incentivise energy saving, invest in energy efficiency, and consider adjusting untargeted support currently in the form of stable electricity prices for all households and micro-, small and medium-sized companies. However, as Albania is a member of the Energy Community, the ERP should also provide for the timely alignment with and implementation of the EU Energy Efficiency Directive (2018/2002/EU), following the adoption of the Clean Energy package in November 2021. **The ERP's analysis on the green transition** recognises that barriers to it include a lack of awareness, inadequate data, poor coordination among green economy players, and gaps in human and institutional capacity. It also recognises that there is a lack of knowledge about the opportunities the green economy can offer. The ERP highlights major gaps in human and institutional capacity to put into practice the green economy concept and points out that there is not much political will to implement policies in line with ecological procedures. Albania has only put forward one reform measure in this area, which is designed to tackle an important issue (F-gases). The measure is relevant and seems to be well conceived. However, beyond this (and not mentioned in the analysis or addressed by related measures), Albania also needs to tackle the need for integrated low-carbon transport systems and waste issues. More energy diversification, as already mentioned, is also crucial in light of Russia's war of aggression on Ukraine. The **Economic and Investment Plan** for the Western Balkans (EIP) and the further development of a **Common Regional Market** will help boost the economy's competitiveness, backed by the digital and green transition.

Reform measure 11: Reducing environmental pollution and promoting the decarbonisation of energy-intensive industries

This measure is carried over from 2022-2024 ERP. Although updating legislation to lower emissions of fluorinated greenhouse gases is important, there are several other measures that could have been included under measure 11. Albania has endorsed the Green Agenda for the Western Balkans, but besides the measure to lower F-gases, the 2023-25 ERP does not address these issues or increase the capacity in the environmental sector. It is give the size of the business sector that is affected by the measure. There are also other new measures and programmes that have been initiated or been implemented, that have not been reported under measure 11, despite falling under the Green Transition. These include a EUR 240 million donor loan for a budget support programme called 'Support for Nature', which will focus on green development, waste management and protected areas. Also, for the first time, Albania launched a financial support scheme in 2022 to cover up to 70% of the cost of water-heating solar panels. The first call of this scheme, through the Agency for Energy Efficiency, supported around 2 000 families. However, neither of these measures are included in the ERP.

Reform measure 14: Energy security through the promotion of renewable energy sources and energy efficiency improvements

This measure on diversifying energy sources was also carried over from the three previous ERPs, (although they had differing names). Although it includes promoting the use of renewable energy sources besides hydropower, it also includes the construction of the Skavica hydro power plant. However the Energy Treaty Secretariat expressed a concern and insisted that this major project would need an environmental and social impact assessment (ESIA) study in line with Energy Community Treaty rules. The study would identify the environmental and social implications of the project and put forward suitable mitigation measures to be carried out in due course. Therefore, preparation of the ESIA study should have been one of the actions under this measure.

Activities promoting other renewable energy sources to generation electricity are essential to reduce the country`s dependency on energy imports, and ultimately aim to reduce the cost of energy for businesses and households. Such energy efficiency activities might only to produce results in the long term rather than in the short term. However, no energy audits are planned, although feasibility studies are underway for both the Skavica hydro power plant (in 2023) and interconnections with Greece. A combination of energy audits and feasibility studies would make the energy efficiency projects more technically mature and speed up their financing and implementation. The activities planned in 2023, 2024, 2025 would need to be reviewed and updated with regards to Skavica, Karavasta PV Power Plant and the Offshore Wind Auction.

Key structural challenge 3: Increase competitiveness, in particular by improving business support services, funding research and innovation, continuing to address the informal economy and implementing reforms to facilitate the digital transition

Albania's micro- and small- businesses still often struggle to access finance due to a lack of business know-how and skills and low financial inclusion and literacy. They continue to account for a far higher level of employment and added-value than the EU average **-** yet many SMEs still do not have bank accounts and cannot prepare financial reports to obtain funding. Several steps have been made to tackle informality, including the authorities' fiscalisation programme, along with measures to encourage online banking, is expected to increase financial inclusion and level the playing field in the medium term. Despite some progress, diversification of production and exports is still low. Albania could improve competitiveness by addressing some of the weaknesses identified in the 2022 OECD SME policy index. These include digital skills, infrastructure performance, collateral execution and property titles. Skills investment in particular is key, as described under key structural challenge 1, as firms' readiness to innovate is closely linked to the availability of staff with the right skills. AIDA has launched a new digital platform aimed at informing firms of the available financing opportunities. (https://e-albania.al/). The country should also develop insolvency prevention policy measures, including a fully-fledged early warning system, and stimulate digitalisation and the adoption of e-commerce.

On research and innovation funding, budget increases have been planned until 2025. However, there was little progress in 2022 and the target remains very optimistic. Further sustainable efforts to increase public funding of research and Innovation (R&I) are needed, alongside incentives for businesses to increase their R&I expenditure and to cooperate with universities. Reliable statistics and data on science and technology are welcomed, as is a clear methodology to define the indicator on gross domestic expenditure on Research and Innovation are planned for 2023. Albania has also made good use of its participation in the Horizon programme, where 2022 marked the best year of Albania's participation in EU Research and Innovation Framework Programmes. However, on the European Research Area, Albania should improve its linkage with European partners to engage in international cooperative research. There was good progress in 2022 on innovation new Start-ups Law and public funds for start-ups financing for up to 10 EUR million over the following 4 years, however there is no mention of smart specialisation (S3) in the 2023-2025 ERP.

The informal economy is seen as an obstacle to business development and competition, which make Albania's business environment challenging. The introduction of fiscalisation has helped to combat this, in particular by comparing VAT data against profit and employment data. Furthermore, informal activity often occurs due to exclusion factors, where those with lower skills and education in less productive sectors rely on subsistence income, notably in agriculture and sectors where enforcement is weaker. The 2023-2025 ERP includes a useful analysis of the impact of measures used to date to tackle the informal economy, although it does not include a sectoral analysis. Such a sectoral analysis could have been useful in order to set out more targeted, sector level, anti-informality actions in the ERP, and justify why they are needed. Also, continued efforts to decrease the cash in the economy should continue as a way of fighting the informal economy.

Contracting authorities need to continue to build capacity to manage public procurement processes in line with the new law on this, by training more officials. While businesses with an annual turnover up to ALL 30 million benefit from simplified bookkeeping rules, some policy measures may be a barrier to formalisation. In Albania SMEs that want to voluntarily register for VAT face restrictions that could increase compliance costs, resulting in a very high tax burden for low-income entrepreneurs. Nevertheless, the 2023-2025 ERP includes useful measures to continue and expand the fight against the informal economy.

Albania scores below the regional weighted average in the 2022 OECD SME policy index for its legal frameworks for survival and bankruptcy procedure regulations. The country has made marginal progress since the OECD's 2019 SME policy index, despite Commission recommendations for transparent and well-defined legislation in line with EU and UN requirements. Like all other Western Balkan economies, Albania does not provide any training to bankruptcy administrators, bankruptcy judges, appraisers or creditor associations. It also collects very little bankruptcy data, which hinders effective and regular monitoring of how insolvency measures are implementation.

Some business services have improved. According to the OECD, Albania (with Serbia) made more progress than any other economy in the region on adopting and implementing policy measures to ease SMEs' access to public procurement. The business investment and development strategy (2021-2027) is now being implemented. It includes specific support measures for SMEs to develop a dynamic and sustainable entrepreneurship environment, and communication to SMEs on what support is available to them has improved. However, the 2023-2025 ERP seems to have postponed the plans for the establishment of a training sector for SMEs at AIDA, as envisaged in the BIDS 2021-2027. Business licensing practices are quite advanced as applications for all business licences can be made on a portal, whose operator receives business licences and submits them to the relevant authorities as needed. Albania is the only economy in the Western Balkans that has introduced electronic distribution and nomination of licensing officers. However, Albania's skill levels remain below the regional average in the OECD SME policy index for entrepreneurial learning (it had the second-lowest score).

Albania's legal and regulatory framework on access to finance is weaker than other regional counterparts, according to the OECD. The financial literacy of Albanian SMEs also remains low. To help address these challenges, an access to finance portal, a one-stop shop to assist SMEs to expand and develop their businesses, was launched in 2021 and had 965 registered users by the time of the publication of the OECD 2022 SME policy index. Nevertheless, the 2022 business barometer shows that businesses still see access to finance as a problem when trying to scale up.

Albania has made some progress on the digital agenda strategy and e-government. Driven by the COVID-19 pandemic, e-learning, digital training services and, to some extent, e-commerce has become more prevalent in businesses. However, as mentioned above, Albania still needs to create an environment that supports SME digitalisation and e-commerce adoption as the country lags behind regional peers in these areas. While Albania has a solid and well-designed e-commerce policy framework, despite the fact that the actual use of e-commerce is rather limited compared to neighbouring economies. Low use of credit and debit cards and high use of cash, as well as low capacity of telecommunication operators and Internet providers, are among the reasons why e-commerce has not bloomed even during the COVID-19 pandemic. More public and financial services are being made available online, and the government aims to offer 95% of public services online. However, there is a risk that this rapid shift could be made at the expense of delivery, accessibility, and there may also be cybersecurity risks.

There has been mixed progress on digitalisation. In June 2022, the government adopted a digital agenda with a corresponding action plan for 2022 – 2026. Digital infrastructure continued to improve and the share of businesses with faster network connections (>10MB/s) increased from 79.8 % in 2020 to 90.5 % in 2021. However, there has been only a small rise in internet use and business websites. Fixed broadband penetration also remains an issue, notably in rural areas where 40 % of the population live but which have four times fewer subscribers connected to fixed broadband than urban areas. Investment in digital infrastructure is also needed in schools - many lack computers and have poor internet connections; currently there are about 0.2 computers per pupil, and this remains an obstacle to using digital technologies in schools and beyond.

As part of its new regulatory framework, in January 2021, Albania strengthened the guidelines for reporting, monitoring and evaluation of public-private consultations (PPCs) conducted by line ministries. The overall PPC process is monitored by the Council of Ministers. However, the lack of meaningful a public consultation on the 2022 ERP, signals that businesses are not consulted enough on government initiatives and are not yet ready to do so purely online (the consultation was only carried out online through a platform that civil society was unaware of at the time). The public consultation on the mid-term revenue strategy was also suspended in early 2022.

In the ERP, the analysis of the main obstacles to digital transformation and a digital economy is rather complete. It underlines the importance of the issue, updates the data on broadband usage, and notes the discrepancy between urban and rural areas. It highlights a lack of investment in rural areas due to a lack of or low return on investment. The ERP also goes on to note that the development of digital and broadband infrastructure requires large investments, synergies between infrastructure projects and digitalisation projects at central and local levels. Furthermore it points out that affordability of both fixed and mobile broadband remains an issue especially in rural and low-income areas.

Reform measure 03: Improving institutional, financial and human capacities for research and innovation

This measure is carried over from the 2021 and 2022 ERPs. It remains relevant and could help Albania strengthen its innovation and research capacities. The measure was initially ambitious, providing for R&D to be doubled as a percentage of GDP in 3 years (from 0.1% in 2022 to 0.2% in 2024). However, there have clearly been delays, as the 2023 ERP pushes the first benchmark to 2023 and now sets the 0.2% target for 2025, not 2024. In addition, the measure also no longer mentions the completion and implementation of the smart specialisation strategy (S3). However, it does provide for legal and support initiatives to be put in place over 2023-2025, including a legal framework for science, innovation and technology.

Some progress on this measure was made in 2022 with the establishment of the Interinstitutional Working Group for monitoring the implementation of the 2017–2022 national strategy for scientific research, technology and innovation**.** However, very limited progress was made in the implementation of the important ongoing smart specialisation strategy (S3) process, leading to a backlog of tasks. In January 2023, the political responsibility for S3 was moved from the Ministry of education to the Deputy Prime Minister's Office. Cooperation across ministries and governmental bodies will need to be strengthened to ensure that the Albanian S3 is drafted and adopted by mid-2024 as planned.

Budget increases are planned in these areas until 2025; however, the possibility of meeting the target increase in % of GDP is remote. Further sustainable efforts to increase public research and Innovation (R&I) funding are necessary, as well as incentives for businesses to increase their R&I expenditure and cooperate with universities. The EU therefore welcomes that reliable statistics and data on science and technology and a clear methodology to set an indicator on gross domestic R&I expenditure are both planned for 2023.

The EU welcomes that Albania has joined and participates in the EU's Horizon Europe programme and notes that in 2022 the country had its participation highest rate in EU R&I framework programmes.

However, Albania should try to increase private sector participation in Horizon Europe. The country should also improve its links with European partners in the European Research Area (ERA) to become more involved in international cooperative research, as it has not joined any of the 20 ERA actions so far. As this aspect is not properly addressed in this ERP, Albania should rapidly identify the ERA actions most relevant to it and then actively itself engage in them.

Reform measure 06: Strengthening the fight against informality

This is a worthwhile measure that builds on the work already done in 2022. However, in the description of the measure, it would have helped to assess the extent of the informal economy and the sectors in which it is most prevalent. It would also have been useful to include more information on the measures planned in the MTRS to tackle the informal economy (the MTRS was still a draft document at the time of writing despite its adoption being part of the 2022 policy guidance). The creation of a cross-sectoral anti-informality unit is welcomed; however, further reporting on the unit's action plan would have been useful. The measure should also have contained a summary of the monitoring reports prepared by the unit's secretariat. This would have shown the added value of the new anti-informality structures even more clearly.

Reform measure 07: Developing a legal framework to support innovative start-ups

The description of this measure, which is carried over from the last ERP, focuses heavily on the drafting of the law on start-ups. However, this law has now been adopted, making parts of the text mostly historical. Furthermore, it does not explain why there was a need to amend the law (is it, for example to add elements to the legal framework on the digital nomad and legal instruments of financing of start-ups (for example venture capital, business angel investments)). The text also neglects to mention that the government has already set up a fund (equivalent to EUR 10 million) over 4 years to provide free advice to start-ups. This operational information is arguably more important than the legal issues on which the text focuses. Furthermore, the result indicators need to be revised.

Reform measure 08: Support measures to MSMEs

This is a potentially useful measure, however, in the description part of the information on the overall amount of assistance provided for the sector is missing. Only fragmented information about two donor-funded programmes is provided, which does not provide a complete picture of the full amount of assistance available or planned for MSMEs. The description of the measure would need further elaboration, in order to see a gradual matching with the planned activities. Although an export strategy is very much needed, the process of its drafting could be better explained, perhaps as component of BIDS, and followed up in the list of activities. Furthermore, in the result indicators, there is no mentioning of the export strategy, export promotion actions, or agreements signed between companies.

Reform measure 12: Development of the broadband infrastructure for digital economy

This measure is carried over from the last three ERPs. The information on the reform has been updated, supplemented with new developments in the sector, and it highlights the European Green Deal. In addition, the measure is analysed in light of the green transition. The reform seems well-prepared, it will have a clear impact on the economy, and it is in line with the EU strategy for the digital agenda in the Western Balkans. Albania has patchy broadband penetration, particularly in rural areas, and the proposed measure clearly addresses this. The text also links the measure to reform measure 8 (access to finance), which includes digitalisation and ICT access for SMEs. It also flags that the measure on digital skills is also relevant (though this is under education and reform section). That measure is specifically aimed at the development and empowerment of teachers' digital skills.

1.5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2022

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye has adopted targeted policy guidance for all partners in the region. The guidance represents the participants' shared view on the policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The underlying rationale of the policy guidance is similar to that of the country-specific recommendations usually adopted under the European Semester for EU Member States. Implementation of the policy guidance is evaluated by the Commission in the following year's ERP assessments. The following table accordingly presents the Commission's assessment of the implementation of the 2022 policy guidance jointly adopted by the EU and the Western Balkans and Türkiye at their Economic and Financial Dialogue at Ministerial level on 24 May 2022.

Overall: Partial implementation (47.2 %) ([16])	
2022 policy guidance (PG)	**Summary assessment**
PG 1: If needed, use the available fiscal space in the 2022 budget to cushion the potential adverse shocks through targeted support to vulnerable households and firms provided the economic recovery is well entrenched, plan in the MTBF a gradual reduction of the public debt ratio and a return to a positive primary balance by 2024 while lowering general government arrears below 2.5% of total expenditure in 2022.	There was **partial implementation** of PG 1: 1) **Substantial implementation:** According to the ERP, ALL 20 billion or 1% of GDP was allocated to support households and companies to cushion the impact of inflation and energy prices. This support was targeted to a large extent at vulnerable households (around ALL 14 billion or 0.7% of GDP), but the figure also includes general fiscal policies that are unrelated to the price shock. In addition, 1.4% of GDP (ALL 28 billion) went to the state-owned energy companies so they could keep electricity prices stable for all households and SMEs, but not in a targeted way. In 2022, public debt is expected to have been reduced to about 68.8% of GDP from 73.2% in 2021. It looks set to further decline to around 67.5% in 2023. Under the ERP's baseline scenario, public debt is expected to fall to about 64.2% in 2026 and about 54.9% by 2031. The ERP expects the primary budget balance to turn positive already in 2023. By November 2022, arrears had accumulated to 3.7% of total expenditure but were reduced to 2.2% of GDP in December. The one-off clearance of a part of the arrears via reallocation in the end -of -year budget amendment is not the spirit of the PG. This is because arrears still increased in the second half of the year, and no systematic approach has been observed that sustainably prevents arrears that do not arise due to a lack of funds.
Restrict budget revisions to the regular revision process set out in the Budget Law and use the regular legislative process should an amendment of the Budget Law become necessary.	2) **No implementation:** In 2022, four normative acts (two less than in 2021) to amend the budget were adopted with no regular amendment process. There was no amendment to the budget law. Unexpected circumstances could possibly have justified the use of normative acts for two of the

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

	amendments, but not the amendment of 27 December. The fact that the regular revision process was not used at all cannot be justified either.
Assess the fiscal risks from state owned enterprise and develop proposals for their mitigation	3) **Substantial implementation:** The Fiscal Risk Unit (FRU) in the Ministry of Finance and Economy extended its monitoring of state-owned enterprises. It also proposed additional financing in form of budget support to public electricity providers in 2022 and 2023 to mitigate risks from international price increases. In addition, the FRU issued an order that requires all public bodies to report on their fiscal risks and include proposals for their mitigation.
PG 2: Implement the activities outlined in reform measure 10 of the ERP on Public Strategic Investments and in the PFM strategy to improve the management of public investments including PPPs	There was **limited implementation** of PG 2: 1) **Partial implementation:** Since 1 January 2023, a new Decision of the Council of Ministers (DCM) has been in force requiring all investment project proposals of a certain volume to be included in the strengthened National Single Project Pipeline and to be subject to an improved appraisal process, regardless of their source of financing, that is including PPP proposals. The principles for the identification, proposal, prioritisation and evaluation of investment projects have been improved. However, the DCM still needs to be operationalised, and additional legal amendments are necessary to fully integrate PPPs into the process.
Adopt the medium-term revenue strategy following an intensive public consultation, and complement it with a budgeted, operational implementation plan to guide tax policies in the coming years	2) **No implementation::** The public consultation of the draft MTRS was suspended, earlier comments were not taken into account, and there appears to be no budgeted operational plan for its implementation. The formal adoption also seems to have been abandoned. Selected measures proposed in a preparatory International Monetary Fund technical assistance report for the MTRS were included in the 2021, 2022 and 2023 fiscal packages but not to the proposed extent and without a meaningful public consultation.
Continue to increase the shares of spending on education, health, social protection and R&D in total expenditure	3) **Limited implementation:** The shares of spending on education and health in total expenditure are not planned to increase in the coming 2 years (in 2025, 10% to 11% on education). However, social protection expenditure is expected to increase its share from 28% to 32% in 2025. Public expenditure on R&D has not been reported.

PG 3: Carefully assess and analyse price developments and stand ready to tighten monetary policy, if needed, to preserve price stability in the medium term.	There was **partial implementation** of PG 3: 1) **Full implementation:** The Bank of Albania began normalising monetary policy, ending the provision of unlimited liquidity to banks and raising the policy rate. The Bank of Albania has continually communicated that the policy rate will continue to increase in the future, while the normalisation pace will be data dependent.
Ensure a transparent and accurate reporting of asset quality and adequate provisioning, further reduce remaining obstacles to NPL resolution, particularly by resolving the bailiff deadlock, and reduce data gaps in particular as regards the real estate sector	2) **Substantial implementation:** The Bank of Albania made efforts to ensure a transparent and accurate reporting of asset quality but has not conducted an asset quality review of the five major systemic banks as previously recommended. There was progress on the resolution of the bailiff impasse with the ruling of the supreme court at the end of 2022. The Bank of Albania has prepared a draft regulation to improve data collection on the exposure of the banking system to the real estate sector, and this is currently under consultation.
Foster the implementation of measures aimed at promoting saving and borrowing in national currency and at limiting the use of foreign currency in the real economy, including through measures in the remit of the government in line with the Memorandum of Cooperation.	3) **No implementation:** While the Bank of Albania implemented measures taken in line with the Memorandum of Cooperation earlier, the government made no progress and has no plans to introduce measures to increase the use of the national currency.
PG 4: Provide enhanced business support services to improve access to finance and entrepreneurial know-how.	There was **partial implementation** of PG 4: 1) **Substantial implementation**: There has been good progress in: i) adopting legislation on micro, small and medium-sized enterprises and its by-laws, ii) in developing an e-commerce guide and a self-assessment tool for e-commerce and iii) continuing business support services by AIDA. The 'access to finance' platform has been upgraded and new functionalities were introduced for grants, other financial schemes, and consultants. Calls on innovation, technology and education have generated higher interest from SMEs. Further efforts are needed in developing AIDA's training capacity
Assess the effectiveness of the consultation mechanism and then revise it with input from businesses and social partners in order to make the process more comprehensive, practical and transparent.	2) **Limited implementation:** No assessment on the effectiveness of the consultation mechanism has been reported on. Although not mentioned in the document, the Investment Council, led by the Minister of Finance and Economy, held a dedicated meeting on business consultation At this meeting participants addressed concerns related to the consultation process with social partners and business associations. It was confirmed that such consultations need a different approach than the one currently used by state institutions. This is why the publication of certain draft laws and strategic documents on the online platform konsultimipublik.gov.al has not yielded any relevant comments.

Design a strategic and coordinated action plan for implementing anti-informality policies, based on, but not limited to, the medium-term revenue strategy.	3) **Partial implementation**: Efforts have been made to address the informal economy in a coordinated way through establishment of the '*special anti-informality unit for revenues from employment and services'*. The unit is made up of representatives from the Ministry of Finance and Economy, the General Directorate of Taxation, General Directorate of State Police, the General Directorate of Prevention of Money Laundering, the State Cadastre Agency, and the State Labour Inspectorate. The unit operates based on an action plan. Progress in fiscalisation is noted. Further analysis of the results of cross-checking data from the fiscalisation process would have helped to assess the implementation of this PG. A recommendation would be to continue coordinated actions in tackling fiscal evasion and the informal economy, as well as the ongoing widespread usage of cash in the economy. The use of fiscalisation data in risk management and by inspectors needs to be improved
PG 5: Finalise, in co-operation with all relevant ministries, their agencies and stakeholders, a Youth Guarantee Implementation Plan, adopt it and initiate its implementation Conduct the regional labour market analysis in all regions, institutionalise the national skills needs analysis and utilise these tools together with the Labour Market Observatory to improve the labour market relevance of initial and continuous vocational education and training for young people and adults and to target the use of active labour market measures. Encourage cooperation between innovative businesses and academia as foreseen in the Strategy on Business and Investment Development 2021-2027, by continuing to increase science and research funding, and by creating the conditions for the development of business incubation programmes	There was **partial implementation** of PG 5: 1) **Partial implementation**: The Youth Guarantee plan has been drafted with a wide consultative process and in alignment with the new 2023-2030 national strategy on employment and skills. The national implementation plan for the Youth Guarantee scheme has been adopted in March 2023 as part of the 2023-2030 national strategy on employment and skills. . 2) **Partial implementation**: A Labour Market Information Observatory has been developed, as the primary mechanism for fetching and disseminating labour market information and intelligence. The labour market analysis was completed for two regions: Elbasan and Durres. A recommendation would be to complete the labour market analysis for the other regions and consolidate capacities for regular publication of datasets and findings as well as use them in policy making, particularly education, training and ALMPs planning. 3) **Partial implementation:** As reported in the previous PG, spending on science and research remains limited. Albania has made good progress in boosting its participation in EU Horizon Europe programme, in which it has absorbed more than 65% of funds compared to the previous year. Nevertheless, further efforts are needed in this area

PG 6: Finalise the assessment of adequacy of 'Economic Aid' benefits, increase their adequacy as of 2023, and establish a mechanism for their annual indexation.	There was **partial implementation** of PG 6: 1) **Limited implementation:** Ad hoc increases of funds for economic aid benefits occurred in several stages during 2022, partly as a result of the two energy crisis resilience packages that the government adopted. However, a permanent mechanism of annual indexation is needec. It should be based on an impact assessment of the adequacy of the current benefits, and on benchmarks that take into account the cost of living.
Increase allocation to the National Social Fund to ensure coverage, provide additional support to municipalities with limited resources, and improve the sustainability of newly established social services through continued contribution beyond the third year under a condition that municipalities establish a Local Social Fund with sufficient budget.	2) **Partial implementation:** There has been some positive progress on the Social Fund, in particular the continuation of financial support of social services beyond the third year after their establishment. However, the mechanism requires further consolidation and improvement to ensure the sustainability of services, equity in distribution and procurement of services to third parties. Furthermore, municipalities need to start increasing their local budget allocation to fund social services at the local level. The EU is providing technical assistance to improve the overall operational arrangements of the Social Fund.
Redesign reimbursement policy for outpatient medicine to reduce financial hardship, particularly among persons with disabilities and chronic disease, poor households, people aged 65 and over, and minorities.	3) **Substantial implementation:** Significant steps have been taken to ensure higher reimbursement rates and free treatment for patients with chronic diseases and cancer patients. New medicines have been added to the 'reimbursement medicines list'. A new measure was adopted to start reimbursing costs of medical devices. It is limited to diabetes strips for now, but it is important to expanded it. Other packages for treatment and care have been expanded.

1.6. THE POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TÜRKIYE

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

Brussels, 16 May 2023

[…]

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

1. Achieve as envisaged a non-negative primary balance in 2023 while providing targeted support to vulnerable households and firms if needed to cushion the impact of high energy prices and, thereafter, implement the medium-term budgetary plan aiming to reduce the public debt ratio and increase the primary surplus while using the regular revision process for budget amendments. Keep general government arrears in each quarter of 2023 at maximum 2.5% of total expenditure and below 2.4% of total expenditure at end-2023. Inform decisions about new state guarantees and on-lending to public entities by a systematic risk assessment.

2. Continue measures to increase tax revenue as share in GDP in a growth-friendly way while taking into account the results of a broad public consultation on tax policies. Complete procedures to fully establish the National Single Project Pipeline (NSPP) and advance the necessary legal amendments to fully integrate PPPs into the NSPP. Increase spending on education, social protection and health as a percent of total expenditure and issue instructions for data collection on public expenditure on R&D.

3. Continue to carefully assess and analyse price developments, including by publishing additional indicators of underlying price pressures, and ensure a sufficiently tight monetary policy stance to preserve price stability in the medium term, including by further tightening monetary policy, if needed. Strengthen further the reporting and risk management frameworks across the banking system to ensure an accurate reporting of asset quality, to further reduce obstacles to NPL resolution and to reduce data gaps in particular as regards the real estate sector. Continue the implementation of measures aimed at promoting saving and borrowing in domestic currency, limit unhedged lending and the use of foreign currency in the real economy, with all signatories of the Memorandum of Cooperation taking appropriate action.

4. Develop business support services to create a business environment to nurture SMEs' greening transition, further accelerate SME digitalisation and e-commerce, offer robust insolvency prevention policies to SMEs at risk, and ensure a coherent and predictable application of the property law. Enhance energy resilience and diversification towards green energy transition to implement the Green Agenda, notably the electricity, energy efficiency and climate acquis. Implement within 2024 the adopted climate and energy targets based on the National Energy and Climate Change Plans, as part of the 2030 decarbonisation roadmap, and ensure that the Renewable Energy Operator is operational by end 2023, in line with the renewables law that was adopted on 23/3/2023.

5. Encourage cooperation between innovative businesses research organisations, and academia, as foreseen in the Strategy on Business and Investment Development 2021-2027, by continuing to increase science and research funding, and by creating the conditions for the development of business incubation programmes. Conduct a Youth Guarantee pilot and analyse its performance, and in parallel review and adjust the functioning and operational structure of the National Agency for

Employment and Skills (NAES) to accommodate the service delivery of the Youth Guarantee and develop a set of quality offers. Use the outputs of the Labour Market Observatory to improve the labour market relevance of vocational education and training (VET), invest in its quality and ensure cooperation with the private sector; focus on building skills of youth and adults, with a particular focus on digital skills to support the expanding communications and technology sector.

6. By 2024, establish a mechanism for the annual indexation of the 'Economic Aid' benefits to ensure their adequacy based on the assessment carried out. Ensure sustainability of the newly created services and encourage the creation of new services within the increase of the allocation to the National Social Fund, especially in the municipalities offering the least number of social services and with lower resources. Continue the cooperation with NAES on the 'Economic Aid' Exit Strategy to refer beneficiaries to the services offered by NAES, and in particular analyse and address the reasons for refusal to take on offers of employment or training.

ANNEX A: ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE 2023-2025 ERP

The 2023-2025 ERP analyses areas where Albania has identified the biggest obstacles to its economic development. These areas include the business environment, education and skills, labour and employment, the informal economy, and research and development. It also continues to address the negative impact of the COVID-19 pandemic and Russia's war of aggression against Ukraine. It provides a general assessment of the current reforms towards formalisation of the economy, while acknowledging that informal economic activity remains a significant concern, as illustrated by the high number of cash transactions and non-declared workers. However, the analysis of the sectors where informal activity is most prevalent is largely missing, as are the challenges encountered when trying to tackle the issue. The text describes the challenges in the education system and the reform measures proposed, in particular inclusiveness of education, investment in teacher training, reform of pre-university curricula to match labour market and investment in ICT skills for teachers and students. However, there is no analysis of the problems leading to low educational attainment and results.

Although there is now a good analysis of some green transition challenges, related waste and water issues were not included in this analysis. The low level of business digitalisation, innovation, and research and innovation capacities, which generate the increased demand for both new services and improved infrastructure and knowhow, were also largely absent in the analysis, even though the ERP includes reform measures to address these obstacles. The level of foreign direct investment, product diversification, and exports all affect the country's competitiveness and growth and its ability to create jobs, but these are also not analysed. Furthermore, issues with the rule of law, corruption, unclear property titles and the proper functioning of the judiciary system still hinder businesses and reduce Albania's attractiveness for foreign investments.

Public financial management (PFM)

The analysis of this area is short and focuses almost exclusively on managerial accountability. However, PFM is far wider than this specific topic. Furthermore, a comprehensive approach to managerial accountability is incomplete if it is not linked to the delegation of decision making, internal control and external auditing. The analysis should have covered the al the obstacles on PFM, as many were already identified and some were addressed under Albania's 2019-2022 PFM Action Plan. The risk analysis is also incomplete as most of the mitigating measures are missing.

Reform measure 09: Public Strategic Investments

This measure is carried over from the previous ERP. The actions planned for 2023 are relevant as they focus on implementing the single project pipeline, which are useful and necessary. The assessment of obstacles and challenges in public investment management is realistic and is based on the International Monetary Fund's (IMF) 2016 Public Investment Management Assessment (PIMA) findings. The proposed measure, implementing the public investment management process, continues to address PG recommendations on assessing and approving all investments that involve public funds and PPPs through the same approval process. The measures could be more specific since the DCM on the National Single Project Pipeline has now been adopted. The adoption of the PPP law in 2023 could also have been included in the list of activities.

Reform measure 10: Strengthening managerial accountability in general government units

This measure is welcome as this is an important issue. However, the list of activities requires further development as they are just repeated for each of the 3 years of this ERP. The measure lacks specific verifiable targets on the expansion of managerial accountability. While it is clearly desirable to strengthen managerial accountability in public services, the focus of this measure seems to focus on making managers accountable. It does not look at the wider internal control processes linked to public service standards, internal control and internal audit. Albania should ensure that this reform takes all these aspects of internal control into account. The country should also follow the principles of public administration reform for the Western Balkans, as laid down by OECD/SIGMA ([17]), which it has agreed to. The targets set for this measure are only outputs and do not show the results, which somewhat obscures the potential added value.

Economic integration reforms

The analysis in the ERP is largely a list and short summary of public policies fostering trade integration of the country at regional, EU and global levels. While the text lists many measures and provides updates on the state of play, it does not analyse the issues and potential benefits. While this is to some extent informative, overall it is not analytical. However, there is a short analysis on conformity assessment, the export of animal by-products and trade relations with Kosovo. Even then, this analysis is undeveloped or missing for many other areas that this section should cover.

Reform measure 13: Deepening economic integration

This measure is rolled over from the previous years. Its description could explain in more detail why this specific measure has been drawn up and what is the expected impact in the medium term, rather than just describing the activities. The government should focus on aligning national legislation with EU *acquis* under Chapter 29. One activity planned in 2023, a possible customs union with Kosovo, seems optimistic as the parties are still assessing its feasibility, which will then be followed by negotiations. This measure is relevant to Albania's active involvement in regional trade integration, particularly through the Central European Free Trade Agreement (CEFTA), and the text provides most of the relevant information. Albania continues to take steps to open its market and to ensure deepening economic integration within the region. The follow-up of CEFTA work, such as the process of mutual recognition of authorised economic operators, are actions that will support Albania's EU integration process. However, some activities described in the measure are not well defined. For 2023-2025, this measure focuses on four actions: a possible customs union between Albania and Kosovo, CEFTA actions, the Open Balkan initiative, and cross-border trade projects. A possible customs union between Albania and Kosovo is mentioned for the first time in an ERP, and it only seems to cover a feasibility study of the scenario - the text does not go into detail about what it might cover. The rest of the measure is largely a continuation of existing actions

Transport market reforms

The analysis is well developed in identifying the main obstacles facing the transport sector. It states that further reforms are necessary in this area; Albanian companies in the World Bank 2019 Enterprise Survey identified transport as one of the main obstacles to improving the business environment. The 2021-2025 National Transport strategy, which includes building the intermodal railway connection linking the new Port of Durrës in Porto Romano with the energy park, in line with the national transport plan. This transport strategy is now ongoing in principle though this is not mentioned in the ERP. The ERP admits that work has been sluggish so far, but expects that it will now pick up pace. The text states that impediments, notably land expropriation, have been identified and are being resolved.

Reform measure 15: Rehabilitation and construction of the railway segment Durrës-TIA-Tirana

This measure has been rolled over from several previous ERPs. Upgrading and extending the Durrës-Airport-Tirana railway will increase intermodal transport, and should double the speed of passenger and

([17]) See Master doc - Principles of Public Administration (sigmaweb.org) freight transport between Tirana and Durrës, boosting traffic and reducing road congestion. A contract for upgrading the Tirana-Durrës railway was signed in February 2021. This strategic investment also benefits from EU funding under the European Economic and Investment plan. It forms part of Rail Route 2, linking the capital of Albania, Tirana with the capital of Montenegro, Podgorica, and is extended to the port of Durrës. This is a key project for the region. Project-level indicators are used and need to be further developed to better measure the implementation of reform, which includes information on electrifying the railway line, although there is little indication on when this will take place. New information has been added about the link between investment and the revised national transport plan.

There has been little progress on this measure and the proposed activities were all postponed by a year. Most of the comments in the previous ERP assessment are still valid. Progress has been slower than expected. The document admits that delays have been caused by several factors: (i) a lack of *ex-ante* evaluation of possible environmental effect of the disputes; (ii)(a lack of) experience with the technologies; (iii) issues with the expropriation of land, and (iv) difficulties with the implementing legislation in the transition phases and legal provisions for the setting-up of the relevant structures and agencies. The risks and mitigating measures are well presented, as is the impact on job creation (including the impact on the gender balance) and the environmental and energy efficiency considerations.

The ERP also flags that this measure should enable Albania's rail system to move toward alignment with the EU rail system and that it will be relevant to the green agenda. As mentioned above, unlike the previous ERP, the 2023 ERP mentions urban planning and land acquisition and the potential risk of land expropriation. This issue was introduced in this ERP, and it is elaborated upon. However, the ERP does not include the reasons preventing it from being fully addressed. The issue has resulted in all dependent activities being delayed. Furthermore, the measure should reflect the impact of the planned relocation of cargo activities from the Port of Durrës to a new port which is to be constructed near Porto Romano. The timeline of the activities for 2023 and beyond need to be revised taking into consideration delays in the project so far.

Agriculture, industry and services

The analysis of the main obstacles in the 2023-2025 ERP focuses almost entirely on the agriculture and tourism sectors (as did the previous ERP). It largely fails to address obstacles in the industrial sector or in other service sectors, apart from a list of issues (without any analysis) at the end of the section. This limits the ERP's usefulness as a document for economic policy coordination and prioritisation, and the consistency of economic policies is not ensured.

The Albanian agriculture sector is not very competitive compared to EU-27. Land fragmentation and small agricultural holdings discourage investments in mechanisation and automation and prevent any economies of scale. The main obstacle in addressing land fragmentation is the lack of property reform, such as an integrated land management policy and how it would subsequently be enforcement. Furthermore, the availability of cheap, skilled labour is the main factor that contributes positively to the sector's competitiveness is. However, this is under pressure, and statistical trends suggest that fewer workers are available. This is mainly due to internal migration from rural areas to urban areas and to external migration. Moreover; the educational system (in particular vocational education) continues to be disconnected from the industry needs of the and fails to equip the young generation with the skills demanded by the market. The analysis of the agricultural sector is long but incomplete as it fails to mention the impact of EU IPARD support. The analysis in the previous ERP on this area seemed more realistic. The sector remains prone to structural problems such as land consolidation, land fragmentation, and property ownership issues, some of which are mentioned in the ERP. Another issue poor access to finance for economic operators in the sector. Despite agriculture making up 18 % of GDP in 2021, banks' lending to the agricultural sector made up just 1.4 % of all lending to the private sector in Albania in 2022, as the sector is seen as risky by banks, land is highly fragmented, and producers often lack the collateral necessary

Besides the issues listed as obstacles in the 2023-2025 ERP, Albania should also consider the following: i) consolidating the food-safety system following an integrated approach by ensuring cross-compliance along the entire food chain; i) exploring new market opportunities related to food product exports ; iii) enforcement of registration and approval of establishments operating with products of animal origin; and iv) the classification and upgrading of existing operating establishments in line with EU requirements.

Obstacles and opportunities regarding maritime tourism are well defined, highlighting some potential for expansion. However, apart from that there is almost nothing is mentioned of other services, even though this is a major economic sector.

As regards industry, this ERP does not provide any analysis for this significant sector, as was the case in the last two ERPs. This is a significant shortcoming.

Reform measure 16: Better marine and maritime governance and services

This was a new measure in the 2021 ERP. The same comments then and in 2022 apply – the reform is small in scale and seems to be an isolated initiative, based on some legal reforms. The measure should ideally have been treated as part of a larger reform, where relevant policies/plans regarding marinas/ports should be also considered. The description of the measure has clear references to strategic policy documents, and other sectoral reforms, such as those related to the blue economy and the financial approach to incentivise maritime tourism. Within these constraints the activities are well planned and detailed. They seem feasible and are relevant to the proposed measure, however, some baselines are still not included.

Reforms in the tourism sector are welcome, as it is an sector with high untapped potential for economic development. However, this measure does not seem to be integrated into the overall sectoral development policies and plans. Furthermore, although the text presents the legal framework for marinas (and legal clarity is certainly really important for such investments), the text does not examine the environmental effects of building and running them The overall description of the measure has improved from last year, and concrete results are reported. However, the activities are very generalised and repeated for each of the next three years, which will make their monitoring very difficult.

Education and skills

Skills, VET and reform measure 1 are analysed in section 4 of this document, under key structural challenge 1.

Investment in education continues to be lower than in the EU – 3.1% in 2021 compared to 4.8% in the EU. This is reflected in the quality of education and lower results and levels of attainment: a significant proportion of 15-year-olds still lack basic reading and numeracy skills. The share of early leavers from education and training (17.4% in 2021) is also much higher than in the EU (9.7%).

University education in Albania is of low quality and largely disconnected from the labour market. In a list of 400 higher education institutions (HEIs) (QS – World University Ranking 2021), the University of Tirana is ranked 351-400, behind its regional peers. There are 40 HEIs in Albania, with more than 1 300 study programmes. These programmes are often multiplied across different HEIs , which is a clear indicator of the lack of structural planning and education development strategies. This results in poor content and a lack of alignment with labour market needs. There is a theory-practice gap, with limited internships opportunities, mostly in the public administration. Even EQF level 5 professional programmes are mostly theoretical and lack practical content. Inter-disciplinary study programmes are also not promoted. The 2021-2026 national strategy for education plans to partly address this issue through increasing the offer of professional programmes, promoting career offices, and interdisciplinary and Science, technology, engineering, and mathematics (STEM) programmes. However, cooperation with the private sector is still very weak, and this needs to be strengthened to prioritise the provision of programmes based on labour market demand. The ERP does not include any reform measure to tackle issues in higher education.

The ERP presents a good overview of the measures taken in the area of pre-university education. However, an analysis of the problems that result in these low levels of attainment and comparatively low performances in international assessments would have been useful.

Reform measure 17: Support the implementation of pre-university curricular reform and teacher training

The measure is carried over from the previous ERP and focuses on a reform of the curricula to align them with labour market needs (one of the most crucial areas in the pre-university education area). and investment in teacher training. If implemented completely, the measure has the potential to significantly improve the development of skills in the education system and the quality of investments in human capital.

A particular emphasis is placed on teacher training and a professional network to empower and encourage teachers. This serves as a mechanism to support the professional development of teachers and improves the quality of the curriculum implemented in schools. This reform measure is supported closely by the EU Programme on Social Inclusion.

The reform measure contains many activities needed to improve the education system, but their effectiveness depends on the quality of implementation. In particular, planning international assessments is welcome; however, these assessments should not just be carried out: it is even more important that their results are used to inform further policy decisions. The teacher training plan could have been much more ambitious considering the number of teachers in the country. In the estimated cost of activities, teacher training is also noticeably under-prioritised. In addition, teachers are already required to have 3 days of a training every year, which is insufficient to adapt their teaching methods and content fully to the changes in curricula.

Reform measure 18: Inclusiveness and equality in education

This reform measure is carried over from the previous two ERPs and is a priority in the country's education strategy. It aims to: (i) ensure inclusive education for all vulnerable groups by providing free textbooks and transport; (ii) further increase the number of assistant teachers for children with disabilities in mainstream public schools; (iii) support deinstitutionalisation; and (iv) set up resource centres to offer daily support for persons with disabilities. The planned budget increase from 2023 to 2025 presents a good foundation for the success of the measure. This increase demonstrates the government's commitment in addition to the support from the EU programme on Social Inclusion and other development partners.

Albania has made progress in setting up a professional network of assistant teachers and training heads of the network and assistant teachers. However, it is necessary to put in place an integrated approach that combines the investments in physical environment and accessibility, curriculum and assistive technologies, as well as more training of general teachers.

The planned action t transform special education schools and institutions into resource centres is a comprehensive investment that goes through several stages. It brings changes to the structure, management, teaching, specialised staff, curriculum, and infrastructure. However, it is also crucial to ensure that these new centres do not prevent children with disabilities from attending mainstream education if it is possible. As mentioned above, this requires a continued comprehensive investment in all aspects of the education environment.

The continued support to students from Roma and Egyptian minorities, such as scholarships, free transport and textbooks, are positive. However, educational outcomes of Roma and Egyptian students remain among the lowest in Albania, and their school dropout rates are close to 50%. This shows that a further analysis of the barriers is needed, together with corresponding support measures.

The measure sets indicators on the number of assistant teachers and psychological services staff. However, would have benefited by including an indicator on the number of children with disabilities who are integrated in the mainstream schools.

Reform measure 19: Development and empowerment of digital competency of teachers

This reform measure is carried over from the previous ERP and is a positive step to tackle and adapt to new labour market developments. Focusing on ICT skills as a key part of the digital transition – it not only supports the EU priorities in that direction but also reflects a reference to EU and international competency frameworks for teachers. The measure also includes investment in infrastructure and equipment, which is essential for its success. Ensuring that everyone has access to a high-quality internet connection should also be one of the prerequisites so that digital skills become part of everyday schoolwork.

Employment

The employment of vulnerable groups and reform measure 2 are analysed in Section 4 of this document, under key structural challenge 1.

Wages are not featured in the 2023-2025 ERP. However, they are a significant factor in the country's economic situation. Wages are closely related to other issues, such as the informal economy, social protection contributions, the number of people living in poverty and social exclusion, and brain drain. Wage growth has continued increasing, with the average wage having increased by 5.8% between Q1-2021 and Q1-2022, although that increase does not match current inflation. In addition, there is no mechanism for revising and updating the minimum wage. And even though minimum wage increases should usually be discussed and approved by the National Labour Council, there was no proper consultations on the two increases adopted in 2022.

Albania has taken steps to improve **social dialogue**, and the National Labour Council is finally operational. However, the Council does not meet frequently enough (only two meetings in 2022), which does not allow for meaningful discussion and participation. Updating the trade unions law would also strengthen collective bargaining. It is essential to develop stronger cooperation on and discussion of policies, including the draft budget, at the highest level with both employers and employees. This is crucial for ensuring a strong link between economic and labour market development. Furthermore, stronger social dialogue is necessary to help ensure healthy and safe working conditions, adequate minimum wages and decent work.

ANNEX B: OVERVIEW OF THE MAIN INDICATORS PER AREA/SECTOR OF THE ECONOMY

Area/Sector	2017	2018	2019	2020	2021	EU-27 Average (2021 or most recent year)
Energy						
Energy imports dependency (%)	38.2%	21.1%	31.5%	35.82%	N/A	55.6%
Energy intensity: kilograms of oil equivalent (KGOE) per thousand euro	219,15	209,44	204,16	196,31	N/A	110.35
Share of renewable energy sources (RES) in final energy consumption (%)	35.90%	36.84%	38.04%	45.02%	41.39%	21.7%
Transport						
Railway network density (metres of line per km^2 of land area)	11.62 [w]	11.62 [w]	5.88 [w]	7.79 [w]	7.80	N/A
Motorisation rate (passenger cars per 1000 inhabitants)	146.8 [w]	159.9 [w]	174.1 [w]	191.3 [w]	N/A	N/A
Agriculture						
Share of gross value added (agriculture, forestry and fishing)	21.8%	21.1%	21.0%	22.0%	20.3%	1.8%
Share of employment (agriculture, forestry and fishing)	38.2% [w]	37.4% [w]	36.4% [w]	N/A	N/A	4.3% (2020)
Utilised agricultural area (% of total land area)	40.8 [w]	40.8 [w]	40.8	40.5	N/A	40.6% (2020)
Industry (except construction)						
Share of gross value added	12.8%	14.1%	13.8%	12.5%	22.0%	19.9%
Contribution to employment (% of total employment)	12.5% [w]	12.7% [w]	14.4%	N/A	N/A	16.1%
Services						
Share of gross value added	54.9%	54.5%	55.4%	55.3%	57.7%	79.2%
Contribution to employment (% of total employment)	42.4% [w]	42.9% [w]	43.5% [w]	N/A	N/A%	70.9%
Research, development and innovation						
R&D intensity of GDP (R&D expenditure as % of GDP)	N/A	N/A	N/A	N/A	N/A	2,26%
R&D expenditure – EUR per inhabitant	N/A	N/A	N/A	N/A	N/A	EUR 734,5

Digital economy						
Percentage of households who have internet access at home	N/A	84%	85%	87.2%	90.9%	92.5% (2022)
Share of total population using internet in the 3 months prior to the survey [NB: population 16-74]	N/A	62.6% w	68.6% w	72.24%	N/A	90%(2022)
Trade						
Export of goods and services (as % of GDP)	31.6%	31.6%	31.3%	22.7%	30.6%	50.4%
Import of goods and services (as % of GDP)	46.6%	45.3%	45.0%	37.9%	43.9%	46.7%
Trade balance (as % of GDP)	-22.7%	-20.2%	-20.7%	-20.1%	-22.9%	N/A
Education and Skills						
Early leavers from education and training (% of population aged 18-24)	19.6% w	17.4% w	16.3% w	15.6% w	17.4%	9.7%
Young people not in employment, in education and training (NEET) (% of population aged 15-24)	26.9%	28.9%	26.5%	25.5%	24.0%	13.1%
Children aged less than 3 years in formal childcare (% of under 3-years-olds)	N/A	N/A	N/A	N/A	N/A	36.2%
Individuals who have basic or above basic overall digital skills (% of population 16-74)	N/A	N/A	21%	N/A	23.8%	53.92%
Employment and labour market						
Employment rate (% of population aged 20-64)	63.9% w	65.6% w	67.1% w	66.3% w	63.3%	73.1%
Unemployment rate (% of labour force aged 15-74)	13.7% w	12.3% w	11.5% w	11.8% w	11.6%	7%
Long term unemployment rate (% of labour force aged 15-74)	8.9%w	8.3%w	7.3%w	7.0% w	N/A	2.8%
Gender employment gap (Percentage point difference between the employment rates of men and women aged 20-64)	16.5 ppsw	16.5 pps w	15.0 pps w	15.2 pps w	16.3 pps	10.8 pps
Disability employment gap (Percentage points						

difference in employment rates between people with and without a disability)	18.1 pps	16.9 pps	18.7 pps	13.3 pps	N/A	23.1 pps
Real gross disposable income of households (Per capita increase, Index = 2008)	N/A	N/A	N/A	N/A	N/A	110.27
Social protection system						
At-risk-of-poverty or social exclusion rate (AROPE) (% of population)	58.5%	53.9%	50.8%	46.2%	N/A	21.7%
At-risk-of-poverty or social exclusion rate of children (% of population 0-17)	62.0%	57.7%	53.9%	51.0%	N/A	24.4%
Impact of social transfers (other than pensions) on poverty reduction	12.55%	11.03%	11.88%	12.10%	N/A	37.08%
Income inequality - quintile share ratio (S80/S20) (Comparison ratio of total income received by the 20% of the population with the highest income to that received by the 20% with the lowest income)	7.47	6.98	6.38	5.86	N/A	4.97
Housing cost overburden (% of population)	9.2%	6.0%	5.5%	3.8%	N/A	8.3%
Healthcare						
Self-reported unmet need for medical care (of people over 16)	13.1%	14.8%	14.6%	10.6%	N/A	2.0%
Out-of-pocket expenditure on healthcare (% of total health expenditure)	44.45% [z]	44.58% [z]	N/A	N/A	N/A	14.39% [(2020)]

w: *data supplied by and under the responsibility of the national statistical authority and published on an "as is" basis and without any assurance as regards their quality and adherence to EU statistical methodology'*

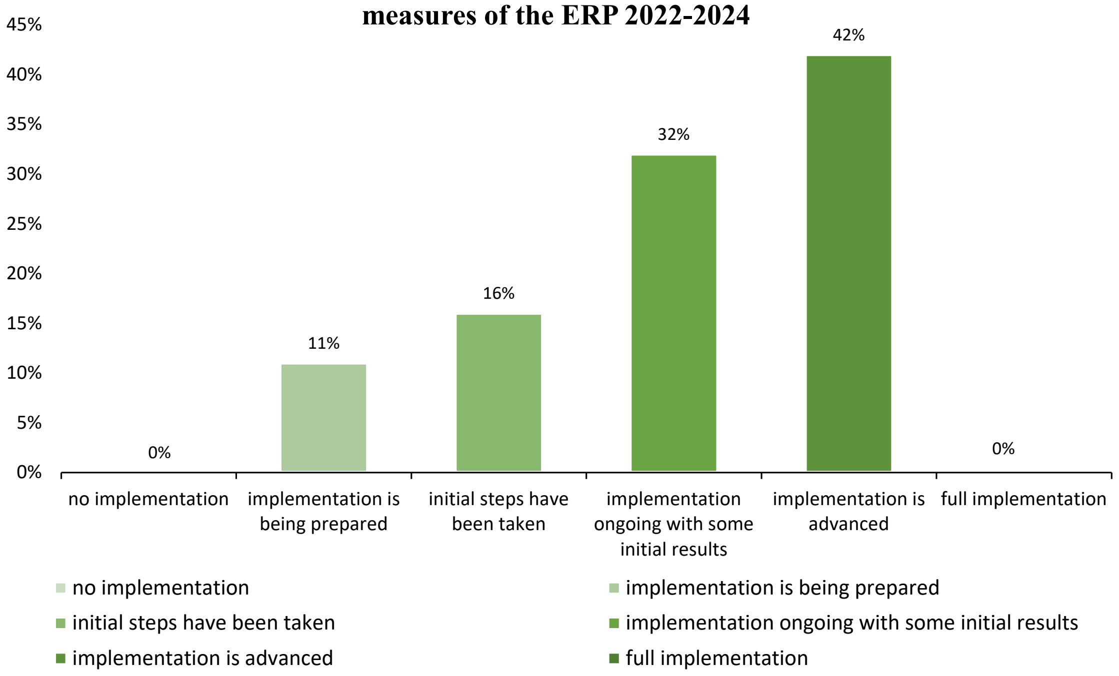
z: data from the World Health Organisation

Source of data in Annex B: EUROSTAT, unless otherwise indicated

ANNEX C: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM THE 2022-2024 ERP

Progress was made in implementing the measures from last year's ERP (average score: 3.3 out of 5). Activity reports provide a fairly accurate description of the level of implementation of the measures that were reported on. However, two measures were not reported on. These were measures on i) the quality and coverage of VET; and ii) access to healthcare. The Commission therefore had to independently evaluate the extent to which these two measures were implemented in the reporting period. The scoring was slightly imprecise for the measures related to addressing the employability of the most vulnerable unemployed jobseekers, improving capacities for research and innovation, increasing social care, support measures to MSMEs, broadband, liberalisation of the energy market, maritime governance, and pre-university curriculum reform. Only text assessment, rather than numerical values, were provided on deepening economic integration. Some of the activities related to broadband and inclusive education were not reported on, so also had to be estimated.

Graph II.1.2: **Albania - Implementation of the structural reform measures of the ERP 2022-2024**



ANNEX D: COMPLIANCE WITH PROGRAMME REQUIREMENTS

Coordination of Albania's ERP is led by the Ministry of Finance and Economy. In 2022, the overall ERP coordination task was delegated from one deputy minister to another. However, the Ministry of Finance and Economy continued to lead the coordination process.. There was limited consultation with private stakeholders. No consultation with Parliament or with local/regional authorities took place during the drafting process. The document was published for consultation in the government portal www.konsultimipublik.gov.al, and on the Ministry of Finance and Economy's website. No comments were registered there by the social partners/private stakeholders. Only the national Agency on Information Society, the Data Protection Commissioner, and one Embassy provided comments on, the document.

The Ministry made some additional efforts were made this year to draw the attention of business associations to the ERP, by sharing the invitation for comments on the draft document through the Investment Council network. Decide just publishing documents online, the requirement to discuss and engage in dialogue with social partners and business associations on important documents, such as the ERP, needs to be formalised. Some business associations requested additional time for comments, beyond the 6 January deadline. The responses from these bodies are well documented in the Annex to the ERP.

The structure of the section on structural reform priorities follows the guidance note. However, there is room for improvement in the format and content. For example, Section 2 on implementation of the policy guidance (PG) is about 16 pages long, exceeding the four-page limit set in the guidance. In some cases, the reporting on PG implementation was mixed with actions planned for the future, and in two cases (PG 3.2- in part and PG 3.3) the information was missing altogether. While there are 19 reform measures, below the limit of 20, the page limit was not observed (it was 20 pages more than the maximum limit).

Macroeconomic framework

The programme is in line with the medium-term budgetary framework and the Budget Law of Albania. It was submitted on time on 1 February 2023 and adopted on 1 March 2023. It describes the past economic developments based on the available data and includes an updated medium-term macro-fiscal framework. Both were published on the Ministry of Finance and Economy's website, but no information about the public consultation and its results is included. Projections for growth in 2023 and beyond lack a detailed explanation, particularly projections for the balance of payment. However, overall, the revised projections are more in line with international estimates than in earlier ERPs. Information on the level of implementation of policy guidance 3 is incomplete. The ERP does not provide an analysis of labour productivity, skills shortages, migration, brain drain and the investment environment. There is also no assessment of the impact of the shrinking size of the population on social insurance and growth.

Fiscal framework

The data in the ERP and the medium-term macro-fiscal framework are consistent, and the fiscal planning is based on latest outturn data. These are both significant improvements compared to last year's ERP. However, data on central government capital investment in the GDP tables does not tally with the data in the fiscal tables. The information about discretionary measures planned for 2023 and 2024 is still rudimentary and fragmented, and there is still no data on the long-term sustainability of public finances (demographic developments, pensions, health expenditure), including past data. However, there is more information on contingent liabilities / use of sovereign guarantees and discretionary measures. The calculation of functional expenditure still needs to be improved. It is still difficult to link policies mentioned in the ERP with the macro-fiscal and budget tables or make comparisons over time. This is because various expenditures are aggregated under one budget heading, and the use of budget headings for the same kind of expenditure varies from one budget to another. Additionally, new headings are introduced every year, which complicates matters. The headings used to record the treasury's outturn data do not fully correspond to the headings used in the budget and fiscal tables.

The ERP does not make clear a link between the analysis of the challenges the economy faces, the proposed reforms, and the corresponding budget allocations. It lacks details on the expenditure plans, in particular plans for capital expenditure. It remains unclear if policies are sufficiently financed because the structural reforms costs presented in the ERP cannot be linked to the budget. There is only limited information on: (i) contributions to the coverage of social insurance benefits and entitlements; and (ii) the deficit of the social insurance schemes to be covered by the budget. Information is missing on: (i) arrears and repayments from public entities (although it is set out to be included in the fiscal framework tables); and (ii) local-government expenditure. Fiscal data do not yet meet ESA 2010 requirements. Albania regularly sends EDP notifications to Eurostat on a best-effort basis and strives to improve them and align its fiscal statistics with EU requirements (with the support of Eurostat). Government finance statistics are not yet aligned with international standards.

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2. BOSNIA AND HERZEGOVINA

The economic reform programme (ERP) was submitted with a nearly 7-week delay on 20 March 2023. This significantly reduced the time available for analysing and assessing the authorities' projections and policy plans to address the significant economic challenges the country is facing.

2.1. EXECUTIVE SUMMARY

The economic reform programme (ERP) anticipates that economic growth will slow in 2023 before a moderate, investment-driven rebound in 2024-25. After a post-pandemic rebound in 2021, a deteriorating international environment and increasing inflationary pressures led economic growth to slow in 2022. Still, output growth was solid at 4%, largely driven by domestic demand. The ERP expects GDP growth to moderate to 1.7% in 2023, before accelerating again in the last 2 years of the ERP period, benefiting from an improving international outlook, strengthening domestic demand and, in particular, increasing private and public investment. Inflation is projected to fall to close to 2% by 2025. Despite a domestically driven growth acceleration in 2024-2025, the programme forecasts a reduction in the current account deficit. A key domestic downside risk to economic growth is the continued lack of reform momentum due to sustained political stalemates, which would impede investment. Externally, stronger-than-expected negative effects from Russia's war of aggression against Ukraine could dampen economic growth prospects.

The ERP expects rising revenues to lead to sizeable fiscal surpluses while public investment is set to remain low, contrary to the country's needs. After higher-than-expected inflation boosted the country's revenue performance in 2022, the programme envisages a balanced budget in 2023 and fiscal surpluses of around 1.5% of GDP in 2024 and 2025. The main contribution to fiscal consolidation is set to come from increased revenues, in particular from social contributions and taxes. Total expenditure is projected to remain largely unchanged as a percentage of GDP, with low growth in investment making room for larger increases in social transfers and government consumption. The planned reduction in investment spending in 2024, presented in the fiscal framework, is in conflict with the macroeconomic framework's assumptions and is not in line with the country's needs and the jointly adopted 2022 policy guidance. From 2024 onwards, significant primary surpluses are expected to reduce the debt ratio, to close to 28% of GDP by 2025. Key fiscal risks stem from over-optimistic assumptions about revenue growth and insufficiently specific expenditure measures. The reliability of the fiscal framework as presented is diminished by weak alignment with EU public sector accounting standards and incomplete reporting on contingent liabilities. As a result, both the deficit and debt ratios may be higher than reported. Overall, despite the relatively low level of public debt, the fiscal scenario as presented does not appear to correspond to the challenges the country is facing, in particular the moderate growth outlook, high investment needs and challenges involved in moving towards EU accession.

The main challenges facing Bosnia and Herzegovina are the following:

- **Country-level policy formulation is strongly impeded by highly fragmented competences and a lack of cooperation among the country's stakeholders.** The high degree of institutional fragmentation, a lack of cooperation among key stakeholders and excessively politicised decision-making processes continue to undermine the country's ability to formulate consistent short- and medium-term fiscal strategies. As a result, the ERP continues to lack a countrywide perspective, and suffers from an insufficient medium-term orientation and inconsistencies between the various programme elements. This is partly a reflection of the country's insufficient central administrative capacity. Furthermore, the economic analysis is negatively affected by the lack of accurate and timely empirical data.

- **The quality of public spending and revenue collection remains low.** Public spending focuses strongly on public consumption and poorly targeted social transfers, clearly neglecting medium-term investment needs in areas such as education, infrastructure and environment. At the same time, the overall quality of health services remains inadequate. Social spending is still not properly targeted, partly as a result of the country's fragmented administration. The level of public investment is low in view of the country's needs and its implementation appears to be uncoordinated, insufficiently prioritised and slow. Public investment would need a substantial and sustained boost to move the economy onto a higher growth trajectory. Revenue collection is negatively affected by a significant informal economy and insufficient transparency of taxable income. Given the continuing high uncertainty about the impact of Russia's war of aggression against Ukraine, a readiness to provide targeted support to vulnerable households and firms, if needed, seems appropriate.

- **A difficult business environment and weaknesses in the country's single economic space are key factors driving poor labour market outcomes, holding back improvements in competitiveness and living standards and impeding preparations for the green and digital transitions.** A persistent issue is the insufficient political ambition to tackle regulatory burdens and corruption. The country's high degree of institutional and regulatory fragmentation and low level of coordination among all levels of government are also major obstacles. The ERP acknowledges problems related to the business environment and regulatory burden. However, it does not include measures capable of meeting the scale of the challenge, nor does it recognise the underlying issues relating to lack of coordination among the various levels of government. Targets for renewable energy and energy efficiency have still to be adopted, as has key legislation at the State-level on opening gas and electricity markets to ensure the green transition and facilitate the necessary investment, including by the private sector. Delivering on commitments to gradually phase out coal subsidies and introduce carbon pricing instruments will be particularly challenging. Digital transformation is lagging behind in both business and in the public administration. A more focused, urgent approach is needed from the authorities on the green and digital transitions.

- **The still-oversized public administration and poorly performing state-owned enterprises (SOEs) put a significant burden on taxpayers and adversely affect the business environment.** SOEs are a heavy burden on the country's public finances and undermine competition. Many of these companies have low productivity while at the same time offering significantly higher wages than in comparable private industries. Many public companies rely on state support and sometimes delay payments to the social security systems or to private suppliers, creating substantial liquidity imbalances in other areas of the economy. Whereas legislation partially provides for open and transparent selection procedures, in practice appointments to SOE boards are highly politicised. The ERP acknowledges the need for and potential benefits of improved governance of SOEs, but reform efforts are slow. Plans for the first steps of reform (to establish central SOE oversight units in both entities) are still at an early stage and SOE registers are still incomplete in terms of coverage and information available.

- **The main labour market indicators highlight a worrying lack of dynamism** with, in particular, a high inactivity rate and low employment rate. Indeed, it is worth noting that more than half the working-age population are neither employed nor looking for work. These figures reflect not only a lack of employment opportunities, especially for young people, women and most vulnerable, but also a large informal economy and societal norms that do not favour a functioning labour market. Clientelism is widely practised. Discrimination can take various forms, reflected in education and consequently in the labour market. The country is facing an enormous 'brain drain' and employers have difficulties in finding the skills they need. This worrying situation is mainly due to disagreement between different levels of the state structure, on policies that should attract a broad consensus.

The implementation of the policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2022 has been limited. Some effort has been made to use the fiscal space to cushion the impact of external shocks, but the measures are not properly targeted. Steps have been taken to increase public investment, but measures to improve investment management have remained very limited. No action has been taken to improve the efficiency of tax collection or to clarify the constitutional competences for establishing a central registry of private individuals' bank accounts. No progress has been achieved on reporting contingent liabilities related to the COVID-crisis response. Efforts to improve the analytical capacities of governmental institutions have remained limited, including in the field of statistics. The currency board arrangement and central bank independence have been maintained, although the smooth functioning of the central bank was impeded by delays in appointing its governing board members. No further progress was made on simplifying business registration, licensing and permitting procedures and harmonising them countrywide, nor was there any progress in adopting a law on electronic identity and trust services, though substantial progress was made on customs policy. While the country did adopt a comprehensive, countrywide public finance management strategy, work on reforming the governance of SOEs is still at an early stage and is advancing only slowly. No progress has been made in strengthening coordination mechanisms on employment policies at country level, and only one of the two entities was able to adopt a new employment strategy, which thereby undermines the development of a countrywide approach. Almost no progress has been made on introducing a Youth Guarantee in the country. Some progress was achieved at entity level to improve access to early childhood education and care for vulnerable groups, even though the closure of many pre-schools resulted in a lower rate of enrolled children.

The ERP identifies reform challenges that are partly in line with those identified by the Commission. Macroeconomic analysis is strongly impeded by low quality and out-of-date countrywide statistics. The fiscal framework is overly optimistic with respect to revenue projections, while spending policy is not sufficiently growth- and investment-oriented, especially given the country's investment needs. The measures to promote employment, social policies and education are not sufficiently detailed and lack a fiscal underpinning. Reform measures that would plan the implementation of Youth Guarantee are missing. Given the aim of fostering a common internal market in the country, more specific references should have been made to identifying and addressing the structural weaknesses burdening the business environment. Many of the measures in the ERP are not countrywide and often lack consistency and coherence. Adopting a whole-of-government approach is a prerequisite for addressing these challenges. Bosnia and Herzegovina should set up a well-functioning coordination and consultation mechanism for the ERP process and integrate it better into wider budget and economic policymaking processes.

2.2. ECONOMIC OUTLOOK AND RISKS

After a strong rebound in 2021 from the pandemic-induced crisis, economic activity slowed down in 2022, reflecting a deteriorating international environment and accelerating inflation. Annual output growth slowed from 7.2% in 2021 to 4% in 2022 ([18]), which is a better outcome than the ERP estimate of 2.7%. To some extent, this slowdown reflects a base-year effect after the strong rebound in 2021, which also led to increasing price pressures as early as late 2021. Russia's invasion of Ukraine further contributed to inflationary pressures by pushing up prices for imported energy and primary commodities. At the same time, external demand declined, though from a high level. The main drivers of growth in 2022 were exports, gross investment (in particular inventories) and private consumption. The labour market remained resilient in 2022. Registered employment was 2.3% higher than in 2021, while the unemployment rate - as measured by the labour force survey (LFS) - dropped to 15.4% in 2022,

([18]) Macroeconomic and fiscal estimates and forecasts covering the period 2022-25 have been taken from the ERPs themselves; if available, preliminary macroeconomic and fiscal outturn data for 2022 have been taken from the relevant national sources (national statistical office, ministry of finance, central bank).

compared to 17.4% in 2021. Youth unemployment (age group 15-24) returned to pre-COVID-19 levels, dropping to a still high rate of 36.1% in 2022.

The programme expects economic growth to decelerate in 2023, mainly reflecting sluggish external demand and weak growth in disposable income due to high inflation, but to regain momentum in 2024 and 2025, driven mainly by domestic demand. Compared to last year's programme, the baseline scenario forecasts significantly weaker growth in 2023 (1.7% instead of 3.5%). For 2024 and 2025, the programme projects a more dynamic growth profile, with output growth increasing to 2.7% and 3.0%, respectively. This brings average output growth during the programme period to 2.5%, compared to 3.5% expected in the previous programme. The more moderate growth profile reflects weaker export demand, higher inflation negatively affecting disposable income, and less benign monetary and financial conditions. As in previous programmes, the main sources of growth are seen to be private consumption and higher fixed investment and inventories. Investment is expected to benefit from increased public spending on transport and energy. In terms of the economy's cyclical position, the ERP expects the negative output gap of the previous years to turn positive in 2023. The programme again anticipates mainly indirect effects from Russia's invasion of Ukraine, such as lower export demand in the main trading partners and significant increases in energy and food prices, eroding disposable income. The ERP estimates the country's growth potential to be around 2½%.

The programme also presents an alternative macroeconomic scenario, which assumes less favourable external demand and higher inflation. This would reduce average annual GDP growth by about half a percentage point, compared to the baseline scenario, to 1.9% on average during 2023-2025, mainly as a result of lower exports and investment and slightly higher inflation in 2023. With respect to internal risks, the programme points to complex decision-making and the slow reform implementation as potential downside risks, which could lead to lower investment but also a bigger brain drain. However, the alternative scenario does not quantify the potential impact of those risks on GDP growth. As last year, the alternative scenario briefly discusses the key risks to the benchmark scenario in a qualitative way, but unfortunately does not quantify the underlying assumptions. Given the multitude of potential risks, the estimated annual impact of half a percentage point on overall GDP growth appears to be on the low side.

Table II.2.1:
Bosnia and Herzegovina - Macroeconomic developments

	2021	2022	2023	2024	2025
Real GDP (% change)	7.6	2.7	1.7	2.7	3.0
Contributions:					
- Final domestic demand	4.9	1.4	0.9	1.1	2.1
- Change in inventories	4.0	1.4	0.5	1.1	0.8
- External balance of goods and services	-1.4	-0.1	0.3	0.5	0.2
Employment (% change)	-1.9	0.6	0.5	1.0	1.4
Unemployment rate (%)	17.4	15.7	15.3	14.4	13.1
GDP deflator (% change)	4.7	7.3	4.5	2.6	2.4
CPI inflation (%)	2.0	13.1	6.7	3.1	2.2
Current account balance (% of GDP)	-2.0	-4.0	-3.0	-2.2	-1.6
General government balance (% of GDP)	1.8	0.3	0.0	0.7	1.6
Government gross debt (% of GDP)	32.0	30.5	30.2	29.5	28.4

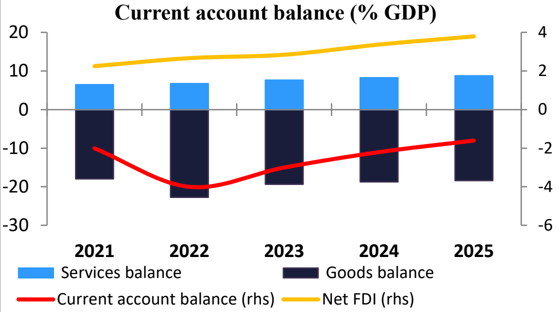
Sources: Economic Reform Programme (ERP) 2023.

The ERP's overall baseline scenario is largely plausible, although the projected strong growth contribution from inventories is questionable. The main risks are seen to be related to weaker-than-expected international demand, weaker investment and a further substantial brain drain. Key upside and downside risks are related to the international uncertainty, partly due to Russia's invasion of Ukraine, which could lead to weaker external demand in 2023 and significantly higher inflationary pressures. This would reduce household spending, which the programme sees as a key growth driver. Unfortunately, like the previous programme, the ERP does not provide information on the impact of structural reforms or of ongoing or planned recovery measures. Overall, the baseline macroeconomic scenario is largely plausible, expecting weaker output growth in 2023 and a strengthening of the economic dynamics in 2024 and 2025. International institutions expect annual GDP growth of some 2% to 3% in 2023 with some acceleration in the following years.

The programme expects a swift drop in inflationary pressures. After annual average inflation of 2% in 2021, inflationary pressures started to mount during 2022, especially after Russia's invasion of Ukraine, which resulted in higher energy and food prices. Consumer price inflation reached a peak in October 2022 with a year-on-year increase of 17.4%, which moderated to 12.9% in February 2023. On average, consumer price inflation was 14.0% in 2022. The programme expects a rapid decline to 6.7% in 2023 and then to 3.1% and 2.2% in 2024 and 2025, respectively. The main factors behind this rapid disinflation are lower import prices, in particular for energy. Bosnia and Herzegovina's currency peg to the euro has served the country well so far, but also limits the central bank's ability to influence price developments. The country has a track record of relatively low inflationary pressures, which to some extent might reflect the country's below-potential growth performance. Nevertheless, there are also some upward risks to the programme's inflation scenario. Recent, relatively generous wage agreements not only reflected rapidly rising energy and food prices, but also election-related public sector wage hikes. Another inflationary factor might be the increasing scarcity of qualified labour, resulting from a substantial brain drain, especially among the young and educated. Finally, inflation is measured using a relatively old consumer basket by an under-resourced national statistics agency.

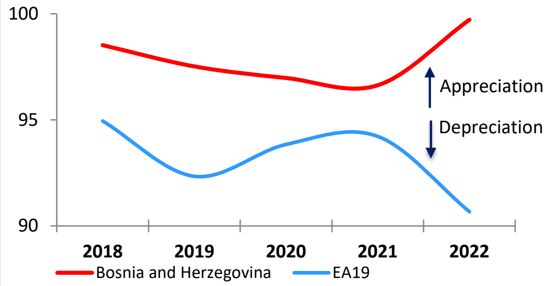
External competitiveness and current account

Graph II.2.1a: **Bosnia and Herzegovina - Current account balance (% GDP)**



Source: Economic Reform Programme (ERP) 2023.

Graph II.2.1b: **Bosnia and Herzegovina - Real effective exchange rate (index)**



Source: Economic Reform Programme (ERP) 2023 and ECB.

The current account balance projection is based on expected stable workers' remittances and tourism revenues but also moderate growth dynamics and low investment, which keeps import growth down. After a drop in the current account deficit to 2% of GDP in 2021, the programme expects a marked, but temporary increase to a deficit of 4% of GDP in 2022, mainly due to much higher spending on energy imports. During the programme period, the ERP projects a sustained reduction in the deficit, to 3% of GDP in 2023 and 1.6% of GDP in 2025. The programme expects that the deficit in the balance of goods and services will be largely financed by current transfers, primarily consisting of workers' remittances, accounting for more than 10% of GDP. Foreign direct investment inflows are relatively low, expected to be just under 2% of GDP in 2023-2025, and mainly consisting of reinvested earnings. The inflow of investment into new companies has been quite limited in recent years, which, to some extent, might reflect the cumbersome business environment, the country's fragmented internal market and political uncertainty resulting from persistent political stalemates. The country's external competitiveness deteriorated recently as a result of an appreciation of the real effective exchange rate, but also reflecting strong wage increases. The expected reduction in the current account deficit appears to rely largely on an increasing service balance surplus, which, however, is not explained in the programme. While last year's programme forecast a slight increase in the current account deficit, from 2.5% of GDP in 2022 to 2.9% in 2024 in line with the expected acceleration in output growth, the current programme expects a slight decline in the current account deficit, from 4% in 2022 to 2.2% in 2024 and 1.6% in 2025, against a background of slightly weaker, but still accelerating growth. Unfortunately, the programme does not provide a sufficient explanation for this more favourable development. The effect of the war in Ukraine on the country's external balances is not explicitly discussed. Arguments used in the programme, such as weaker external demand and higher import prices due to the fallout from Russia's invasion of Ukraine, would actually suggest increasing external imbalances. As far as the financing of the current account deficit is concerned, the financing needs so far were to a large extent covered by (rather limited) foreign direct investment inflows and loans from international financial institutions at relatively favourable rates. The gross external debt ratio remained moderate, at some 58% of GDP in 2022, while the net international investment position remained stable in nominal terms, but improved in relation to nominal GDP, from -35% of GDP in 2020 to about -28% in 2022. Partly as a result of international, COVID-related support, such as the additional special drawing right (SDR) allocations by the International Monetary Fund (IMF), the country's foreign exchange reserves are relatively high. At the end of 2021, the reserve would cover 9.3 months of imports, which, due to higher spending on energy imports, dropped to some 8 months in the third quarter of 2022.

Table II.2.2:

Bosnia and Herzegovina - Financial sector indicators

	2018	2019	2020	2021	2022
Total assets of the banking system (EUR million)	15 264	16 621	16 824	18 121	18 628*
Foreign ownership of banking system (%)	84.8	84.7	83.1	82.2	73.9*
Credit growth (aop)	6.6	5.7	1.1	1.7	4.2
Deposit growth** (aop)	11.3	9.3	5.6	10.1	5.9
Loan-to-deposit ratio*** (eop)	91	89	83	77	76
Financial soundness indicators (%, eop)					
- non-performing loans to total loans	8.8	7.4	6.1	5.8	4.5
- regulatory capital to risk-weighted assets	17.5	18.0	19.2	19.6	19.6
- liquid assets to total assets	29.3	29.2	28.6	30.7	30.5
- return on equity	8.5	9.1	5.6	9.6	12.0
- forex loans to total loans	56.7	53.9	53.9	50.2	43.3

* Q3
** Total deposit growth
*** Non-interbank loans to customer deposits
Sources: Central Bank, Supervisory banking agencies, CBBH calculation.

The country's financial sector has remained stable and so far has weathered the impact of Russia's invasion of Ukraine well. The banking sector benefited from a solid capital endowment and government measures to support the economy. A few days after Russia's invasion of Ukraine, the two entity-level banking agencies had to take over the subsidiaries of Russia-based Sberbank when their liquidity deteriorated rapidly as a result of quickly accelerating deposit withdrawals. In 2022, credit growth slowed to 4.3%, which is especially low given the underlying double-digit inflation rates. Deposit growth has also slowed, reflecting the deteriorating liquidity situation of households and businesses. So far, the banking sector has managed to avoid a marked deterioration in financial soundness indicators. The non-performing loans (NPL) ratio decreased further to 4.5% end of 2022, and the ratio of foreign-denominated loans to total loans has also continued to decline. However, in some smaller, domestically-owned banks, NPL ratios appear to be significantly higher. There appears to be scope to increase the financial sector's role in reaching climate and energy targets in line with European and international commitments by adopting policy measures in the area of sustainable finance (such as sustainability disclosures, sustainable finance taxonomies etc.).

2.3. PUBLIC FINANCE

Fiscal performance in 2022 benefited from stronger than anticipated revenue growth. Official data on the country's fiscal performance in 2022 is not available yet. However, based on provisional data, the programme anticipates that total revenue will have risen by 10.3% in 2022, compared to the 2.9% anticipated increase in the previous programme. Total spending is estimated to have increased by 14.5% in the current programme, compared with last year's 1.5% estimate. The 2023 programme estimates a surplus of 0.3% of GDP, while the 2022 programme expected a deficit of 0.2% of GDP in 2022. Thus the current programme anticipates a 0.5 pp improvement in the country's fiscal position, compared with last year's estimate. However, according to the central bank estimates, which try to align with the European system of national accounts (ESA) standards, the general government registered a deficit of 0.3% of GDP in 2021. Official fiscal data for 2022 is expected by November 2023. The main factor behind the better-than-expected revenue performance was the strong increase in tax revenues (+16%), compared to a nominal GDP increase of 10.2%. On the spending side, the main driving factors were strong increases in social transfers (+14.3%) and collective consumption (+12.6%), accounting for some 70% of the total spending increase. In addition to COVID-19, the higher spending probably was also related to the general elections in October 2022. The public debt ratio declined from 32% of GDP in 2021 to some 30.5% at the end of 2022, mainly benefiting from a 10.2% increase in the level of nominal GDP. There is a significant degree of non-alignment with EU public sector accounting standards, particularly with respect to publicly owned enterprises, which strongly impedes the assessment of the country's actual fiscal position. As a result, both the deficit and debt ratio could be significantly higher than reported.

The ERP's medium-term fiscal strategy envisages a balanced budget in 2023 and targets increasing primary surpluses in 2024 and 2025. This underlying fiscal stance is surprising given the country's moderate growth, high investment needs and low public debt levels. During the ERP period, total revenues are set to increase by 1.1 pps of GDP, while total spending is set to fall by 0.2 pps of GDP. Both the budget balance and the primary balance are set to remain in surplus and improve by 1.4 pps and 1.7 pps respectively. Revenues are expected to rise by 6.7% on average in 2023-25, compared to nominal GDP growth of 5.7% during this period. According to projections, this is to be partly driven by the 9% average annual increase in social contributions, which is surprisingly high given projected employment growth rates of below 1.5%. Property tax income is also expected to be almost 20% higher than last year, although this is not explained further in the ERP. On the spending side, the slowdown in total expenditure growth is mainly the result of decelerating increases in collective consumption and social transfers, albeit from a high base, due to COVID-19 and the energy crisis. However, by 2025, social transfers will still be nearly 1 pp of GDP higher than in 2022, and 1½ pps higher than in 2021. At the same time, investment spending is projected to remain below nominal GDP growth, with a 0.4 pp fall in investment in 2022-2025, to just 3.4% of GDP. The neglect of public investment is not in line with the country's needs and is also in conflict with the jointly agreed policy guidance. Another feature of the country's fiscal position that would have merited more explanation is the increasing surpluses for local government and social security funds.

For 2023, the ERP projects balanced general government accounts, as the surpluses for local governments and social security funds are set to largely compensate the expected central government deficit of 0.6% of GDP. The fiscal data provided for 2023 is based on the country's medium-term fiscal framework, and not on actual budgetary proposals, even though these were already available when the programme was submitted. The programme expects an 8% increase in total revenues, mainly driven by higher revenues from social contributions and taxes, increasing by 9.4% and 7.7% respectively, compared to nominal GDP growth of 6.3%. On the expenditure side, the overall increase is primarily driven by higher spending for collective consumption (+9.2%) and social transfers (+10.5), while investment will increase by 3.8%.

Table II.2.3:
Bosnia and Herzegovina - Composition of the budgetary adjustment (% of GDP)

	2021	2022	2023	2024	2025	Change: 2022-25
Revenues	40.4	40.4	41.1	41.3	41.5	1.1
- Taxes and social security contributions	35.5	36.7	37.5	37.8	38.1	1.3
- Other (residual)	4.9	3.7	3.6	3.5	3.5	-0.2
Expenditure	38.6	40.2	41.1	40.7	39.9	-0.2
- Primary expenditure	37.9	39.5	40.2	39.7	39.0	-0.6
of which:						
Gross fixed capital formation	3.3	3.8	3.8	3.4	3.4	-0.4
Consumption	16.5	16.8	17.3	16.9	16.5	-0.3
Transfers & subsidies	16.3	16.8	17.4	17.8	17.7	0.9
Other (residual)	1.9	2.0	1.7	1.5	1.4	-0.7
- Interest payments	0.6	0.6	0.9	1.0	1.0	0.4
Budget balance	1.8	0.3	0.0	0.7	1.6	1.4
- Cyclically adjusted	2.5	0.6	-0.3	0.3	1.5	0.8
Primary balance	2.4	0.9	0.9	1.7	2.6	1.7
- Cyclically adjusted	3.1	1.2	0.6	1.2	2.4	1.2
Gross debt level	32.0	30.5	30.2	29.5	28.4	-2.1

Sources: Economic Reform Programme (ERP) 2023, Commission calculations.

The relatively low debt level suggests that there is fiscal space to support stronger investment and growth. According to the programme, the country's debt ratio rose to 32% of GDP in 2021, partly reflecting higher borrowing due to COVID-19. For 2022, the programme expects the debt ratio to have fallen to 30.5%, benefiting from a primary surplus of 0.9% of GDP and from a favourable snowball effect due to strong nominal GDP growth. The increasing primary surplus is set to drive the continuing fall in the debt ratio to 28.4% of GDP by 2025. Interest payments are expected to rise moderately but only to about 1% of GDP in 2024-25, reflecting both the relatively low level of debt and the favourable borrowing costs due to the country's strong reliance on financing from the IMF, the World Bank and the European Investment Bank. The decomposition of the debt dynamics points to significant debt-increasing component from the stock-flow adjustment, which is not further elaborated on in the programme.

Box II.2.1: **Debt dynamics**

Bosnia and Herzegovina
Composition of changes in the debt ratio (% of GDP)

	2021	2022	2023	2024	2025
Gross debt ratio [1]	**32.0**	**30.5**	**30.2**	**29.5**	**28.4**
Change in the ratio	-2.0	-1.5	-0.3	-0.7	-1.1
Contributions [2]:					
1. Primary balance	**-2.4**	**-0.9**	**-0.9**	**-1.7**	**-2.6**
2. "Snowball" effect	**-3.1**	**-2.3**	**-0.9**	**-0.5**	**-0.6**
Of which:					
Interest expenditure	0.6	0.6	0.9	1.0	1.0
Growth effect	-2.3	-0.8	-0.5	-0.8	-0.8
Inflation effect	-1.4	-2.1	-1.3	-0.7	-0.7
3. Stock-flow adjustment	**3.5**	**1.7**	**1.5**	**1.5**	**2.1**

[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) 2023, Commission calculations.

Risks to the programme's fiscal scenario are significant, primarily because of the optimistic revenue assumptions, the possibility of another domestic political stalemate and uncertainties relating to Russia's war of aggression against Ukraine. Despite the country's track record of an overall solid fiscal position, there is a significant risk that the optimistic revenue expectations will not materialise. A further risk, in view of upcoming municipal elections in 2024, is that public spending will further intensify the country's focus on transfers and public consumption, at the expense of much-needed public investment in infrastructure, education and the development of a well-functioning country-level administration. Furthermore, there are significant upcoming fiscal financing needs in the *Republika Srpska* entity, which, in view of the currently high uncertainty on global financial markets, could become costly to cover.

The quality of public finances and budget planning remains low. The country's public finances continue to be plagued by substantial payment arrears, particularly in the health sector, which are likely to have increased further during the COVID-19 pandemic. In addition, significant budget guarantees have been provided and the fiscal situation of many publicly owned companies is far from transparent. The programme does not present sufficient plans to improve spending structure and, as in previous years, lacks a sustained pro-growth orientation. This approach is not in line with the policy guidance jointly adopted in the last 6 years, which called for higher investment and a more growth-oriented fiscal policy. Transparency and governance of the public sector are very limited, leading to major governance issues particularly in the health sector and in publicly owned companies.

The country's fiscal framework continues to be beset by institutional fragmentation, low-quality fiscal data and a lack of cooperation among the various stakeholders. Alignment with EU reporting standards and budgetary frameworks is still very limited. There are also significant weaknesses in consolidating and aggregating fiscal data from lower levels of government, in particular on the countrywide level but also within the Federation entity. So far, only one entity has adopted fiscal rules, and there is no independent fiscal council to monitor countrywide fiscal performance. The effectiveness of the medium-term fiscal framework is also very limited. Finally, the availability and quality of fiscal data suffers from a number of issues, including lack of cooperation among the various budget users, and political resistance that impedes alignment with the ESA. As a result of these deficiencies, there is a risk of significant fiscal under-reporting.

2.4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

Substantial structural weaknesses in Bosnia and Herzegovina's economy are preventing the country from catching up faster. Sustained reform measures are needed to significantly improve the living standards of its people. Drawing on Bosnia and Herzegovina's own ERP but also using other sources, the Commission has conducted an independent analysis of the economy to identify the key structural challenges to boost competitiveness and inclusive growth. While there are a number of obstacles, especially in the context of the economic fallout from Russia's invasion of Ukraine and the related energy crisis, the key structural challenges identified point to the areas with the biggest potential for fostering economic resilience as well as boosting inclusive growth and competitiveness if the challenges are properly addressed.

High structural unemployment and consistently high emigration are clear consequences of those weaknesses, rather than merely the result of an insufficient functioning of the country's education system. It also points to a poor business environment resulting from the country's institutional and economic fragmentation, a weak rule of law as well as an inadequate and inconsistent legal framework. Furthermore, the economic activities of the public sector negatively affect the economy due to their inefficient management.

High structural unemployment and consistently high emigration are clear consequences of the structural weaknesses, rather than merely the result of a poorly functioning education system. They also point to a poor business environment resulting from the country's institutional and economic fragmentation, weak rule of law and an inadequate and inconsistent legal framework. Furthermore, public sector activity has a negative effect on the economy due to the inefficient way it is managed.

The main challenges for boosting competitiveness and long-term and inclusive growth are therefore to:

(i) increase employment, particularly of young people, women and people in vulnerable situations

(ii) improve the business environment and strengthen the country's internal market and readiness for the green and digital transitions

(iii) improve the performance, transparency and accountability of public enterprises.

A thread common to all three challenges is the need for Bosnia and Herzegovina to tackle corruption, improve the rule of law and strengthen institutions, including independent institutions, in order to promote competitiveness. Addressing these fundamental concerns is a prerequisite for successful economic development. The Commission is closely following aspects relating to strengthening the rule of law and fighting corruption in its annual country report on Bosnia and Herzegovina.

Furthermore, the country should proactively implement the Energy Community's Decarbonisation Roadmap to achieve the agreed climate and energy targets, and strive towards establishing a carbon pricing instrument compatible with the EU ETS.

Key structural challenge 1: Increasing employment, particularly of young people, women and people in vulnerable situations

A large portion of the population is facing social exclusion in Bosnia and Herzegovina, with some 18.9% estimated to be living below the income poverty line. Over the past two decades, Bosnia and Herzegovina's human development index score has increased from 0.667 in 2000 to 0.780 in 2021, indicating that the country has reached high levels of human development. However in spite of steady economic expansion in recent years, a large proportion of the population are unable to exit poverty because of the labour market. This vulnerability is due to a number of factors including quality of education and lack of economic opportunities for all, in particular for women, young people and people in vulnerable situations. In addition, it is recognised that the widespread patronage system disproportionately affects vulnerable groups ([19]) as they often depend on public services. In this context, the hypertrophy of the public service should be highlighted: it accounts for 29.2% (2018) of total employment, compared with 23.7% in the OECD-EU region ([20]).

The main labour market indicators reflect a limited dynamism and a significant gender gap, with women's activity and employment rates around 25 pps lower than those for men. A report ([21]) by UN Women on gender equality in Bosnia and Herzegovina highlights that women in rural areas face greater challenges in accessing education, healthcare, and employment opportunities, compared to their urban counterparts. The report also highlights the prevalence of gender-based violence in rural areas, which further exacerbates the gender gap. The latest figures from the labour force survey published in the third quarter of 2022 ([22]), indicate that 1 521 million working-age people – more than half the total number – are neither employed nor looking for work, while the total number of people who are employed or looking for work is 1 366 million, of which 1 163 million (85.2%) are employed and 203 000 (14.8%) are unemployed. Unsurprisingly, the high inactivity rate is not accompanied by a very high unemployment rate. It reflects widespread discouragement given the lack of employment opportunities, especially for young people, women and minorities, but also conceals a large amount of informal labour and societal norms that do not favour a smooth functioning of the labour market. Out of the total labour force, 846 000 (61.9%) are men and 520 000 (38.1%) women. In addition, women account for just 36.1% of those employed compared to 49.6% of those unemployed. Moreover the gender pay gap in the country is estimated at around 18% compared to 12.7% in EU (2021). Among the unemployed population, unskilled and low-skilled workers predominate. According to the labour force survey, 57% of the unemployed have been looking for a job for 2 years or more (third quarter 2022). One in four young people (15-29) is not in employment, education or training (NEET). The employment rate of recent graduates (56.2%, 2021) remains one of the lowest compared to the regional peers and EU average (79.6%). This persistent situation holds these people permanently back, in a spiral of unemployment and precariousness. Discouraged by a labour market that cannot meet supply and trapped in inactivity, many young people seek a way out through emigration. The shift towards an older population is also challenging: in 2019, 17% of people in Bosnia and Herzegovina ([23]) were over the age of 65), with projections for this percentage to increase dramatically by 2050 ([24])

Bosnia and Herzegovina is still facing major challenges in achieving gender equality both in the economic sphere and in daily life. The country has made significant efforts to improve its comprehensive policy framework for eliminating discrimination against women and promoting gender

([19]) According to the U4 Anti-Corruption Helpdesk Overview of corruption in Bosnia and Herzegovina, The most vulnerable groups susceptible to social exclusion and poverty in Bosnia and Herzegovina include returnees and internally displaced people, persons living in distant rural areas, Roma, youth, women, victims of gender-based violence, older people, those living with HIV/AIDS and tuberculosis, and people with disabilities. Roma women, in particular, face multiple forms of discrimination due to their ethnic as well as gender identity.
([20]) Governement-at-a-glance, Country fact sheet, Western Balkans 2020, OECD.
([21]) Country Gender Equality Profile of Bosnia and Herzegovina, UN Women (2021).
([22]) Labour force survey, 3rd quarter, 2022.
([23]) World Bank database.
([24]) European Health for All database.

equality ([25]). However, disparities remain in the implementation of legislation on gender equality owing to the decentralised structure of the state, the overall modest human and financial resources and the absence of systematic and mandatory initial and in-service training for relevant professionals (staff of social work centres, teachers etc.) Nevertheless, the evaluation report ([26]) from the Group of Experts on action against violence against women and domestic violence (GREVIO) mentions that several initiatives have been taken to secure gender equality including, for example, the introduction of gender-sensitive budgeting in ministries at state and federal entity level and the establishment of contact persons for gender equality in state and entity institutions. Effective monitoring of the legislation on gender equality and on prohibition of discrimination is unsatisfactory.

Domestic work, lack of accessible care services and other obstacles restrict women from taking up paid jobs, pursuing advanced education and skills training and participating in public life. The traditional division of roles within the household persists despite social and economic transformations. More than half of Bosnians favour a traditional family arrangement where the man works and the woman takes care of the family, while 34% think a woman should do the household chores even if her husband is not working ([27]). Bosnia and Herzegovina is ranked 76th out of 146 countries in the Global Gender Gap Index 2022 ([28]). On economic participation and educational attainment, the country is ranked respectively 116th and 100th. Gender-based discrimination is reflected in education and consequently in the labour market. Occupational profiling results in highly qualified women not being treated the same way as highly qualified men.

Although the number of female students and professors has increased significantly, some academic disciplines and activities are still predominantly male or female. While gender parity has been achieved in primary and secondary education, women exceed men in higher education in Bosnia and Herzegovina ([29]). Women mostly choose social sciences and humanities, as opposed to natural sciences, technology, engineering, and mathematics. These gender stereotypes in the choice of academic fields lead to loss of economic and human potential and reinforce gender pay gaps ([30]). Gender equality principles are not sufficiently mainstreamed in teaching curricula and textbooks. In this way, knowledge of students on gender equality remains limited, allowing room for gender stereotypes to persist and further perpetuating inequalities.

The COVID-19 pandemic had a drastic impact on those who were already vulnerable. The international Labour Organisation (ILO) estimated that 170 000 jobs were lost in Q3 2020 ([31]) and 245 000 workers were at immediate risk because of the type of jobs they did. A UNDP/Unicef survey suggests that the financial situation of women has worsened more than that of men. Women appear to have been more affected by job losses and salary cuts. Young people who are already experiencing the greatest difficulties in finding work are seeing their opportunities diminish further. According to various assessments, Roma people (of whom an estimated 46 000-76 000 live in Bosnia and Herzegovina, accounting for 1.7% of the population) are facing greater difficulties than other groups, due to the complexity of their situation. Data from governmental and non-governmental reports and documents point to a persistent pattern of exclusion of Roma pupils from compulsory and especially post-compulsory education ([32]). The Balkan Barometer (2022) indicates (a strong reluctance on the part of

([25]) Committee on the Elimination of Discrimination against Women: Concluding observations on the sixth periodic report of Bosnia and Herzegovina.
([26]) Evaluation report of the Group of Experts on action against violence against women and domestic violence (GREVIO) published on 8 November 2022.
([27]) Social Impact Assessment of COVID-19 in Bosnia And Herzegovina - 3rd household survey, UNDP, 2022
([28]) Global Gender Gap report 2022 , World Economic Forum.
([29]) In the 2021-2022 academic year, 39 177 women and 26 384 men were enrolled in higher education schools and universities, Agency for Statistics of Bosnia and Herzegovina (BHAS).
([30]) How to achieve gender equality at universities in Bosnia and Herzegovina, UNDP, 2022.
([31]) COVID-19 and the World of Work, Bosnia and Herzegovina, ILO and EBRD, 2021.
([32]) Education of national minorities in Bosnia and Herzegovina: a case of Roma people, Anita Lukenda and Slavica Pavlovic, University of Mostar, Article in Pedagogika, · December 2018.

employers to recruit employees of Roma origin. Only 11% of Roma participate in employment, compared with 29% of non-Roma Bosnians Roma also have worse outcomes in access to healthcare, housing and education ([33]). High levels of informal work (about 30.9% of total employment in 2019) further limit social security coverage. Among self-employed workers (24.9% of total employment), about 53.1% were estimated to be working informally in 2020.

Even among the most highly educated group in the workforce, the high level of youth unemployment (including those not in employment, education or training (NEETS) is a result of the patronage system and a lack of coordination between the institutions. Bosnia and Herzegovina is considered the least competitive and worst-governed economy in the Western Balkans and also one of the most poorly governed in the broader European Bank for Reconstruction and Development regions ([34]). Lack of cooperation among the various levels of government hampers the possibilities for change and fuels political and socio-economic instability. For example, the country struggles to adopt a credible countrywide employment strategy due to the constitution, which distributes responsibilities for employment amongst all levels of administration. With some delay, the country started on the preliminary studies for implementation of the Youth Guarantee ([35]). With some technical assistance and coordinated involvement of relevant stakeholders, the scheme has the capacity to initiate a comprehensive reflection on tackling youth unemployment, to identify the blocking points and to boost the necessary reforms. However, the youth guarantee implementation plan has not yet been adopted: the different levels of the state structure are unable to agree on an issue on which there should be broad consensus. Difficulties in accessing lucrative jobs for individuals who are highly educated but without political connections are causing an enormous 'brain drain'. It is estimated that about 100 000 young Bosnians and Herzegovinians left the country between 2018 and 2020 in search of greener pastures. Around 30% of workers in Bosnia and Herzegovina are undeclared, around 30% of households report additional informal incomes while around 40% approve of tax evasion practices to some extent.

The country faces a paradox: companies cannot find the talent they need in the labour market despite the high level of unemployment and inactivity. The OECD report *Labour Migration in the Western Balkans (2022)* highlights that 38% of surveyed firms identify applicants' lack of skills as a reason for unfilled vacancies. The President of the Union of Construction and Industry complains that there are almost no trained carpenters, locksmiths, tilers or painters ([36]). In the Banja-Luka region, employers had difficulties finding close to 1 400 workers ([37]). The IT industry is facing a severe skills shortage ([38]). The brain drain is becoming a worrying phenomenon. Trained and qualified personnel are seeking better employment and living conditions abroad, notably in Slovenia. According to the Union for Sustainable Return and Integration, 40 000 people migrated ([39]) to other countries in 2018. All sectors are affected including education, healthcare and information technology. An 'employment observatory' is being set up, capable of identifying employment opportunities and anticipating current and future needs on the basis of reliable data. Monitoring and evaluation of employment policies with the participation of

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([33]) Fostering social cohesion in Bosnia and Herzegovina, Multi-dimensional Review of the Western Balkans; From analysis to Action, OECD, 2022.
([34]) European Bank for Reconstruction and Development's 2021 assessment of transition qualities.
([35]) Western Balkans Declaration on ensuring sustainable labour market integration of young people at the Brdo EU-Western Balkans Ministerial meeting on employment and social affairs in July 2021.
([36]) Bosnia-Herzegovina facing with shortage of construction workers, Sarajevo Times, 21 Feb. 2020.
([37]) Labour market research in Republika Srpska 2021/2022, Thematic Report Banja-Luka-Region, for Public Institution Employment Service of the Republika Srpska, 2021.
([38]) Skill Mismatch Assessment: Example of Software Industry in Bosnia and Herzegovina. Journal of Economics, Finance and Management Studies. Halilbasic, Muamer, 2021.
([39]) In accordance with the law, the Labour and Employment Agency collects foreign requests for domestic and foreign labour and, in cooperation with the Entity Employment Services and Brcko District Employment Service, implements them within its area of responsibility. Slovenia is the most important partner in terms of labour mediation and employment, and it is estimated that over 44 000 workers have gone to work there through official labour exchange channels since 2013. (Analysis of announcements for mediation of workers in the Republic of Slovenia collected by the Agency for Labour and Employment of Bosnia and Herzegovina during 2020.

social partners is still at an early stage, but there is a persistent lack of funding to face the almost insurmountable challenges.

Reforms to make the public employment service (PES) more client-oriented are ongoing but budget and human resources are scarce. Substantial efforts have been made to improve job-counselling and mediation processes in recent years in both entities. Labour market policies may include employment mediation, reskilling and upskilling, and employment subsidies. However, funding remains limited given the level of inactivity and unemployment ([40]) and depends on an annual budget and contributors. The financing of active labour market Policies (ALMPs) is mainly directed towards employment subsidies. ALMPs suffer from many weaknesses, including insufficient personalisation of the programmes, lack of transparency of public calls and an insufficient focus on upskilling and reskilling to improve employability. The PES's capacity is limited, measured against the sheer scale of unemployment. For instance, in 2019, the ratio of PES officers to beneficiaries in the Federation entity stood at 1:2023 ([41]). Administrative tasks limit their availability to engage in counselling, intermediation, jobs searches and other services. Among the problems highlighted by a plethora of reports are: weak coordination mechanisms at all levels of the country, a mismatch of education curricula and a gender gap in addition to an unfavourable and complex environment for job-creating investments, high tax-burden, high proportion of informal work, corruption and finally lack of national financial means are. However, political instability plays a major role in this situation.

Reform measure: 5.1.1.1. Increase the efficiency of the labour market through effective employment policies and strengthen the role of mediation

According to the authorities, the measure is focused on solving the main socio-economic challenges that BiH is facing, including solving the high unemployment as explained in the ERP, i.e. mainly by aligning legislation with EU legislation and international commitments, implementing effective employment policies and strengthening the mediation role of public employment services. While the diagnosis is correct, it is followed by statements of faith and good intentions that are not really translated into concrete action. For example, the ERP announces the intention to continue preparing the youth guarantee implementation plan, which is significantly behind schedule, as highlighted in last year's Financial Dialogue and sign the agreement to participate in the EU programme for employment and social innovation (EaSI) programme (ESF+). The ERP also says that relations with the social partners will be intensified, services for key beneficiaries will be improved and better interaction between employers and employees will be facilitated. While these are laudable intentions, it is not clear how this will be put into practice. The lack of a national employment strategy is very evident.

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Key challenge 2: Improving the business environment and strengthening the country's internal market and readiness for the green and digital transitions

A difficult business environment and weaknesses in the country's single economic space are key factors driving poor labour market outcomes and holding back improvements in competitiveness and living standards and preparations for the green and digital transitions. Some progress was made in previous years at the entity-level towards simplifying administrative procedures. However, insufficient political ambition to tackle regulatory burdens and corruption and to face the challenges of the green and

([40]) European Committee of Social Rights, conclusions 2020, Mars 2021.
([41]) Federal employment institute, 2021.

digital transitions remains an issue, but the country's high degree of institutional and regulatory fragmentation is also an obstacle, as is the low level of coordination among all levels of government.

Businesses that wish to operate across the entire economy still face technical and administrative obstacles and must frequently obtain the same licenses or permits in each entity or local government area and pay a range of different taxes and fees, hindering the operation of an effective single economic space. This increases the costs of establishing a company, protects incumbent companies from competition and deters investors. Over half of businesses in Bosnia and Herzegovina identify burdensome procedures, paperwork and cost as a major obstacle to obtaining licenses, a higher proportion than in any other country in the region and well above the regional average of 35%. Businesses in Bosnia and Herzegovina were also more likely than in any other country in the Western Balkans to cite the lack of a fully digitised process for applications and approvals of licenses as a major obstacle, with 76% of businesses citing this as at least a 'moderate' obstacle, compared with a regional average of 49% (Balkan Business Barometer 2022).

Cooperation and coordination among the country's various levels of government must be significantly improved to strengthen the single economic space and prepare for the green and digital transitions. Internal political disputes block or delay decision-making, hindering progress on much-need reforms, such as strengthening the rule of law, the fight against corruption and the functioning of countrywide supervisory and regulatory institutions.

The ERP acknowledges problems related to the business environment and regulatory burden. However, it does not include measures capable of meeting the scale of the challenge, nor does it recognise the underlying issues related to lack of coordination among the various levels of government. There was no progress over the last year in implementing the policy guidance in this area. The measures in the 2023-2025 ERP include changes to the tax regime in the Federation entity to reduce the burden of taxation on lower income levels, a longstanding ambition. However, it is notable that these changes are not likely to bring any further harmonisation of the regimes for businesses that operate countrywide. Further measures relating to fiscal devices and support for entrepreneurship do not tackle the main structural challenges identified, are likely to be limited in impact and scope, and do not seem intended to bring about any reduction in the administrative burden for businesses that operate across both entities. None of the reforms comes with a detailed list of actions or a timeline, and none has been adequately costed.

Key enabling legislation has still to be adopted at the state-level related on opening gas and electricity markets and setting targets for renewable energy and energy efficiency. This is needed to ensure the green transition and facilitate investment, including by the private sector. The absence of a fully-functional energy market in Bosnia and Herzegovina, with slightly differing legal frameworks and implementation practices across the country, hampers the sector's development. Bosnia and Herzegovina still needs to make significant efforts in creating a single regulatory framework and market space to ensure a reliable and secure energy supply and to attract investment in a low-carbon energy sector. Adopting laws on renewable energy and energy efficiency should be a priority, as should state-level legislation on electricity and natural gas with which the entities must comply. The country should also design and implement a comprehensive building renovation strategy at all levels of authority to improve energy efficiency and demand reduction measures, including required legislation and incentives for private sector and households. Bosnia and Herzegovina should ensure timely transposition and implementation of the Energy Efficiency Directive following its adoption as part of the Clean Energy Package by the Energy Community in November 2021. Lack of progress in these areas contributes to the poor business environment in the country and will prolong the path to decarbonisation, transition to renewables and improved energy efficiency that the current energy crisis has made even more urgent.

Delivering on commitments to gradually phase out coal subsidies and introduce carbon pricing instruments will be particularly challenging. The country remains heavily reliant on lignite coal, and the level of emissions from coal-fired power plants is of concern. Any future plans to prolong or increase its energy generation based on fossil fuels will jeopardise its commitment to decarbonisation and climate neutrality by 2050 and prolong and increase the socio-economic risks of an eventual transition from coal. The ERP mentions a deadline of December 2022 for finalisation of the draft national energy and climate plan (NECP); it will now be important for the country to stick to its commitment of providing the Energy Community Secretariat with the draft no later than 30 June 2023 and to adopt it in 2024.

The ERP refers to a number of these measures but without the required urgency. For instance, while the ERP acknowledges the necessity of state-level legislation on electricity and natural gas, there remain clear disagreements among the levels of government on this. There is a clearer analysis of the implications of the energy transition for coal, but some of the measures were included in last year's ERP and have simply been rolled over, unimplemented. As part of the energy support package for the region, Bosnia and Herzegovina is receiving EUR 70 million in budget support from the EU. To fully benefit from this package, the country adopted an action plan that includes urgent support measures for vulnerable consumers, urgent energy efficiency measures for households, and micro-businesses and small and medium-sized enterprises (SMEs), and long-term measures with the setting-up of energy-resilient and green transition strategies. The action plan should be used as a starting point for the country's green transition, including by the country's businesses (via diversification of energy sources, renewable energy projects and energy efficiency measures, and upgrading of energy transmission systems). A more focused, urgent approach is needed from the authorities on the green transition.

Political leaders and judicial institutions have failed to tackle widespread corruption and have even actively blocked progress in this area over the past year. Transparency International again ranks the country 110th out of 180 countries in its 2022 annual Corruption Perception Index making it the worst performer in the Western Balkans after 6 years of declining performance. Just 14% of businesses surveyed in Bosnia and Herzegovina say that the fight against corruption in the country is effective, a lower proportion than any other country in the region, and a higher proportion of businesses said that they had to make irregular payments than in any other Western Balkans country. There has not been progress on necessary reforms to strengthen legislation on anti-money laundering and countering the financing of terrorism, and the country risks being listed as a jurisdiction under increased monitoring by the international standard-setting body in this area, the Financial Action Task Force.

Bosnia and Herzegovina is lagging behind in the digital transition. Businesses in the country are the least satisfied of any in the Western Balkans with the digitalisation of public services. Only around 60% of small businesses have a webpage and only 18% are active in e-commerce. In line with the Digital Agenda for the Western Balkans and the Economic and Investment Plan, improvements to the administrative environment for firms would include the digital transformation of government services for businesses, including e-signature, e-registration of businesses and e-construction permits. Economy-wide implementation of service digitalisation is still hampered by the lack of political ownership and coordination between different levels of the government, which also leads to the allocation of insufficient budgetary resources for implementation. The lack of interoperable information systems across entities and different levels of government in Bosnia and Herzegovina is a major obstacle to developing economy-wide digital government services (OECD, 2021). Countrywide harmonisation of e-signature and the related coordination, cooperation and data exchange between different administrations is still needed. The country has yet to adopt a new law on electronic identification and trust services for electronic transactions with a single supervisory body for the whole country in line with the EU *acquis*. This would accelerate the digital transformation and allow for easier integration into regional and international markets.

The ERP acknowledges the importance of these reforms but does not provide a credible response to the challenges. The ERP contains no path forward yet for the electronic ID and trust services legislation, and the measures on e-government are exclusive to the *Republika Srpska* entity rather than countrywide.

While the measure on supporting the digital transformation of industry and SMEs identifies the priority in that area, the measure seems limited to one part of the country and is not convincingly costed.

Key challenge 3: Improving the performance, transparency and accountability of public enterprises

The still-oversized public administration and poorly SOEs put a significant burden on taxpayers and adversely affect the business environment. State influence on the economy is significant, and countrywide public spending remains relatively high, while people's overall perception of public services is very poor. Business perceptions that taxes are too high and public services unsatisfactory are stronger in Bosnia and Herzegovina than in the other Western Balkan countries (Balkan Business Barometer 2022).

Efforts to rebalance the country's current public sector-led growth model and move to a more private sector-led model are not sufficient, given that, according to official statistics, public spending accounts for more than 40% of GDP. Ineffective service delivery, poor human resource management and accountability have major implications for efficiency, quality and access to public services. Public procurement plays an important role for the private economy, but procedures are complex and administrative capacity and competition remain low. The public sector's payment arrears are substantial, creating a considerable burden for private companies, but also a high degree of uncertainty for other public services because of unpaid contributions to health and pension funds.

Oversized, non-transparent and inefficient SOEs continue to have a large economic footprint. Legislation defines public enterprises as companies that are either public corporations or companies that would otherwise be part of the general government (IMF, 2020). According to estimates (IMF 2019), there are over 550 SOEs employing around 80,000 people, thus accounting for around 11% of total employment (about a quarter of public sector employment). They control assets worth an equivalent of 100% of GDP. Among all SOEs, entity-owned SOEs (including the entities' electricity companies, coal mines in the Federation entity, the *Republika Srpska* entity forest company, highway companies and railways) have the largest operations and account for most employment in SOEs. Despite lower productivity ([42]), the average salaries of SOE employees are 40% higher than in private companies.

SOEs are undermining competition, damaging the country's overall competitiveness. Productivity is low in many large SOEs, and many are not profitable. SOEs and public enterprises dominate key sectors of the economy, including energy and telecommunications utilities (World Bank, 2018). In the OECD's 2021 Competitiveness Outlook, the county has a below average score on ensuring a level playing field with private companies. While most SOEs in both entities are incorporated under general company law, the presence of a separate legal form ('public enterprises') for some SOEs raises concerns about their operational treatment. The authorities should also consider fully corporatising SOEs that undertake primarily commercial activities but are still organised under the separate legal form of 'public enterprise' (OECD, 2021). Subsidies give SOEs a competitive advantage over the private sector, and in so doing harm efficient resource allocation and the country's fiscal performance. As for the interaction of SOEs with the private sector, the poor-quality and fairly high-cost provision of inputs to private companies diminishes the private sector's competitiveness. Liabilities to suppliers (4% of GDP according to the IMF) have negative repercussions on the private sector.

SOEs are a significant burden on the country's public finances. Many of the country's SOEs are in poor financial shape and close to half experience shortfalls in liquidity and require both explicit and implicit budgetary support. Monitoring and managing fiscal risks in ministries of finance is not sufficient. About three quarters of the largest (20) SOEs face considerable financial risks. The cost of supporting public companies and guarantees, which often translate into substantial contingent liabilities, is a heavy burden on public finances and thus the country's taxpayers. Many public companies rely on state support

([42]) Average revenue per worker (measuring productivity) is considered to be around 8% lower than in the private sector.

or delay due payments to the social security systems or to private suppliers, in order to remain in operation. This creates substantial liquidity imbalances in other areas of the economy. Potential investors are required to assume these debts and maintain the existing workforce. Some of the SOEs requiring subsidies are no longer operating, but still maintain workers. SOEs' total debts (including approximately 4% of GDP in tax and social contribution arrears) are around 26% of GDP (IMF, 2019). While the precise numbers have not yet been determined, total public sector debt is likely to be approximately 55-60% of GDP.

As a result of weak ownership arrangements and underperformance, Bosnia and Herzegovina has a relatively low score in terms of governance and efficiency in the OECD's 2021 Competitiveness Outlook. In the Federation entity, an SOE registry is now in place and publicly available, but further steps are needed to oblige SOEs to upload all the required information. In the *Republika Srpska* entity, there are three separate registers of public enterprises depending on the type of company. Not all public enterprises are in one of the registers, and not all public enterprises submit the required information. The *Republika Srpska* entity has set up a central oversight unit with three employees as of March 2023 and the Federation entity has announced its intention to do so, but so far the necessary human resources have not yet been allocated in either entity.

The planned centralised SOE oversight units (coordinating government efforts to monitor performance in order to strengthen the sustainability of the SOE sector) should separate oversight from policy and from the regulatory functions of the line ministries. In addition, both entities will need to assign ministries of finance responsibility for monitoring and assessing fiscal implications relating to SOEs. Plans for this are underway in both entities, and in the *Republika Srpska* entity the ministry of finance has allocated one staff member to these tasks. The Supreme Audit Institutions (SAIs) have only limited powers to carry out financial audits of SOEs, and the implementation of SAI recommendations is low (IMF, 2020).

Whereas legislation partially provides for open and transparent selection procedures, appointments to SOE boards are highly politicised in practice. Major gaps exist, both in the legal framework and in implementation. There are no established criteria for promoting independent and professional boards in SOEs (OECD, 2021). SOE performance and board decision making are insufficiently separated from the political cycle. Vested interests are largely responsible for the slow privatisation process and attempts to sell shares in public companies earmarked for sale have been largely unsuccessful.

Both entities should adopt much-needed ownership policy documents outlining the rationale for government ownership of SOEs. There is a problematic absence of any overarching policy explaining why the government owns companies and what it expects those companies to achieve. Ownership responsibilities are often exercised in a decentralised manner by various line ministries, subject to almost no central co-ordination. While entity governments have identified 'strategic companies', the rationale for public ownership is not based on clearly-defined policy objectives. Privatisation (accompanied by a thorough restructuring where appropriate) may be considered when there is no policy rationale for continued public ownership. Solid and operational registries of SOEs at all levels are a precondition for a proper categorisation in terms of policy relevance and economic viability.

The privatisation process is still not complete and restructuring efforts have made little progress. Due to the COVID-19 crisis, measures to restructure or dissolve public enterprises remained very limited. Strategic sectors such as transport and energy are still dominated by poorly-managed and often inefficient state-owned companies. The Federation entity aims to privatise public enterprises in the processing and mining industry and some mining companies are subject to bankruptcy procedures, though the most recent privatisations took place in 2016. The *Republika Srpska* entity is continuing to restructure its railways. The setting up of a central restructuring facility as a central source of standards, analytics, technical assistance, and public financing for SOE restructuring and resolution may be considered, to ensure that the process of company-level reform and restructuring – which can also accelerate the green and digital transformation – is transparent, systematic and predictable.

The ERP acknowledges the need for and potential benefits of improved governance of SOEs and contains rolled-over plans to set up central oversight units in both the Federation entity and the *Republika Srpska* entity but, though work on this began in 2020, the plans remain at an early stage of implementation.

Box II.2.2: **Monitoring performance in light of the European Pillar of Social Rights** ([43])

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights on equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion for the benefit of citizens in the EU. The European Pillar of Social Rights Action Plan, adopted on 4 March 2021, aims at rallying all relevant forces to turn the principles into actions. Since the 20 principles provide a compass for upward convergence towards better working and living conditions in the EU, they are equally relevant for candidate countries and potential candidates. The new reinforced social dimension for the Western Balkans includes an increased focus on employment and social reforms through greater monitoring of relevant policies (EC, 2018). The Western Balkans Ministers' Declaration on improving social policy in the Western Balkans (6 November 2018) confirms that they will use the Pillar to guide the alignment of their labour markets and welfare systems with those of the EU.

Relative to the EU-27 average, there is scope for improvement in most available indicators of the Social Scoreboard supporting the European Pillar of Social Rights.

BOSNIA and HERZEGOVINA		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Better than EU avg., improving
	Individuals' level of digital skills (basic or above basic)	Worse than EU avg., trend N/A
	Youth NEET (% of total population aged 15-29)	Worse than EU avg., improving
	Gender employment gap	Worse than EU avg., deteriorating
	Income quintile ratio (S80/S20)	Worse than EU avg., trend N/A
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-64)	Worse than EU avg., improving
	Unemployment rate (% of population 15-74)	Worse than EU avg., improving
	Long term unemployment rate (% of population 15-74)	Worse than EU avg., no change
	GDHI per capita growth	N/A
Social protection and inclusion	At risk of poverty or social exclusion (in %)	Worse than EU avg. (proxy), trend N/A
	At risk of poverty or social exclusion rate for children (in %)	N/A
	Impact of social transfers (other than pensions) on poverty	Worse than EU avg. (proxy), trend N/A
	Disability employment gap	N/A
	Housing cost overburden	N/A
	Children aged less than 3 years in	Worse than EU avg., improving
	Self-reported unmet need for medical care	Worse than EU avg., trend N/A

The employment and activity rate in Bosnia and Herzegovina remains very low, particularly for women, young people and the most vulnerable. A large proportion of unemployed people are long-term unemployed. Job creation is localised and the low mobility of workers limits the allocation of labour resources to emerging needs. The gender employment gap is more than twice as high as the gap in the EU-27 (11.0 pps.). This gap is widened by the low availability of elderly care and early childhood education and care. Discrimination in hiring is numerous and multiple.

Education continues to be of low quality, and the country suffers from a continuing skills mismatch. Average achievements of students in mathematics, reading and natural sciences in BiH are below the OECD average (Pisa 2018). There has been little change in levels of educational attainment in recent years. This indicates slow structural change in both the labour market and the education system. It is positive that the share of early school leavers is very low at 4.7% in 2020, much below the EU-27 average (9.9%). However, there is a large share of low-skilled people in the population. Upskilling strategies to increase the skill levels of the workforce are not sufficiently developed. Participation in early childhood education and care (ECEC) is significantly lower than in the EU and elsewhere in the region. Although it is improving, in 2019/2020 ECEC only covered 7.3% of children under 3, compared to the EU average of around 35%. Most children enrolled in ECEC come from urban families where both parents are employed, while children from rural areas or whose parents are unemployed very rarely attend. 23% of women and 20.3% of men (aged 15-24) are not in employment, education or training (NEET).

Social transfers have a limited impact on reducing poverty. Means-tested social assistance does not cover basic living needs. Other non-contributory social benefits insufficiently target low income vulnerable segments of the population. The reduction of the at-risk-of-poverty rate by social transfers is estimated at 9.16%, significantly lower than the EU-27 average (32.68% in 2019). Based on 2015 data, self-reported unmet need for medical care was 5.1%, which was higher that the EU-27 average of the same year (3.3%).

Further efforts are needed to collect timely and reliable data. The availability of indicators is limited, particularly in the area of social protection and inclusion, with missing Statistics on Income and Living Conditions, which were planned for 2019, but were not published. A lack of data also holds back the development of evidence-based policies and measures. As of 2020, the Labour Force Survey is published on a quarterly basis, but there has been a long publication delay.

([43]) The table includes 16 headline indicators of the Social Scoreboard, used to compare performance of EU Member States (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators). The indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2020 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). For data see Annex B. NEET: not in employment, education or training; GDHI: gross disposable household income.

2.5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2022

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye has adopted targeted policy guidance for all partners in the region. The guidance represents the participants' shared view on the policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The underlying rationale for the policy guidance is similar to that of the country-specific recommendations usually adopted under the European Semester for EU Member States. Implementation of the policy guidance is evaluated by the Commission in the following year's ERP assessments. The following table accordingly presents the Commission's assessment of the implementation of the 2022 policy guidance jointly adopted by the EU and the Western Balkans and Türkiye at their Economic and Financial Dialogue at Ministerial level on 24 May 2022.

Overall: Limited implementation (33.3%) ([44])	
2022 policy guidance (PG)	**Summary assessment**
PG 1: If needed, use the available fiscal space in the 2022 budget to cushion the potential impact of adverse shocks through targeted support to vulnerable households and firms; provided the economic recovery is well entrenched, return to a debt-stabilising fiscal policy as of 2023 and foresee a gradually improving primary balance in the medium-term fiscal plans.	There was **limited implementation** of PG 1: 1) **Partial implementation:** During the last year, the authorities adopted significant increases in public spending, largely for social purposes However, little effort was made to properly target the funds and certain measures appear to have been primarily oriented towards securing public support in the 2022 general elections.
Increase the share of government capital spending in GDP, by measures to improve public investment management and through an accelerated implementation of those investment projects that have been subject to a clear positive cost-benefit assessment.	2) **Partial implementation:** In 2022, spending on public investment appears to have increased. (though countrywide data are not yet available for 2022). Both entity budgets for 2023 envisage a substantial increase in investment, largely related to infrastructure investment (Corridor Vc). However, the authorities intend to reduce public investment again in 2024.
In order to improve the efficiency of tax collection, ensure an effective exchange of taxpayer information amongst the country's tax authorities, and in particular, clarify the constitutional competence for establishing a central (i.e. countrywide) registry of bank accounts of private individuals, in line with the EU *acquis*.	3) **No implementation**: No progress was made on improving the efficiency of tax collection or with improving data exchange between the four tax administrations in BiH during 2022. There were also no steps taken to clarify the constitutional competence for establishing a central (i.e. countrywide) registry of bank accounts of private individuals
PG 2: Prepare a report on contingent liabilities, with a particular emphasis on those related to the COVID-19 crisis response, and prepare a strategy on how to contain the emergence of new contingent liabilities and manage risks related to existing ones.	There was **limited implementation** of PG 2: 1) **No implementation**: No such report was prepared/published. No related strategy was prepared.

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

Strengthen the analytical capacities of governmental institutions at all levels of government, in particular the BiH Ministry of Finance and Treasury with a view to improving the preparation and quality of the ERP in line with EU requirements. Invest more significantly in building up the country's statistical capacity for macroeconomic statistics, regional accounts, labour force survey and government finance statistics, and pursue efforts to improve the coverage and timeliness of all statistics.	2) **Limited implementation:** There has been training on the costing of structural reform measures. But otherwise no measures have been taken to improve the country's analytical capacities with a view to improving the preparation and quality of the ERP in line with EU requirements. In fact, the administration's capacities in this respect appear to have declined, as not enough retired qualified staff have been replaced. 3) **Limited implementation:** BiH made very limited progress in most of these areas, except for the labour force survey, which benefitted from EU support, and government finance statistics, where the central bank has been working to improve the alignment of public finance data with EU standards. However, there are still substantial capacity building needs
PG 3: Carefully assess and analyse price developments, supported by the statistical offices through improving price statistics, including a timely update of CPI weights and publishing core inflation series. Ensure a transparent and accurate reporting of asset quality and adequate provisioning, improve the NPL resolution framework for instance by further reducing institutional and legal obstacles, and reduce data gaps in particular as regards the real estate sector Safeguard the integrity of the currency board arrangement and the independence of the central bank, and appoint the Governing Board members without further delay.	There was **partial implementation** of PG 3: 1) **Partial implementation:** While the central bank continued to carefully monitor price dynamics, the limitations due to data availability remain. The statistical office did not produce a core inflation series and the CPI weights are outdated and published with unusually long lags. This complicates and constrains a proper assessment of price developments. 2) **Partial implementation**: The bank resolution framework is still not fully operational and needs to be strengthened further. The Sberbank case highlighted again the potential importance of a single resolution fund. In addition, the remaining obstacles to an effective NPL resolution framework have not been addressed, for example by facilitating out-of-court restructurings and amending the tax treatment of NPL sales to specialised companies. However, the two banking agencies continued to cooperate well in general and handled the Sberbank crisis effectively. 3) **Partial implementation**: The full convertibility of the domestic currency was maintained. However, no resolution was found to the uncertainty around the governing board of the central bank, prevailing since 2021.
PG 4: With a view to improving the business environment and strengthening the single economic space, simplify business registration as well as licensing and permitting procedures and harmonise them across the country. To foster digitalisation of public services and to complement the development of e-Government	There was **partial implementation** of PG 4: 1) **No implementation.** No further progress was made on simplifying business registration, business licensing or permitting procedures. No progress was made on harmonising these procedures across the country. 2) **Partial implementation:** The law on electronic identity and trust services for electronic transactions was not

infrastructure, adopt the law on electronic identity and trust services for electronic transactions with a single supervisory body in line with the EU *acquis* and ensure that the Indirect Taxation Authority, whose ability to fulfil its vital country-wide role must be maintained, begins issuing of electronic signatures. Once the 2015 Customs Policy Law has entered into force, implement the new computerised transit system (NCTS) at national level, as well as the authorised economic operator (AEO) concept.	adopted. Legislation at the level of the entities remains out of step with the EU *acquis*. The Indirect Taxation Authority has begun issuing electronic signatures. 3) **Substantial implementation:** The Customs Policy Law entered into force in August 2022. The NCTS is being implemented at national level, but the AEO concept is not yet being implemented.
PG 5: Adopt a comprehensive, countrywide public finance management strategy in BiH with performance-based monitoring and reporting. Create/update in both entities publicly available registers of public enterprises with complete, searchable list of all public enterprises including comprehensive financial statements, audits and organisational information. Establish public enterprises central oversight units in both entities and allocate adequate human resources.	There was **partial implementation** of PG 5: 1) **Full implementation**: A comprehensive, countrywide public finance management strategy in BiH was adopted in July 2022. The strategy includes performance-based monitoring and reporting. 2) **Limited implementation:** The *Republika Srpska* entity still has three separate registers of public enterprises depending on the type of company, with plans for a single register rolled over into this year's ERP. Some public enterprises are not in any of the registers, and some do not submit the required information. The Federation entity has a single register of public enterprises and has now added comprehensive non-financial information. 3) **Limited implementation**: The *Republika Srpska* entity has set up a central oversight unit and the Federation entity has announced its intention to do so, but so far sufficient human resources have not yet been allocated in either entity, and the units' key tasks and scope of work remain undefined.
PG 6: Strengthen the coordination mechanisms within the country as regards employment policies and establish an inter-ministerial task force involving relevant ministries, their agencies and stakeholders to develop and finalise a Youth Guarantee Implementation Plan, adopt it, and initiate its implementation. Develop a system to monitor and forecast the skills needs in the labour market to facilitate the alignment of the education and training systems and of reskilling and	There was **limited implementation** of PG 6: 1) **Limited implementation:** The coordination mechanisms within the country involve only informal cooperation between individual labour institutions (public employment services only) but no official mechanism has been set up. No progress was made towards a countrywide employment strategy. The Expert Group for development of the Youth Guarantee implementation plan for BiH was set up and the drafting process is ongoing with support from the EU-ILO Technical Assistance Facility. However, submission and adoption of the draft is significantly delayed. 2) **No implementation:** In 2021, for the second year in row, the employment agency and bureaus of the country conducted a labour market research to analyse the market situation and to design their activities to match the needs of

upskilling provision to labour market needs. Improve access to early childhood education and care services towards children/families with vulnerable backgrounds and in rural areas.	the employers. No information is given as regards the sustainability of the research for 2022. 3) **No implementation**

2.6. THE POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TÜRKIYE

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

Brussels, 16 May 2023

[…]

In light of this assessment, Participants hereby invite Bosnia and Herzegovina to:

1. Use the available fiscal space in the 2023 budget for targeted support to vulnerable households and firms if needed to cushion the impact of high energy prices. Increase the share of government capital spending in GDP by measures improving public investment management and an accelerated implementation of those investment projects that have been subject to a clear positive cost-benefit assessment. In order to improve the efficiency of tax collection, ensure an effective exchange of taxpayer information amongst the country's tax authorities, and in particular, clarify the constitutional competence for establishing a central (i.e. country-wide) registry of bank accounts of private individuals, in line with the EU acquis.

2. Prepare a report on contingent liabilities, and a strategy on how to contain the emergence of new contingent liabilities, in particular in publicly owned enterprises, and manage risks related to existing ones. Strengthen the analytical capacities of institutions responsible for fiscal accounting, in particular of the BiH Ministry of Finance and Treasury, of the Federation's Ministry of Finance and the Ministry of Finance of RS with a view to improving the quality of fiscal accounting including those required for the preparation of the ERP and improve the procedures for preparing the ERP in order to ensure a timely submission and compliance with the requirements. Continue to strengthen the country's capacities in the areas of macroeconomic statistics, regional accounts, labour force survey and government finance statistics, and increase efforts to improve the coverage and timeliness of all statistics.

3. Continue to carefully assess and analyse price developments, supported by the statistical offices through improving price statistics, including a timely publication of CPI weights and developing and publishing core inflation series. Strengthen further the reporting and risk management frameworks across the banking system to ensure an accurate reporting of asset quality, further reduce institutional and legal obstacles to NPL resolution, reduce data gaps in particular as regards the real estate sector and initiate setting up a single resolution fund. Safeguard the integrity of the currency board arrangement and the independence of the central bank, in particular appoint Governing Board members without further delay.

4. With a view to improving the business environment and preparing for integration into the single market, engage with work related to the second cluster, further simplify business registration, licensing and permitting procedures and harmonise them across the country with a view to digitalising them in the near future. Adopt the law on electronic identity and trust services for electronic transactions with a single supervisory body in line with the EU acquis and ensure that the Indirect Taxation Authority, whose ability to fulfil its vital country-wide role must be maintained, begins implementing the authorised economic operator (AEO) concept and starts preparations for joining the Common Transit Convention. Strengthen the governance of public enterprises by updating the registers in both entities to ensure they include all public enterprises together with comprehensive financial statements, audits and organisational information; allocate adequate human resources to the central oversight units in both entities; and prepare a report on the contingent liabilities related to public enterprises and a strategy to manage these fiscal risks.

5. In line with the Green Agenda for the Western Balkans and the Energy Community Treaty, adopt and begin implementing a single integrated energy and climate plan for lowering carbon emissions through increases in renewable energy and energy efficiency. Adopt State level legislation for electricity and gas and ensure the full harmonisation of laws at entity level in these areas to prevent further delays in the opening and operating of the energy market and establishment of a day-ahead electricity market. Design and implement a comprehensive building renovation strategy at all levels of authority to improve energy efficiency and demand reduction measures, including required legislation and incentives for private sector and households.

6. Strengthen the coordination mechanisms within the country as regards employment policies and establish an inter-ministerial task force involving relevant ministries, their agencies and stakeholders to develop and finalise a Youth Guarantee Implementation Plan, adopt it, and initiate its implementation. Develop a system to monitor and forecast the skills needs in the labour market to facilitate the alignment of the education and training systems and of reskilling and upskilling provision to labour market needs. Improve access to early childhood education and care services towards children/families with vulnerable backgrounds and in rural areas.

ANNEX A: ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE 2023-2025 ERP

Due to the almost two-month delay in submitting the ERP, it was not possible to organise the usual fact-finding and assessment missions with the country authorities or, consequently, to provide the usual sector-by-sector analysis and assessment of reform measures.

Most measures presented in the ERP do not address economy-wide challenges, but cover entity-specific activities only and in a fragmented way. There is often no clear indication of which level of government or institution the activities relate to. The planned activities and expected outcomes of measures are often not adequately explained, and in some cases the text is simply repeated. In many cases, the activities planned do not appear to match up with, and do not address, the main obstacles identified for the various sectors in the preceding analysis. In other cases, a more coherent approach is taken in the analysis but the activities themselves are more fragmented.

Despite the availability of technical assistance for the costing of measures, very few of the reform measures reflect costs and even fewer provide an indication of financial assistance from international partners, including from the EU through the Instrument for Pre-Accession Assistance.

Social protection and inclusion

Social protection systems in Bosnia and Herzegovina, organised at the level of its entities and Brčko District, are dominated by social insurance systems, offering protection on the basis of contributions payments. However, the employment rates and labour market participation rates being structurally low in both entities in addition to a high level of unregistered employment, a significant share of the population is excluded from the systems. The responsible governments have not yet responded effectively to that situation. At the same time, social inclusion policies and labour market activation policies are limited in scope and have questionable effectiveness. Moreover, the most significant non-contributory social protection schemes, such as child and family benefits and means-tested minimum income benefits, characterise insufficient funding, resulting in small coverage and inadequate benefits. Recently, both entities passed legislation to increase child and some family benefits. At the end of 2021, the *Republika Srpska* changed the Law on child protection, thereby introducing child assistance for the first child in the family and increasing the level of existing benefits significantly. The changes became effective in January 2022. The FBiH entity adopted the Law on financial support to families with children, aimed to abolish inequalities in the provision of child and family benefits on the territorial principles by introducing the single amount of child benefit, financed by the FBiH Government, and a single amount of maternity allowance, financed by cantons. The implementation of the law was planned for the second half of 2022.

ANNEX B: OVERVIEW OF THE MAIN INDICATORS PER AREA/SECTOR OF THE ECONOMY

Area/Sector	2016	2017	2018	2019	2020	2021	EU-27 Average (2021 or most recent year)
Energy							
Energy imports dependency (%)	31.5%	34.0%	24.3%	27.4%	25.4%	N/A	55.6%
Energy intensity: kilograms of oil equivalent (KGOE) per thousand euro	448.81	434.20	463.40	435.70	442.51	N/A	110.35
Share of renewable energy sources (RES) in final energy consumption (%)	25.36%	23.24%	35.97%	37.45%	39.84%	N/A	21.7%
Transport							
Railway network density (metres of line per km² of land area)	19.9 [w]	19.9 [w]	19.9 [w]	19.9 [w]	19.9[w]	19.9[w]	N/A
Motorisation rate (passenger cars per thousand inhabitants)	245.0 [w]	252.0 [w]	263.1 [w]	269.5 [w]	N/A	N/A	N/A
Agriculture							
Share of gross value added (agriculture, forestry and fishing)	7.5%	6.6%	6.9%	6.6%	7.0%	6.6%	1.8%
Share of employment (agriculture, forestry and fishing)	18.0%[w]	18.9% [w]	15.7% [w]	18.0%	12.0%[w]	9.4%[w]	4.3% (2020))
Utilised agricultural area (% of total land area)	34.7% [w]	34.4% [w]	34.8% [w]	35.3% [w]	N/A	N/A	40.6%(2020)
Industry							
Share of gross value added (except construction)	22.6%	23.3%	23.9%	23.1%	23.0%	23.3%	19.9%
Contribution to employment (% of total employment)	22.7% [w]	22.2% [w]	23.5% [w]	23.8%[w]	23.9%[w]	24.4%[w]	16.1%%
Services							
Share of gross value added	65.1%	65.3%	64.4%	65.3%	64.5%	64.8%	79.2%
Contribution to employment (% of total employment)	50.8% [w]	51.6% [w]	52.1% [w]	50.3%[w]	54.7%[w]	57.0%[w]	70.9%

Digital economy							
Percentage of households with internet access at home	61.5%[w]	66.0%[w]	69.0%[w]	72.0%[w]	72.8%[w]	75.5%[w]	92.5%[(2022)]
Share of total population using internet in the 3 months prior to the survey [% of population aged 16-74]	N/A	64.9%[w]	70.1%[w]	69.9%[w]	73.0%[w]	N/A	90%[(2022)]
Trade							
Export of goods and services (as % of GDP)	36.3%	40.9%	42.6%	40.6%	34.5%	44.9%	50.4%
Import of goods and services (as % of GDP)	53.0%	57.1%	57.3%	55.2%	48.5%	56.3%	46.7%
Trade balance (as % of GDP)	-22.5%	-22.7%	-22.0%	-22.7%	-18.6%	-19.6%	N/A
Research, development and innovation							
R&D intensity of GDP (R&D expenditure as % of GDP)	0.24%[w]	0.20%[w]	0.19%[w]	0.19%[w]	0.21%[w]	N/A	2.26%
R&D expenditure – EUR per inhabitant	N/A	N/A	N/A	N/A	N/A	N/A	735.50
Education and skills							
Early leavers from education and training (% of population aged 18-24)	4.9%[w]	5.1%[w]	5.4%[w]	3.8%[w]	4.7%[w]	4.7%[w]	9.7%
Young people not in employment, education or training (NEET) (% of population aged 15-24)	26.4%[w]	24.3%[w]	21.6%[w]	21.0%[w]	21.6%[w]	19.9%[w]	10.8%
Children aged less than 3 years in formal child care (% of children aged under 3)	4.7%[w]	5.2%[w]	6.3%[w]	7.1%[w]	N/A	N/A	36.2%
Individuals who have basic or above basic overall digital skills (% of population 16-74)	N/A	N/A	N/A	24%	N/A	34.6%	53.9%

Employment and labour market							
Employment rate (% of population aged 20-64)	44.2% [w]	46.6% [w]	47.7% [w]	49.7% [w]	52.5% [w]	52.6% [w]	73.1%
Unemployment rate (% of labour force aged 15-74)	25.5% [w]	20.7% [w]	18.5% [w]	15.9% [w]	15.9% [w]	17.4% [w]	7.0%
Long-term unemployment rate (% of labour force 15-74)	21.6% [w,y]	16.8% [w,y]	15.2% [w,y]	11.9% [w]	11.8% [w]	N/A	2.5% (2020)
Gender employment gap (percentage points difference between the employment rates of men and women aged 20-64)	24.4 pps [w]	23.0 pps [w]	23.7 pps [w]	23.6 pps [w]	24.9 pps [w]	26.9 pps [w]	10.8 pps
Disability employment gap (percentage points difference in employment rates between people with and without a disability)	N/A	N/A	N/A	N/A	N/A	N/A	24.5 pps (2020)
Real gross disposable income of households (Per capita increase, Index = 2008)	N/A	N/A	N/A	N/A	N/A	N/A	107.23 (2020)
Social protection system							
At-risk-of-poverty or social exclusion rate (AROPE) (% of population)	N/A	N/A	N/A	N/A	N/A	N/A	21.9%
At-risk-of-poverty or social exclusion rate of children (% of population 0-17)	N/A	N/A	N/A	N/A	N/A	N/A	24.2%
Impact of social transfers (other than pensions) on poverty reduction	N/A	N/A	N/A	N/A	N/A	N/A	32.68%
Self-reported unmet need for medical care (of people over 16)	N/A	N/A	N/A	N/A	N/A	N/A	1.8%

Income inequality - quintile share ratio (S80/S20) (Comparison ratio of total income received by the 20% of the population with the highest income to that received by the 20% with the lowest income)	N/A	N/A	N/A	N/A	N/A	N/A	5.24
Housing cost overburden (% of population)	N/A	N/A	N/A	N/A	N/A	N/A	9.9%
Healthcare							
Self-reported unmet need for medical care (of people over 16)	N/A	N/A	N/A	N/A	N/A	N/A	1.8%
Out-of-pocket expenditure on healthcare (% of total health expenditure)	28.61% [z]	29.12% [z]	29.31% [z]	29.35% [z]	N/A	N/A	15.57% (2018)

w: data supplied by and under the responsibility of the national statistical authority and published on an 'as is' basis and without any assurance as to their quality and adherence to EU statistical methodology'

z: data from the World Health Organisation

y: data for people aged over 15

z: data from the World Health Organisation

Sources of data in Annex B: Eurostat and Agency for Statistics of Bosnia and Herzegovina, unless otherwise indicated.

ANNEX C: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM THE 2022-2024 ERP

This year's ERP contains the requested table reporting on the implementation of many, though not all, of the 2022-2024 ERP's structural reform measures, an improvement from last year when this table was missing altogether. Not all of the structural reform measures have been reported on, and for some measures no score for the state of reform implementation is provided.

ANNEX D: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Council of Ministers adopted the 2023-2025 ERP on 20 March 2023 and submitted it to the Commission later that day, nearly 2 months after the deadline. The quality of the programme and the delay in submission point to continuing significant weaknesses in administrative coordination and policy formulation. The document still falls short of being comprehensive and internally consistent and lacks an overall strategic vision. The readability of the document could be further improved. Insufficient time has been left to finalise the ERP as some contributions were submitted very late. Bosnia and Herzegovina needs to strengthen its coordination capacity on economic policy, to build consistent political support for the ERP and increase its visibility and coherence.

Inter-ministerial coordination

The preparation of the ERP was centrally coordinated by the Directorate for Economic Planning (DEP). The Council of Ministers adopted the usual Activity Plan which empowers the DEP to coordinate the drafting process only in November 2022, just 3 weeks before a draft of the ERP was supposed to be made publicly available for a minimum two-week public consultation.

Stakeholder consultation

The ERP itself refers only to consultations on part of the document with social partners in the *Republika Srpska* entity.

Macroeconomic framework

The description of recent macroeconomic performance suffers from the lack of up-to-date data. The macroeconomic framework's is still not fully consistent with other parts of the programme, particularly the fiscal framework. The reasoning behind the chosen policy approach and the links to the overarching policy strategy are not sufficiently explained.

Fiscal framework

The programme continues to lack a consistent, complete and sufficiently detailed presentation of the country's fiscal policy both for 2023 and of budgetary plans for 2024-2025. This strongly impedes analysis of countrywide fiscal developments. Public investment projections in the fiscal part are still not consistent with the macroeconomic framework. The requested links to structural reforms are still largely missing. The rationale for the policy approach taken and underlying measures are not sufficiently developed. The programme provides hardly any quantitative analysis of budgetary measures. The compilation and presentation of fiscal data are not yet in line with the ESA 2010.

Structural reforms

Sections 5, 6 and 7 do not fully follow the programme requirements, which reflects the absence of proper coordination on countrywide challenges and reform priorities. In many cases, policy goals are vaguely formulated and are not supported by implementable measures and activities. Key results indicators are not always present and potential risks frequently indicate political obstacles. Tables 10a, 10b and 11 haven been provided this year, an improvement over last year when they were left out. The tables on costs and financing of the structural reform measures are not, however, fully completed and improvements have still to be made. The table on progress on the structural reforms from ERP 2022-2024 is partially complete.

The ERP contains 25 reforms, five more than the 20 prioritised measures described in the guidance note. Most reforms are not sufficiently narrow in scope, and the activities planned in the three-year period are not clearly defined.

The document is three times as long (275 pages) as the limit provided in the guidance note (90 pages), and nearly 100 pages longer than last year.

Significantly more efforts are required to improve the ERP process, which means more senior policy makers also need to participate in its formulation. Key obstacles are still not identified with sufficient clarity or consistency with reform measures and activities.

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3. MONTENEGRO

3.1. EXECUTIVE SUMMARY

Following 2 years of strong economic growth, the baseline scenario set out in Montenegro's economic reform programme (ERP) projects real GDP growth to slow down in 2023-2025. Helped by a strong tourism sector and surging private consumption, Montenegro's economy expanded by double digits in the first half of 2022, but started to slow down in the later months of the year. The main headwind came from mounting inflation on the back of high global food and fuel prices. In 2023-2025 GDP growth is expected slow to an annual average of 4% and to be driven by a continued recovery in tourism, a strong increase in private investment and decelerating but still positive private consumption growth. The balance of risks is tilted to the downside as domestic political instability and higher financing costs could negatively affect investment, slowing growth in trade partners could dampen tourism exports, while risks related to the fallout from Russia's war against Ukraine could result in further increases in energy and food prices, eroding disposable income. Moreover, imports may increase by more than expected if investment plans in tourism and infrastructure are realised.

The ERP's fiscal scenario projects high and rising budget deficits and the debt ratio to stabilise at a high level. Recent measures weakening the revenue base as well as some new and mostly permanent increases in mandatory spending have significantly increased the deficit target in the revised 2022 budget to more than 8% of GDP. However, the actual outcome was lower, at below 5% of GDP, as high inflation and strong real growth boosted indirect revenue while spending on public investment and wages was lower than budgeted. However, in the absence of consolidation measures, the ERP projects the deficit to exceed 6% of GDP in 2023-2025, implying a loose fiscal stance, and public debt to stabilise at a high level of close to 75% of GDP.

The main challenges facing Montenegro are the following.

- **The high projected fiscal deficits and upcoming large debt repayment needs call for strong fiscal consolidation.** While the uncertainty related to Russia's war against Ukraine is high, the economic outlook is positive with decelerating but stable growth in Montenegro. A loose and pro-cyclical fiscal stance over 2023-2025 is not warranted as inflation remains high and fiscal risks are mounting. Debt repayment needs are set to increase sharply, especially in 2025, which, coupled with tightening financing conditions, raises vulnerabilities, and calls for a more prudent fiscal position. Fiscal sustainability needs to be enhanced with the help of a medium-term plan based on specific consolidation measures. Broadening the tax base, streamlining tax exemptions, and incorporating new budget revenue initiatives to offset recent revenue-decreasing measures would contribute to rebuilding fiscal space and reducing public debt.

- **Strengthening the long-term sustainability of public finances requires improvements in fiscal governance and in the management of public investment.** New spending initiatives have been adopted without properly assessing their fiscal implications. Large infrastructure projects need better management and prioritisation given the very limited fiscal space available. Following up on plans to set up an independent fiscal institution would contribute to strengthening fiscal governance and discipline.

- **Progress on the regulatory environment reforms should remain the authorities' focus in the coming years.** Dialogue between public authorities and private companies continued, but the level of engagement decreased due to political uncertainty. Digitalisation continued, but at a slower pace, hampered by political developments and a series of cyberattacks in the second half of 2022. Reforms in the area of state-owned enterprises (SOEs) were downscaled by the caretaker government and SOEs' reform ambitions need to be urgently clarified. Montenegro's green transition regulatory environment remains at an early stage of development. The country must use the adoption of the national energy and climate plan in early 2024 as an opportunity to cement its green transition.

- **Political commitment, consistency and steadfast implementation are needed to reduce the size and scope of the informal economy.** A long-delayed survey provided fresh insights into the country's informal economy in 2022, but the authorities did not take any of the other planned steps to address it. Further reforms or actions to reduce the informality are to be determined in 2023, with implementation possibly starting in 2024. The impact of the December 2021 tax reforms on the informal sector is yet to be analysed. A clear political vision and steer, and good cooperation between businesses, state and local authorities, is needed to break the current pattern of nominal progress and erratic implementation of the informality reforms.

- **Structural labour market challenges continue to undermine potential growth and improvements in living standards.** While recovery from the COVID-19 pandemic is under way, structural deficiencies in the labour market, including persistently low rates of labour market activity and high unemployment, especially among women, young people and the low-skilled, continue to undermine a just and fair economic growth. Montenegro has taken some initial steps to tackle these problems. Further efforts are needed to tackle women's labour market participation and high youth unemployment, and to reform the social protection system. Active labour market policies are not effective in getting people into the labour market. While some studies on active labour market measures have been conducted in the past year, their recommendations were only partly implemented and the country lacks a mechanism to continuously monitor such measures.

The implementation of the policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2022 has been limited. In 2022, the budget was burdened with new permanent social transfers and temporary tax reductions that were not well targeted. However, the 2022 fiscal outcome was better than envisaged in the revised budget due to the good performance of indirect tax revenue. No new medium-term fiscal strategy has been adopted. Nor has progress been made on public investment management and the review of tax expenditures. However, plans have progressed on setting up a fiscal council even if further steps still need to be taken. Montenegro has also made progress on preparing its draft Youth Guarantee Implementation Plan, but has not made significant progress on preparing a clear timeline and financial planning for the reform of the social and child protection system or on developing a mechanism to continuously monitor active labour market measures.

The ERP 2023 sets out a comprehensive programme integrating economic, fiscal and structural reform plans, but targets and plans are not fully in line with the key challenges and priorities identified by the Commission. The core of the programme comprises already-adopted initiatives. Fiscal plans lack a comprehensive medium-term consolidation strategy. On structural reforms, the ERP builds on reforms introduced in recent years, focused primarily on key challenges to the country's economy. Digitalisation, with a long-awaited reform on cybersecurity, reforms of the labour market and of SOEs remain particularly relevant. Looking ahead, the European growth model linked to the twin green and digital transitions should be better consolidated in the ERP process for Montenegro. Limited progress was made on implementing the reform measures in 2022.

3.2. ECONOMIC OUTLOOK AND RISKS

Montenegro's economy recorded strong growth in the first half of 2022, but the momentum slowed down in the later months of the year. Driven by strong growth in private consumption and exports, real GDP increased by 10.3% year on year (y-o-y) in the first half of 2022. Policy measures, including a sharp rise in the minimum wage and the abolition of mandatory health insurance contributions, supported a large increase in the average net wage of around 35% y-o-y in December 2022, which led to a double-digit increase in private consumption. Private consumption was also supported by Ukrainian and Russian nationals taking up temporary residence. Exports were boosted by the continued strong recovery in tourism. Headwinds came from mounting inflationary pressures, related to Russia's invasion of Ukraine, and political instability at home. The ERP estimates annual growth at 7.7% in 2022 but the actual figure turned out to be lower at 6.1% due to sharply decelerating economic activity in the second half of 2022 ([45]). Soaring commodity prices, in particular for food, fuel and construction materials, led to rapidly accelerating inflation, reaching 11.9% on average in 2022 ([46]). Labour market conditions improved with the average unemployment rate falling to a historical low of 14.7% in 2022 from 16.6% in the previous year.

The ERP baseline scenario projects GDP growth to average around 4% in 2023-2025 with a mildly decelerating trend. The ERP expects domestic demand to be the key driver of growth due to decelerating but still positive private consumption growth and sharply rising investment. Private consumption is projected to increase by an average of 2.4% per year in 2023-2025, helped by factors such as growing remittances, expanding credit activity, improvements in the labour market and higher social transfers included in 2023 budget. The ERP assumes a strong increase in investment (6.6% a year on average in 2023-2025), especially in tourism, agriculture, energy as well as to support the green and digital transition. Further support for GDP growth is projected to come from net exports, mainly tourism services which are expected to reach their pre-COVID-19 level in 2023, while import growth is set to decelerate from 16.7% in 2022 to an average of 4.8% in 2023-2025. Following 2 years of strong growth, Montenegro's GDP surpassed its pre-COVID-19 level in 2022. The ERP estimates a positive output gap of 3.2% in 2022 which is projected to rise gradually to 5.6% in 2025. Compared to the previous year, the ERP revises GDP growth downwards by 0.7 percentage points (pps) and 0.5 pps for 2023 and 2024 respectively. The ERP also contains an alternative downside scenario which assumes an escalation of the war in Ukraine and a related recession in the EU. The resulting fallout on trade, including lower tourism activity, and investment, together with elevated inflation, would result in lower GDP growth in Montenegro, ranging from 2% in 2023 to 2.5% in 2025.

The baseline GDP growth scenario is on the optimistic side and subject to significant risks. The baseline scenario for 2023 is more positive than the Commission's autumn forecast, and the divergence widens in 2024. In particular, the programme's ambitious assumption on capital investment seems overly optimistic considering the ongoing political uncertainty, high inflation and technical hurdles to public investment experienced in the past. The strong deceleration in import growth forecast for 2023-2025 in the baseline scenario is not consistent with projected investment dynamics, as these usually require significant imports of construction machinery and equipment. Tourism exports might rise less than expected due to weak projected growth in the major source markets. The macroeconomic outlook is subject to risks stemming from Russia's war against Ukraine, in particular high food and energy prices which translate into domestic inflation. The ERP refers rightly to domestic risks related to political uncertainties, macro-financial stability and the management of public finance when there is limited fiscal space.

([45]) Macroeconomic and fiscal estimates and forecasts covering the period 2022-25 have been taken from the ERPs themselves; if available, preliminary macroeconomic and fiscal outturn data for 2022 have been taken from the relevant national sources (national statistical office, ministry of finance, central bank).

([46]) Statistical Office of Montenegro.

Table II.3.1:
Montenegro - Comparison of macroeconomic developments and forecasts

	2021		2022		2023		2024		2025	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	13.0	**13.0**	7.0	**7.7**	2.9	**4.4**	3.2	**4.0**	n.a.	**3.5**
Contributions:										
- Final domestic demand	0.0	**0.0**	6.2	**9.2**	1.5	**3.6**	3.5	**4.1**	n.a.	**3.2**
- Change in inventories	0.2	**0.2**	0.0	**3.0**	0.0	**0.0**	0.0	**0.0**	n.a.	**0.0**
- External balance of goods and services	12.9	**12.9**	0.8	**-4.5**	1.4	**0.7**	-0.4	**-0.2**	n.a.	**0.4**
Employment (% change)	-2.1	**-3.1**	2.9	**11.7**	1.1	**4.0**	1.6	**3.2**	n.a.	**3.1**
Unemployment rate (%)	18.9	**16.6**	16.3	**15.5**	17.4	**14.5**	15.9	**13.7**	n.a.	**12.9**
GDP deflator (% change)	n.a.	**4.7**	n.a.	**6.8**	n.a.	**3.8**	n.a.	**2.0**	n.a.	**1.6**
CPI inflation (%)	2.5	**2.4**	12.2	**13.0**	6.1	**5.0**	3.0	**3.0**	n.a.	**2.2**
Current account balance (% of GDP)	-9.2	**-9.2**	-10.2	**-12.0**	-9.3	**-10.5**	-10.1	**-9.9**	n.a.	**-8.9**
General government balance (% of GDP)	-1.9	**-1.9**	-5.6	**-4.8**	-4.3	**-5.9**	-3.2	**-6.2**	n.a.	**-6.2**
Government gross debt (% of GDP)	82.5	**84.0**	75.5	**76.1**	73.1	**73.6**	71.5	**74.8**	n.a.	**74.8**

Sources: Economic Reform Programme (ERP) 2023, Commission Autumn 2022 forecast.

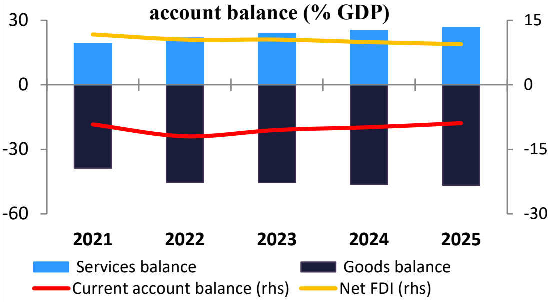
The ERP projects inflation to decline in 2023-2025. Driven mainly by surging commodity prices, especially for food and fuel, as well as large domestic policy-induced wage increases, inflation jumped to double digits in 2022. To mitigate the impact of high inflation on households and firms, the government adopted numerous support measures, including reduced value added tax rates for basic foodstuffs and a lower excise duty on sales of unleaded gasoline and gas oils. The ERP expects the average inflation rate to ease gradually, from 5% in 2023 to 2.2% in 2025, due to the high base in 2022, a deceleration in euro-area inflation, and growth in private consumption stabilising. This rather benign scenario is based on the assumption that import prices, in particular for food and fuels, will stabilise. The ERP rightly acknowledges external risks which could lead to a resurgence of inflation while it offers little discussion on the domestic risks related to further fiscal stimulus measures such as higher social transfers included in the 2023 budget.

The ERP optimistically projects a sizeable decrease in the current account deficit. In 2022 the current account deficit rose to 12% of GDP, higher than the 10.5% projected in the previous ERP, as the high growth in services and goods exports was outweighed by rapidly rising imports due to price effects. Driven by recovering tourism, favourable global demand for Montenegro's goods exports (electricity and non-ferrous metals), and higher output in agriculture, the trade deficit is forecast to fall from 21.7% of GDP in 2023 to 20% in 2025, while the secondary income surplus is projected to remain at some 8% of GDP. The current account deficit is thus expected to decline from 12% of GDP in 2022 to 8.9% in 2025. This is a more benign scenario compared to the previous year's ERP, which assumed the current account deficit to stay at some 10% of GDP over the forecast period. High import dependency and poor diversification of the production base remain structural weaknesses of the Montenegrin economy. The ERP's assumption of a deceleration in growth of imports seems at odds with Montenegro's large investment needs and the projected investment profile. In terms of the savings-investment balance, a 1.8 pps rise in investment as a percentage of GDP is expected to be outweighed by an even larger increase in national savings, driven exclusively by the private sector, which however is not explained in the programme.

Foreign direct investment (FDI) is set to remain high and fully cover the projected current account deficit. Net FDI inflows increased sharply, by 70% y-o-y in January-September 2022, with 38% of these inflows going into real estate, driven partly by purchases by Russian citizens. Total net FDI inflows are estimated at 10.5% of GDP in 2022 and are projected to stay at the same level in 2023. In 2024 and 2025 net FDI is assumed to fall slightly below 10% of GDP. Downside risks to this outlook stem from political instability at home coupled with a tightening of global financing conditions. At the end of 2021, Montenegro's net international investment position was negative at 168.4% of GDP. The external debt declined to 165.8% of GDP in the third quarter of 2022 (driven mainly by the denominator effect, as GDP increased by 13% in nominal terms in 2022) from 191.5% in 2021. There was also a small decline in the nominal value of external debt as the government repaid maturing credit obligations without undertaking new borrowing in the first three quarters of 2022.

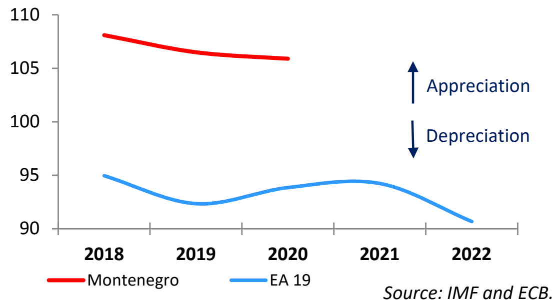
External competitiveness and current account

Graph II.3.1a: **Montenegro - Current account balance (% GDP)**



Source: Economic Reform Programme (ERP) 2023.

Graph II.3.1b: **Montenegro - Real effective exchange rate (CPI based, 2010=100)**



Source: IMF and ECB.

The banking system remains stable and liquid, but the quality of banks' balance sheets needs close monitoring in a rising interest rate environment. Despite the expiry of the pandemic-related support measures, the banking system maintained strong capital and liquidity buffers, both of which exceeded pre-COVID-19 levels. Due to the risks stemming from high inflation and the spill-over effects of Russia's invasion of Ukraine, the central bank has adopted 12 packages of temporary measures aimed at preserving the liquidity and solvency of domestic banks. As a precautionary measure, the central bank secured a repo line from the European Central Bank to meet exceptional liquidity needs. Banks continued to fund themselves mainly through domestic deposits which increased by 23.2% in 2022. Credit growth continued at a similar pace as in 2021 (6.1%). Borrowing costs increased with the nominal weighted averaged lending rate reaching 5.3% in early 2023 as compared to 4.3% at end-2021. The non-performing loan ratio declined moderately to 5.7% of total loans at the end of 2022, as compared to 6.2% in 2021. There appears to be scope to increase the financial sector's role in reaching climate and energy targets in line with European and international commitments by adopting policy measures in the area of sustainable finance (such as sustainability disclosures, sustainable finance taxonomies etc.).

Table II.3.2:
Montenegro - Financial sector indicators

	2018	2019	2020	2021	2022
Total assets of the banking system (EUR million)	4 407	4 604	4 587	5 329	6 407
Foreign ownership of banking system (%)	74.3	67.9	80.3	80.0	82.0
Credit growth (aop)	10.6	4.2	5.0	6.6	6.1
Deposit growth (aop)	12.2	1.8	-2.5	12.8	23.3
Loan-to-deposit ratio (eop)	84.7	88.1	93.7	80.0	70.1
Financial soundness indicators (%, eop)					
- non-performing loans to total loans	6.7	4.7	5.5	6.2	5.7
- regulatory capital to risk-weighted assets	15.6	17.7	18.5	18.5	19.3
- liquid assets to total assets	22.6	20.8	22.2	26.4	31.0
- return on equity	5.4	9.0	4.1	4.6	14.4
- forex loans to total loans	0.5	0.4	0.2	0.2	0.2

Sources: National Central Bank.

3.3. PUBLIC FINANCE

The 2022 budget deficit was contained at 4.8% of GDP which is better than envisaged in the revised 2022 budget. The initial budget set the general government deficit target at 5% of GDP, significantly higher than the 2021 outcome of 1.9%. This was mainly due to the expected 3 pps fall in the revenue-to-GDP ratio stemming from abolishing mandatory health contributions and introducing a non-taxable part of wage income. Following the amendment of the 2022 budget in October to accommodate a number of mostly permanent increases in mandatory spending (including additional allowances for all children and for mothers of three and more children, large increases in minimum pensions, wage increases in the public sector and additional financing for the health insurance fund) the overall deficit target was raised significantly to 8.3% of GDP. The deficit outcome was significantly lower at an estimated 4.8% of GDP due to a combination of higher-than-projected revenue, mainly from VAT; lower-than-expected spending, mainly on investment and wages as there were delays in planned employment; as well as higher nominal GDP than previously projected. Public revenue growth was supported by high inflation, a successful tourism season, high consumer spending and improved tax discipline, while the temporary reduction of excise taxes on fuel and the reduction of VAT rates on basic foodstuff and pellets for heating had the opposite effect. A further increase in government revenue was thanks to the implementation of the economic citizenship programme. Overall, nominal revenues increased by 3.3% compared to 2021 but declined by 4.5 pps as a share of GDP. Overall budget spending increased by 11% as compared to 2021 but fell by 1.7 pps as a percentage of GDP. Current expenditure increased by 9.8% y-o-y, driven by an increase in social security transfers (17.8%) due to higher child allowances and pensions and a rise in transfers to institutions and individuals (29.3%), the latter made necessary by shortfalls in the Health Insurance Fund and the Pension and Disability Fund. Capital spending increased by 22%.

The ERP recognises the need for fiscal consolidation, but its fiscal path assumes a further rise in the budget deficit and public debt ratios. Recent permanent measures weaken revenues and lead to an elevated level of public spending in 2023-2025 due to higher mandatory allocations for public wages, social transfers, pensions and the Health Insurance Fund. Interest costs as a share of GDP are set to rise by 0.9 pps between 2023 and 2025, while capital spending is expected to remain at close to 5% of GDP in this period, with construction of an additional section of the Bar-Boljare highway not expected to start before 2025. Public revenue is set to decline from 39.8% of GDP in 2022 to 37.8% in 2025 while public spending is projected to decrease only slightly, from 44.5% to 44% of GDP over this period. This projected path would result in large budget deficits in the medium term, rising from 5.9% of GDP in 2023 to 6.2% in 2025. The primary deficit would also remain sizeable at close to 4% of GDP on average. The projected fiscal position is much weaker than last year's prediction, which assumed a headline deficit close to zero in 2024. High public deficit and debt are set to exceed the limits prescribed by the rules of fiscal responsibility ([47]). After falling in 2023, the debt ratio is projected to increase to close to 75% in 2024 (5 pps higher than expected in last year's ERP) and remain at this level in 2025.

([47]) Numerical fiscal rules limit the general government deficit and debt to below 3% and 60% of GDP, respectively.

Table II.3.3:
Montenegro - Composition of the budgetary adjustment (% of GDP)

	2021	2022	2023	2024	2025	Change: 2022-25
Revenues	44.3	39.8	39.3	38.0	37.8	-2.0
- Taxes and social security contributions	36.2	33.3	32.8	33.0	33.0	-0.2
- Other (residual)	8.1	6.5	6.5	5.0	4.8	-1.8
Expenditure	46.2	44.5	45.2	44.2	44.0	-0.6
- Primary expenditure	43.8	42.9	43.4	42.0	41.3	-1.6
of which:						
Gross fixed capital formation	4.7	5.0	4.6	4.8	4.8	-0.2
Consumption	18.2	16.7	17.7	16.5	15.9	-0.8
Transfers & subsidies	12.5	13.0	13.7	13.8	14.1	1.1
Other (residual)	8.5	8.2	7.4	6.8	6.5	-1.7
- Interest payments	2.3	1.6	1.8	2.2	2.7	1.0
Budget balance	-1.9	-4.8	-5.9	-6.2	-6.2	-1.4
- Cyclically adjusted	0.3	-5.9	-7.5	-8.1	-8.2	-2.3
Primary balance	0.5	-3.1	-4.1	-4.0	-3.5	-0.4
- Cyclically adjusted	2.5	-4.9	-5.7	-5.9	-5.5	-0.6
Gross debt level	84.0	76.1	73.6	74.8	74.8	-1.4

Sources: Economic Reform Programme (ERP) 2023, Commission calculations.

The expected increase in the budget deficit in 2023 results from recently adopted measures affecting both sides of the budget. At the end of December 2022, the parliament of Montenegro adopted the 2023 budget law, which targets a deficit of 5.9% of projected GDP, assuming real growth of 4.4% and inflation levelling out to 5%. Compared to the 2022 result, government revenue is set to decline by 0.5 pps of GDP. Revenues from labour and corporate income taxation are projected to rise by 3.5% and 26% respectively as compared to 2022, in line with economic trends, the introduction of progressive taxation of corporate income and expected repayments of tax debt in compliance with the Law on tax debt rescheduling. The projected revenue from labour income is roughly unchanged at 2.4% of GDP, while the revenue from corporate income is projected to increase to 2% of GDP, up from 1.6% in 2022. Increases are expected for VAT revenues (5.3%) and excise duties (9.4%), the latter partially supported by the gradual restoration of the excise tax on fuel. The revenue from VAT is projected to decline by 0.4 pps to 15.5% of GDP, while excise revenue is set to rise slightly to 4.4%. Social security contributions are planned to decline considerably to 7.7% of GDP from 8.1% in 2022. As the economic citizenship programme comes to an end, less revenue will be generated in related fees ([48]). However, there is a substantial one-off increase in the 'other revenue' category, as special funds accumulated under the economic citizenship programme in previous years will be allocated to the 2023 budget. In contrast, public spending is projected to increase by 0.7 pps of GDP, mainly driven by the increase in current spending. Social spending is planned to increase by 17.5% y-o-y, or by 1 pp to 12.7% of GDP, reflecting the full-year effect of social transfer rises introduced during 2022. The gross wage bill is planned to rise by 0.7 pps to 11.1% of GDP reflecting public wage increases. The capital budget is set at 4.6% of GDP, somewhat lower than in 2022. Debt repayment is estimated at 5.7% of GDP which is 0.4 pps higher than in 2022.

([48]) The window of applications for the economic citizenship programme was closed by end-2022, but a number of applications will be processed during 2023.

Box II.3.1: **The budget for 2023**

* On 28 December, the parliament of Montenegro adopted the 2023 budget law, targeting a deficit of 5.9% of projected GDP.

* Draft laws, which were submitted for parliamentary approval in early 2023 and aim to strengthen the revenue side, are not included in the budgetary projections.

Revenue measures*	Expenditure measures**
• Reducing the excise duty on sale of unleaded gasoline and gas oils *(Estimated impact: -0.4% of GDP)* • Implementing the Law on tax debt rescheduling *(Estimated impact: 0.2% of GDP)* • Introduction of progressive taxation on profits generated by legal entities *(Estimated impact: 0.4% of GDP)* • One-off change in non-tax revenue due the implementation of the economic citizenship programme *(Estimated impact: 0.4% of GDP)* • Full year effect due to abolishing contributions to health insurance *(Estimated impact: -0.4% of GDP)*	• Implementing the Law on public wages and branch collective agreement for healthcare workers *(Estimated impact: 0.11% of GDP)* • Implementing the Law on public wages and branch collective agreement for the workers of the University of Montenegro *(Estimated impact: 0.08% of GDP)* • Implementing the Law on public wages and branch collective agreement for the public workers (deletion of former 'job group D') *(Estimated impact: 1.08% of GDP)* • Benefit for newborns *(Estimated impact: 0.11% of GDP)* • Benefit for all children under 18 *(Estimated impact: 0.41% of GDP)* • Benefit for mothers of three or more children *(Estimated impact: 0.22% of GDP)* • Increasing the minimum pension and adjusting pensions in line with inflation *(Estimated impact: 0.9% of GDP)*

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.

Source: ERP

In the medium term, the ERP projects elevated deficits due to high current spending, while the capital budget is set to remain stable. Fiscal consolidation is not envisaged. Public revenues are set to grow in nominal terms, but their ratio to GDP is projected to decline. While tax revenue is set to remain stable, the decline is driven by other revenue in 2024-2025, related to the economic citizenship programme coming to an end. On the spending side, legislation adopted in recent years has led to high current spending (nearly 40% of GDP) from 2023 onwards. Responsible factors include higher allocations for social benefits, public wages, the Health Insurance Fund, child benefits and subsidies for agriculture. The capital budget is projected at 4.8% of GDP in 2024-2025.

Despite elevated deficits, the ERP projects public debt to stabilise at close to 75% of GDP in 2024-2025. In the first three quarters of 2022, Montenegro continued with regular debt repayments without undertaking new borrowing, which together with strong nominal GDP growth resulted in a significant decrease in the public debt ratio by end-September 2022 - to 71.4% of GDP from 84.7% at end-2021. The ERP estimates total public debt at 76.1% of GDP at end-2022. Total financing needs amounted to 10.6% of GDP, which was covered by government deposits (7.6% of GDP), new loans (2.4%) and privatisation revenues (0.5%). Despite the projected increase in the primary deficit in 2023, the ERP expects the public debt ratio to fall to 73.6% of GDP, helped by nominal GDP growth and negative stock-flow adjustments, the latter partly related to the continued use of government deposits to meet financing needs. In 2024-2025, rising interest expenditure, high primary deficits and stabilising nominal GDP growth create headwinds for debt reduction, and the increase in the debt ratio is only contained by negative stock-flow adjustments, which are however not further explained in the ERP. Government deposits are not expected to be used for debt repayments in 2024 and only minimally in 2025. The maturity profile of public debt constitutes a risk in the context of tighter global financial conditions. Debt repayment needs will rise sharply, from 5.7% of GDP in 2023 to 6.6% in 2024 and 11.1% of GDP in 2025, bringing gross public financing needs to 17.4% of GDP in 2025. Debt management efforts, including a hedging arrangement concluded in 2021 with four private banks to reduce currency risk for a loan from China, have reduced some vulnerabilities linked to the high debt burden and its composition. Currently, around 95% of the public debt is held in euro while a further 2.7% and 2.3% are held in USD and in other currencies. While 77% of all debt carries fixed interest rates, the ERP assumes a large increase in borrowing costs due to tightening global financial conditions.

Box II.3.2: **Debt dynamics**

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

	2021	2022	2023	2024	2025
Gross debt ratio [1]	**84.0**	**76.1**	**73.6**	**74.8**	**74.8**
Change in the ratio	-21.3	-7.8	-2.6	1.2	0.0
Contributions [2]:					
1. Primary balance	**-0.5**	**3.1**	**4.1**	**4.0**	**3.5**
2. "Snowball" effect	**-13.5**	**-9.0**	**-3.9**	**-2.0**	**-1.0**
Of which:					
Interest expenditure	2.3	1.6	1.8	2.2	2.7
Growth effect	-11.6	-5.6	-3.1	-2.7	-2.5
Inflation effect	-4.2	-5.0	-2.7	-1.4	-1.2
3. Stock-flow adjustment	**-7.4**	**-2.0**	**-2.7**	**-0.9**	**-2.5**

[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) 2023, Commission calculations.

Large primary deficits together with growing interest expenditure are set to push up the public debt-to-GDP ratio. Using government cash deposits to repay public debt is projected to generate some downward stock-flow adjustments in 2023. The very favourable snowball effect seen in recent years is set to gradually diminish, as nominal GDP growth slows and interest costs rise.

The ERP identifies positive and negative risks to the baseline fiscal scenario. The main risks relate to political instability and populist policies which could result in new spending pressures, undermining the sustainability of public finance and credit conditions for future borrowing at a time of rising debt repayment obligations. Revenue projections are conservative and could be higher if amendments to certain tax laws that aim to broaden the tax base, are adopted. Positive revenue risks also relate to the reform of the Revenue and Customs Administration, strengthened measures against the informal economy and the concession of Montenegro's airports. Projections for public spending are set at the maximum and may contain some buffers. There is also a specific issue concerning the revision of future statistical data, namely that alignment with the European System of Accounts (ESA 2010) methodology would require reclassifying some operations of public companies into the general government sector, potentially increasing deficit and debt levels.

Box II.3.3: **Sensitivity analysis**

The ERP includes a detailed analysis of the deficit, with a comparison between the various scenarios as well as with the previous ERP. The comparison of scenarios includes a detailed risk matrix identifying potential positive and negative events (see above). However, a detailed impact of each single risk is not quantified; only their total effect on the budget balance, as reflected in the alternative scenario. Under the low growth scenario, the general government deficit would widen from 6.5% of GDP in 2023 to 7.3% in 2025. In addition, the public debt-to-GDP ratio would reach 79.5% of GDP by 2025 implying higher fiscal sustainability risks.

The current composition of public finance results in large structural deficits and leaves little space for investment. Following initiatives adopted over 2021-2022, high public spending is mainly driven by current expenditure (88% of the total) while resources for productive investment are set below 5% of

GDP. Several social transfer initiatives, e.g. child-related benefits, were adopted without a proper needs and cost assessment. Abolishing mandatory health contributions and introducing a non-taxable part of wages benefited those citizens with lower incomes and helped reduce unemployment. However, these and other measures substantially weakened the tax base, while corrective measures to strengthen public revenue and limit government spending, in particular on the chronically deficit-prone health and pension funds have not yet been adopted.

Numerical fiscal rules are not respected but plans to set up an independent fiscal council have advanced. The current medium-term fiscal planning breaches fiscal rules, as numerous fiscal initiatives were introduced without proper fiscal costing, resulting in high structural deficits. With a view to setting up an independent fiscal council to strengthen fiscal oversight and budgetary discipline, Montenegro has prepared amendments to the draft Law on budget and fiscal responsibility, which received the Commission's comments and should be presented to the parliament in spring. Several measures are being taken to improve the medium-term budgetary framework. These include enhancing the budgetary system, improving the IT system for budget planning and introducing a centralised payroll calculation system to ensure better control and a more efficient management of spending on public wages.

3.4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

Montenegro's comparative advantage is built on its geographical location, climate and landscape. Its small and open economy is service-oriented and largely focused on tourism as the principle source of income. Services account for nearly 80% of all exports, while foreign tourists directly generate over 20% of the country's GDP. Given the country's reliance on one sector and its small size, the economy remains vulnerable to external shocks and the challenges of climate change. This calls for action to diversify the economy and increase the value added in economic activities. Skills development programmes, in response to the country's smart specialisation strategy priorities, as well as action in the policy areas related to the digital and green transitions should become the priorities for the Montenegrin authorities.

The Commission has conducted an independent analysis of Montenegro's economy to identify the key structural challenges to competitiveness and inclusive growth, drawing on Montenegro's ERP and other sources. This concise analysis shows that, despite progress made, the country continues to suffer from several structural and crosscutting weaknesses across many sectors of the economy. The key challenges in terms of boosting competitiveness and securing long-term inclusive growth remain the same as identified in the last years. They are:

(i) increasing employment, particularly of women and young people, and tackling long-term unemployment;

(ii) strengthening the regulatory environment; and

(iii) reducing informality in the economy.

(iv) This assessment therefore focuses on those three key challenges.

Montenegro also needs to tackle corruption, improve the rule of law and strengthen institutions in order to promote competitiveness. Addressing these fundamental concerns is a prerequisite for a successful transformation of the economy. The Commission closely follows progress in Montenegro's annual report on issues of strengthening the rule of law and fighting corruption.

Furthermore, the country should proactively implement the Energy Community's Decarbonisation Roadmap to achieve the agreed climate and energy targets, and strive towards establishing a carbon pricing instrument compatible with the EU ETS.

Key Challenge 1: Increasing employment, in particular of women and young people, and tackling long-term unemployment

With the economic recovery from the COVID-19 crisis, labour market indicators also continued to improve, surpassing pre-crisis levels. The unemployment rate in the third quarter of 2022 fell by a further 1.8 pps to 13%, compared to the same period in 2021. The employment rate increased from 46.5% to 52.3% and the activity rate from 54.6% to 60.1%. By way of comparison, in the EU, the unemployment rate (15-74) was 4%, the activity rate (20-64) was 79.4% and the employment rate (20-64) was 74.7% in the Q3-2022. Significant disparities remain between the country's three regions. The unemployment rate in the Northern region remained high at 32.9% in Q3-2022, and was more than three times that of the Coastal region which increased to 10.3%. Long-term unemployment remains a major structural challenge, with 75.6% of unemployed people being out of work for more than 12 months during Q3-2022. The most vulnerable groups on the labour market remain women, young people, Roma and low-skilled workers, with Roma and people with disabilities facing particular challenges in accessing the labour market. While some support is available for these groups by way of employment and education programmes, these do not seem effective in supporting these groups to better prepare for or integrate into the labour market.

The pandemic had a significant negative impact on young people's labour market situation with no evidence of recovery. Youth employment (15-24) fell to 18.4% in Q4-2020, down from 26.9% in Q4-2019. The unemployment rate (15-24) also rose to 42.0% in Q4-2020, up from 27.8% in Q4-2019. In 2021, the proportion of young people (15-29) not in employment, education or training (NEET) stood at 26.5% signifying a 0.1 pps decrease compared to 2020, but still 5.2 pps above the 2019 level and more than double the EU-27 average (13.1% in 2021). This reflects significant difficulties in transitioning from education to employment, and a mismatch between the skills acquired through formal education and the skills in demand on the labour market. It also indicates too few relevant job opportunities available for young people. This is a structural challenge that persists from pre-COVID-19 times. Like in the EU, the phenomenon of platform work is also rising in Montenegro and a legal framework remains to be developed (ETF, 2022). The NEET profile analysis conducted by the International Labour Organization (ILO) (ILO, 2016) points to a high and increasing number of graduates from secondary and higher education who are out of employment. In 2019 the employment rate of recent graduates (within 1-3 years following graduation from ISCED levels 3-8) stood only at 65% in Montenegro, compared to 81% for the EU average (OECD, 2021).

Women's labour market situation is more responsive to economic fluctuations; while the pandemic further widened the gender gap in the labour market, women's labour market indicators also improved more significantly than those of men. The employment gap (20-64) between women and men decreased by 2.0 pps to a 9.5 pps difference, women's unemployment rate decreased by 1.2 pps more than men's, and their activity rate increased by 1.5 pps more than men's in Q3-2022, although women's activity rate remains significantly (14.1 pps) below men's at 53.2%. Regional disparities in the labour market situation of women are significant, with women's activity rate 20 pps below men's at 37.6% and their employment rate 11.4 pps below men's at 26.2% in Q3-2022. Employment gains continue to be larger for men than for women. Data on the gender pay gap is not available, hindering gender-sensitive employment policymaking. Gender-sensitive career counselling, programmes to encourage young women to enrol in non-traditional vocational programmes and studies, and programmes to help women re-enter the labour market after a prolonged absence, for example as a result of childcare, are lacking (OECD, 2021). Montenegro scored 55 points on the 2019 Gender Equality Index, below the EU average of 67.4. In July 2021, the government adopted a new National Strategy for Gender Equality for 2021-2025, setting out clear operational objectives and measures to improve gender equality, however the results are yet to be seen. The government adopted the Strategy and Action Plan for Early and Preschool Education for 2021-2025 in 2021. Enrolment numbers in pre-primary education have also improved, surpassing pre-pandemic levels at 24 663 children enrolled for the year 2022/2023. Regional disparities remain with low take-up in the north.

The highest share of unemployed people continues to be those with a lower level of education. High long-term unemployment persists; 75.6% of unemployed people had been unemployed for more than a year in Q3-2022. Montenegro adopted its National Employment Strategy for 2021-2025 in December 2021. The ambitious Strategy sets out measures to support a sustainable rise in employment, including through strengthening skills development. Montenegro's local employment strategies guide efforts to address regional differences by setting out tailored measures.

The Public Employment Service's (Employment Agency of Montenegro (EAM)) capacity for job mediation remains weak and lacks a continuous monitoring of active labour market policies (ALMPs), which in turn prevents the design of quality, targeted and effective employment activation measures. The EAM's reform and readiness remains a key challenge and is especially important for implementing the Youth Guarantee. The government, together with the multi-stakeholder working group, advanced on the drafting of the Youth Guarantee Implementation Plan which is expected to be adopted in 2023, with the pilot starting in 2025. It will be crucial that the EAM's capacities and organisational structures are modernised and adapted before the Youth Guarantee is rolled out. Other active labour market measures (ALMMs) targeting young people and women have shown mixed results at best. While the self-employed programme seems to have been effective and other long-running programmes such as the graduate programme have been found ineffective (ILO, 2022), the overall picture is unclear as the effectiveness of ALMMs is analysed in several separate studies. The country lacks a comprehensive monitoring and impact assessment of the effectiveness of ALMPs, including following up on the number of beneficiaries who remain employed in the long-term following their participation in activation programmes. This means that continuous policy adjustments to ensure that policies remain fit for purpose are not made. Efforts are ongoing to improve the currently ineffective institutional set-up and functioning of Montenegro's public employment service, the EAM.

Reform Measures 1 and 2 aim to address shortcomings in the functioning of the EAM and to move towards better job offers for young people by putting in place the Youth Guarantee. *Reform measure 1 – Strengthening operational capacities of the Employment Agency for carrying out services and measures via digitalisation*, is a continuation of a measure from the 2022-2024 ERP. It continues to be an important and adequate measure to tackle some of the shortcomings faced by the EAM. However, other organisational and operational reforms besides digitalisation will also be needed. *Reform measure 2 – Introducing the Youth Guarantee Programme in Montenegro* continues to be in line with Montenegro's commitment to improve labour market opportunities for young people and responds to Policy Guidance 6 from the Joint Conclusions of 2022. It is encouraging that some activities under the measure also focus on improving the capacities of EAM.

A mismatch of skills remains a significant challenge, particularly for graduates of vocational education and training or higher education, despite some recent efforts to improve the transition from education and training to the labour market. The quality and relevance of the entire education system and the lack of practical experience of graduates from vocational and higher education are long-standing challenges. The situation was aggravated by the COVID-19 pandemic and continues to be a reform priority under the Osnabrück and Bologna Declarations (ETF, 2022). A high share of people transitioning from vocational education and training programmes to higher education and other programmes are less suited to market needs. Occupational mismatches (i.e. over-qualification) are highest for people with a tertiary education (around 14%). Although tertiary educational attainment is still lower than the EU average, the labour market cannot absorb the numbers of tertiary graduates in certain areas, such as business and humanities. However, there is still a shortage of medical and STEM graduates (ETF, 2019), demonstrating the need to step up the smart specialisation strategy. The OECD's report on Labour Migration in the Western Balkans found that, in Montenegro, 28% of respondents disagree with the claim that skills learned in the education system meet the needs of their job and 51% of surveyed firms identify applicants' lack of skills as a reason for unfilled vacancies (OECD, 2022). Montenegro's Entrepreneurial Lifelong Learning Strategy for 2020-2024, the National Partnership and the Innovation Fund are expected to help address these skills shortages. Furthermore, the Strategy for the Development of Vocational Education in Montenegro (2020-

2024), along with its action plans, outlines measures to overcome workforce skills shortages and to improve the efficiency and the effectiveness of the VET system and lifelong learning. Reform of career guidance services at all levels leave further space for development (ETF, 2022). Montenegro has committed to the Western Balkans agenda on innovation, research, education, culture, youth and sport, which is expected to guide its reform efforts. Lifelong learning and adult education with up- and re-skilling has not yet played a sufficiently prominent role, including in facilitating the green and digital transitions. Given the very high share of long-term unemployment, developing and implementing these measures remains essential.

The quality and inclusiveness of the education system remains limited, as the Education Sector Analysis 2015-2020 (ESA) (UNICEF and Ministry of Education, 2022) conducted by the Ministry of Education and UNICEF points out. According to the 2020 Human Capital Index issued by the World Bank, ‘a child born in Montenegro today will be 63% as productive when they grow up as they could be if they enjoyed complete education and full health’. During the 2018 PISA test, 44% of Montenegrin pupils (15 years old) scored below level 2 in reading, 46% below level 2 in mathematics and 48% below level 2 in science. In comparison, the OECD average for these is 14%, 13% and 16% respectively. The ESA’s recommendations include improving the curriculum, making teaching interactive and more engaging - which would require adequate teacher training, increasing enrolment rates, providing support to the most vulnerable groups, improving the adequacy of school infrastructure including by making sufficient places available across the country, as reduced hours due to a shifts system can be detrimental to children’s learning in many of the country’s more populated municipalities. Finally, the ESA recommends that a coordinated, funded, well-prioritised and cost-effective strategic plan is put in place for a future sector wide education reform.

Following up on these recommendations, *Reform measure 3 – Developing an integrated approach to improving education quality and inclusivity* is a new measure aimed at preparing an overarching, long-term Education Sector Strategy (2024-2030) to tackle the above-mentioned shortcomings in a coordinated and properly budgeted way. This Strategy will not, however, address the higher education sector, the new strategy for which is pending adoption since 2020. *Reform measure 4 – Digitalisation of the education and development of digital skills* is a continuation of a measure from the 2022-2024 ERP. It remains relevant and justified both in the context of EU accession and in line with national priorities.

Montenegro has adopted several reform measures since 2020 to improve its social protection system, however the effectiveness and sustainability of this system continues to raise concerns. With the publication of the Roadmap for the reform of the social and child protection system in July 2021 it was expected that social protection would become better adapted to vulnerable members of society, while also contributing to labour activation and the sustainability of public finances. However, no further steps were taken in 2021-2022 on a costed analysis and timeframe for implementing priority reforms in line with the Roadmap. Coordination between employment and social services, the interoperability of relevant databases and the expansion of the Social Welfare Information System (SWIS) have not progressed. Therefore, disincentives to formal work persist (see key challenge 2 below for further details). In 2021, the amendment to the Law on Social and Child Protection granted universal benefits to all households with children under the age of six, although they are not automatically distributed due to a lack of interoperability between databases. In addition, the mothers’ benefit was reinstated for previous beneficiaries, but fails to target child poverty as it is distributed to women who became mothers decades ago. While the universal child allowance is expected to help reduce child poverty, there is a lack of targeted measures. Most notably, poverty-targeted material support services have been reduced, reducing the impact of social transfers. As also indicated by the World Bank’s and UNICEF’s Social Protection Situational Analysis (World Bank and UNICEF, 2022), reform priorities include improving social assistance, reassessing the adequacy of combined benefits, finalising the move to a centralised disability assessment , improving the monitoring and evaluation capacities of social services and their coordination with each other, improving employment services and tax authorities, making the relevant databases interoperable, expanding the SWIS and strengthening the adequacy and sustainability of the pension system through a long-awaited pension reform.

Reform Measure 5 – Reform of the social and child protection system based on the Road Map is a continuation of a measure from the 2022-2024 ERP. It responds to the strong need to establish a well-coordinated and better-targeted social protection system that provides adequate support to the most vulnerable while also supporting labour market policies. The government announced that instead of the Roadmap, they plan to develop a National Social and Child Protection Strategy that would integrate all existing social protection strategies, prioritise reforms and budget them, which is expected lead to an overall better coordinated social protection system reform.

Key Challenge #2: Strengthening the regulatory environment, including reforms relevant to digital transition, green transition and climate change

A better and more business-oriented institutional and regulatory environment would contribute to a dynamic development of Montenegrin companies and facilitate investment. The regulatory environment hinders the dynamic development of local companies and foreign investors' activities, as analysed in detail in the Commission's ERP assessments of recent years. This translates into lost opportunities in terms of jobs (with an impact on key Challenge 1) and provides incentives, specifically to micro and small enterprises, to carry out undeclared work and transactions (thus fuelling the issues described under key Challenge 3). Substantial improvements are needed to remedy the inefficiencies and delays of dealings with the administration, excessive complexity of the legal framework and the administrative burden from local taxation and para-fiscal charges. Transparency in decision-making, arbitrary interpretation and law enforcement by public authorities, and access to finance for SMEs are also among the main issues for improvement.

A recent analysis of the regulatory environment, financed by Norway and implemented by the UNDP, pointed out that there are around 280 different legal acts, as well as their implementing acts, that regulate the SME sector alone. Insufficient communication and information exchange between the state and local authorities, and between the local authorities themselves, was singled out as one of the chief obstacles to improving the regulatory environment. The limited participation of municipalities in the drafting and implementation of the state laws and economic policy strategies is another concern that needs to be addressed as soon as possible, possibly in the Competitiveness Council.

The major avenues to consider when addressing this key challenge include: (i) the digitalisation of public administration and deployment of digital technologies in support of businesses; (ii) a continuous, structured dialogue between authorities and the business world; (iii) transparent and inclusive legislative and regulatory processes, involving the relevant state and local authorities; (iv) reconsidering the role of the state exercised via state-owned enterprises (SOEs), their management and financial performance; (v) enabling state-backed green transition; and (vi) ensuring the resilience of the regulatory ecosystem and critical infrastructures in times of crises.

Structured dialogue between authorities and the business world continued but the level of activity decreased due to lack of support and political uncertainty. In recent years, the involvement of businesses in the regulatory processes improved in a number of key areas, including in the design of ERP structural reforms and support to economic operators, with the COVID-19 mitigation measures for example. The Competitiveness Council, which gained momentum in 2021 as a promising forum for dialogue between businesses, municipalities and the government, continued its work on identifying barriers to business and maintained technical level of cooperation with the state administration. The updated document produced by the Council in 2022 identified 98 different barriers. However, due to the lack of political support and interest, the outcome of this work did not lead to any concrete deliverables from the government's side, apart from some partial, technical level replies and statements from the responsible ministries and public institutions. At the same time, the involvement of business partners in designing, drafting and implementing measures affecting businesses practically came to a standstill, as few legislative proposals were adopted by the government or discussed by the parliament.

Work on digitalisation continued in 2022, albeit at a slower pace. In the previous years, and despite a largely adverse economic situation (COVID-19 crisis) Montenegro showed steady progress in the area of digitalisation. The switch to an entirely electronic procurement environment (in the course of 2021) marked a major milestone in addressing the shortcomings of the previous paper-based procurement system. Several structural reforms were launched to improve the business and regulatory environment by developing electronic government services, including for online company registration, a 'single access point' portal for SMEs and broadband infrastructure.

However, the pace of digital transformation reforms slowed down in 2022, due to both internal and external factors. Protracted political uncertainty had a negative impact on the work of the administration and led to general delays or a standstill in the decision-making process. Furthermore, a series of large-scale cyberattacks on the state IT infrastructure in the second half of 2022 interrupted the timeline of the digital transformation reforms. These cyberattacks spurred Montenegro's government to focus one of the new reforms on cybersecurity. The government also proposed a new structural reform to improve the digital skills of public administration employees.

The proposed *Reform Measure 7 – 'Establishing a full electronic registration of enterprises'* is a continuation of the reform initiated in the 2022-2024 ERP and is credible and well developed. It should streamline the procedure of setting up and registering a company. The measure would nonetheless benefit from exploring synergies and complementarity with the new cybersecurity reform measure (Reform Measure 10).

Reform measure 9 – 'Improving digitalisation of the public administration by developing and improving digital skills' aims to develop and continuously improve the digital skills of public administration employees, thanks to the new Digital Academy. The measure appears very relevant, with a mostly clear scope and details provided on the various activities, though the fact that both physical and online courses will be offered merits a clearer explanation. Costing appears underestimated and synergies with the cybersecurity reform measure (Reform Measure 10) should be explored, e.g. on the ICT experts' network.

Reform measure 10 – 'Strengthening cyber resilience' is very relevant in the context of the cyberattacks on the government servers in the course of 2022 and responds to the Commission's recommendations for previous ERP cycles. The measure combines legislative actions and institutional building. The description and planned activities are clear and understandable, the timeline appears feasible and the identified risks are well defined. To ensure maximum benefits and synergies and to avoid duplication of efforts (e.g. when setting up CERT teams, data centres and the Cybersecurity Agency), the reform measure should be include all government institutions.

Reform measure 11 – 'Improving infrastructure for the broadband internet access and introducing next-generation networks' continues from 2022-2024 ERP and supports the development of digital services at national and local level. The measure is well justified and relevant and will undoubtedly contribute to developing a competitive and modern economy. A more detailed description of expected impacts on competitiveness, society and labour is needed.

Planned reforms for SOEs were downscaled by the government and their implementation is now highly uncertain. The caretaker government led by prime minister Abazović stepped back from both the reforms announced in the 2022-2024 ERP and the implementation of the 2022 Joint Conclusions of the Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye in the area of SOEs. The ambition of 2022-2024 ERP reforms was to formulate the ownership strategy of the state and define a portfolio of key companies that should remain in state possession, transform the management structures and practices of the SOEs and ultimately improve their financial performance. However, there was no political agreement on the direction and scope of such reforms among the political parties supporting the caretaker government. Consequently, the government rolled back its previous plans for a holding company to manage and reform SOEs, and limited the scope of its 2022 actions to setting up a small unit in the Ministry of Finance whose role is to monitor fiscal risks related to SOEs.

Reform measure 12 – 'Improving management of state-owned enterprises' continues from the 2022-2024 ERP in terms of its title, but is completely redesigned. Its stated objective is to improve the corporate governance of SOEs and the monitoring of the financial and fiscal risks of their operations. However, the political and administrative risks of the reforms are high. While the planned activities and aims are clearly described, more concrete reform steps focus mostly on uncontroversial monitoring activities. The initiative, which aims to curb the purely political appointments in SOE management bodies and to ensure that only individuals with the required qualifications are appointed, seems to lack the necessary safeguards. The draft envisages a possible new selection procedure to be set up by the government decision, thus making it subject to easy changes for every successive political party in power. Actions (yet to be determined) to improve the regulatory framework of SOEs, their financial control and to reduce fiscal risks of SOEs are planned only for 2024-2025, at least partially in expectation of a better political climate. The EU Reform Facility should be mobilised to provide relevant reform expertise and support.

Trade facilitation measures and support for innovation and research complement the list of regulatory environment reforms. Montenegro's 2023-2025 ERP adds trade facilitation measures in the context of CEFTA cooperation as a new area of structural reforms under the regulatory environment challenge. The reform measure aimed at fostering innovation and providing support for research and development continues from the last year and is progressing well. In contrast, a reform measure aimed at facilitating access to finance for SMEs by setting up a Credit Guarantee Fund, initiated last year, has been discontinued. No significant progress was made on the project following the incomprehensible idea of granting the task to the Investment and Development Fund.

Reform measure 8 – 'Strengthening the national innovation and research ecosystem' continues from the 2022-2024 ERP. The focus of the reform is on the consolidation of the institutional framework for innovation and research and on improving the institutional support provided to scientists and researchers. The reform is relevant and aligned with the EU strategies. Ensuring appropriate administrative capacity in the Montenegrin Innovation Fund and the Council for Innovation and Specialisation is key to the success of this reform. Stable and progressively increasing funding from the state budget is another critical factor.

Reform measure 13 – 'Facilitation of trade in goods and services through implementation of CEFTA Additional Protocols 5, 6 and 7' comes back to the ERP after a one-year absence. The measure is relevant, with a clear impact on competitiveness and reducing regulatory burden. The activities are clear, but the implementation of some actions depends on regional developments. Risks associated with the delayed or partial deployment of the New Computerised Transit System (NCTS) should be recognised in the text.

Montenegro's green transition regulatory environment remains at an early stage of development. The National Energy and Climate Plan, which should be also aligned with 2030 energy and climate targets, adopted by the Energy Community Ministerial Council in 2022, and 'Clean Energy Package' legislation, is under development and is expected to be adopted in early 2024. As EU Member States move towards greener economies, it is important that Montenegro also moves in the same direction in order to strengthen its competitiveness during the accession process (for example on the Carbon Border Adjustment Mechanism), and ultimately to cope with increased market pressures. Consequently, it should proactively implement the Energy Community's Decarbonisation Roadmap and strive towards establishing a carbon pricing instrument compatible with the EU ETS, including a reliable and transparent framework for the monitoring, reporting and verification of greenhouse gas emissions. While the use of renewable energy sources is high (some 43% of the electricity production in 2020 came from renewable sources, mostly hydropower and biomass) the country needs to address significant energy-related challenges, including energy efficiency. In particular, it must take a strategic decision on how to replace the thermal (lignite) power plant in Plevlja, which currently produces approximately 50% of Montenegro's electricity, to further reduce CO_2 emissions without exacerbating energy costs for the local economy. The EU Energy Support Package and Montenegro's association action plan identify a set of reforms to be implemented in 2023.

In summary, Montenegro's efforts to improve the regulatory and institutional environment slowed down significantly in 2022, due mainly to the political situation in the country. Efforts must focus on reinvigorating the country's digitalisation ambition, the reform of state-owned enterprises and structured dialogue with socio-economic actors, given the protracted political uncertainty and external challenges (i.e. Russian war of aggression against Ukraine, energy crisis and cyberattacks on the state IT infrastructure) that challenge the smooth functioning and resilience of state institutions and public administration. The proposed reforms have the potential to improve the efficiency and transparency of the regulatory environment, reduce costs and limit the scope for corruption, but they need to be implemented in a timely and steadfast manner. Working towards an inclusive, business-oriented regulatory environment and the adoption of a business-centric culture by the central and local public administrations should remain the authorities' focus in the coming years.

Key Challenge #3: Formalisation of the economy

The informal economy constitutes a major obstacle to the inclusive, sustainable growth and the competitiveness of Montenegro. The informal sector is fuelled by deficiencies in the institutional and regulatory environment, weaknesses on the labour market, insufficient enforcement capacity of the public authorities, corruption and tax non-compliance. The impact of the informal economy is particularly harmful for the SMEs operating legally and microenterprises in the services sector, which dominate the economy. These smallest companies perceive informal competition as the most costly obstacle to doing business. The costs of the informal economy and corruption are also higher for innovative companies, which particularly hinders the development of sectors of the economy that are based on knowledge and skills.

Policies that aim to reduce the size of informal economy need to be broad and comprehensive due to the diverse causes of the phenomenon and the complex relationship between labour market structures, the institutional and regulatory environment, taxation, social policies and cultural factors. They need to create incentives and conditions for the formalisation of informal economy, apply strong disincentives and penalties to businesses and individuals that continue operating in the informal sector and unfairly compete with legitimate businesses. Public authorities also need to take decisive actions to close gaps in the legal and institutional system that are subject to abuse. The authorities need to draw on a wide spectrum of measures to combat the problem of informal economy effectively.

A 2022 survey provides fresh insights on the country's informal economy. A survey conducted in 2022 by IPSOS for the Ministry of Finance and Social Welfare, estimates the size of Montenegro's informal economy at 20.6% of GDP for businesses and employees operating in the formal sector (a drop of 3.9 pps since the 2014 IPSOS survey), and at 37.5% of GDP for a fully informal sector (IMF MIMIC methodology). The averages for the entire EU are estimated at 4.2% and 16.8% of GDP respectively (ILO, 2016). The methodology used in the IPSOS survey differs from the ILO methodology, so a fully equivalent comparison cannot be made. Nevertheless, the IPSOS survey provides useful information on the relative size of the challenge. Informality figures based on IMF methodology can however be compared with 47 European countries. In this context, Montenegro features among the three European economies with most widespread informality, along with Kosovo and North Macedonia.

The most common practices of the informal economy in Montenegro are reportedly informal employment and other forms of informal contracts (particularly in the services sector), unregistered sales of goods and services, tax avoidance on sales of excisable goods and pursuing economic activity without registration or the required license. According to the survey, every fourth employee (26.4%) works either without paying taxes and contributions or with only partially paid taxes and contributions, and every third company is involved in informal economic activities. Lack of capacity of state inspection services (such as labour inspection, Revenue and Customs Administration and market inspection), infrequent or even sporadic sanctions against the informal businesses, together with corruption among the inspectors and political protection are considered to be key elements for the continuous and successful operation of informal businesses, and responsible for a general failure of the control and restrictive policy measures.

Lack of political support and consistency, in addition to erratic implementation, undermine efforts to reduce informality. While the goal of reducing informality started featuring more prominently among the government's priorities back in 2017 when an action plan was developed for this purpose, the bulk of activities, reported under the successive ERPs, have focused on internal reorganisations, reshuffling responsibilities between different administrative bodies and working groups, and internal reporting, rather than on taking concrete actions to reduce informality. Limited actions undertaken by 2021 focused on detecting and penalising some informal activities in the services sector, notably activities that could provide a quick revenue to the state budget.

The fiscal and tax reform of December 2021, analysed in 2022-2024 ERP assessment, which abolished health contributions paid by both employers and employees on salaries, was the first major initiative in recent years to address the roots of informality. The measure significantly reduced labour costs and, at least in accordance with the economic theory, some of the disincentives for employers to formalise employment. Unfortunately, statistical data were not available to confirm this assumption when the informality survey was conducted (February and March 2022). The tax reform was accompanied by two other initiatives: (i) a still ongoing e-fiscalisation, aimed at registering and supporting proper taxation on all cash transactions at the point of sale; and (ii) new excise duty stamps, backed up by a smartphone application that enables users to check the authenticity and legality of excise goods. Both measures were primarily designed to increase the tax revenue of the state, but they are nonetheless much needed steps to address some of the gaps that allow the informal economy to flourish.

Further reforms and actions to reduce informality are yet to be determined. The 2022 survey report on the informal economy in Montenegro provided some specific recommendations on follow-up actions. However, despite these recommendations, Montenegro did not produce a new action plan on the informal economy, promised already in four consecutive ERPs, leaving the commitments made in 2022 Joint Conclusions of the Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye unfulfilled. Once again, this was due to political instability and the damaging impact it has on the work of the state administration and on decision-making. According to the government, follow-up actions are expected to be determined in 2023, with an implementation timeline starting only from 2024.

At the beginning of 2023 the government set up a working group to develop a comprehensive action plan on informality to guide the actions of the entire public administration. However, the working group appears be purely technical in character. With such a low-key approach and without clear political willingness to identify and implement the necessary reforms, the action plan risks being focused not on necessary, even if difficult, decisions and concrete deliverables, but on mostly administrative outputs and increased internal reporting. Furthermore, a political lead should be complemented by work processes and implementation mechanisms involving all relevant actors, akin to the process devised for the ERP conceptual work and consultations.

Reform Measure 14 – 'Strengthening mechanisms for the formalisation of informal economy' continues from a 2022-2024 ERP tax administration reform and follows up on the informality survey. The aim is to develop a central, crosscutting action plan encompassing all measures to reduce informality in the economy. Although the reform is very relevant and appropriate, it provides little to no information on component 1 (scope and substance of the action plan). Reform activities beyond 2023 are not defined and depend on the development and adoption of the action plan. In contrast, the activities related to the new integrated IT system for the revenue management (component 2) are well defined and clear.

A clear vision, political leadership, consistency and steadfast implementation are required to achieve more results. The yet-to-be prepared government plan to reduce the size of the informal economy would benefit from an approach combining targeted, dissuasive and control measures with further incentives to legalise informal businesses and informal employment. As evidenced by the findings of the informality survey, a deep reform of inspection bodies and their digitalisation is necessary, together with action to develop the capacities of inspections and tax authorities. Obvious gaps and inconsistencies in legislation that allow informal businesses to operate need to be closed. Continuous coordination of action between different public institutions, businesses and other civil society actors, and a structured dialogue involving both central and local authorities are key for the successful and timely implementation of any measures. Digitalising the public administration and public services is a good way to reduce the scope and size of the informal economy. The determination of the public authorities to enforce rules through administrative and judicial means will play an equally important role in the process.

Box II.3.4: Monitoring performance in light of the European Pillar of Social Rights ([49])

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights on equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion for the benefit of citizens in the EU. The European Pillar of Social Rights Action Plan, adopted on 4 March 2021, aims at rallying all relevant forces to turn the principles into actions. Since the 20 principles provide direction on how to achieve upward convergence and better working and living conditions in the EU, they are equally relevant for candidate countries and potential candidates. The new reinforced social dimension for the Western Balkans includes a sharper focus on employment and social reforms through greater monitoring of policies (EC, 2018). The Western Balkans Ministers' Declaration on improving social policy in the Western Balkans (6 November 2018) confirms that they will use the Pillar of Social Rights to guide the alignment of their labour markets and welfare systems with those of the EU.

Relative to the EU-27 average, Montenegro faces challenges on a number of indicators from the Social Scoreboard supporting the European Pillar of Social Rights.

MONTENEGRO		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Better than EU avg, deteriorating
	Individuals' level of digital skills (basic or above basic)	Worse than EU avg., deteriorating
	Youth NEET (% of total population aged 15-29)	Worse than EU avg., no change
	Gender employment gap	Worse than EU avg., improving
	Income quintile ratio (S80/S20)	Worse than EU avg., improving
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-64)	Worse than EU avg., deteriorating
	Unemployment rate (% of population aged 15-74)	Worse than EU avg., improving
	Long term unemployment rate (% of population 15-74)	Worse than EU avg., improving
	GDHI per capita growth	Worse than EU avg., improving
Social protection and inclusion	At risk of poverty or social exclusion (in %)	Worse than EU avg., deteriorating
	At risk of poverty or social exclusion rate for children (in %)	Worse than EU avg., deteriorating
	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU avg., deteriorating
	Disability employment gap	Worse than EU avg., deteriorating*
	Housing cost overburden	Better than EU avg., improving
	Children aged less than 3 years in formal childcare	N/A**
	Self-reported unmet need for medical care	Better than EU avg., improving

Montenegro is recovering from the COVID-19 pandemic, including its labour market. Nonetheless, structural challenges in the labour market persist. These include high long-term unemployment and continued regional disparities. While the gender employment gap narrowed, figures remain below the EU-27 average. Data is not available on the gender pay gap or on the disability employment gap. However, past years' trends indicate a deteriorating situation on the latter.

Skills mismatches and the weak provision of adult learning affect school-to-work transitions and result in workers being insufficiently prepared to find suitable and sustainable employment. The quality and relevance of the entire education system and the lack of practical experience of graduates from VET and higher education are long-term challenges that have been exacerbated by the pandemic. Montenegrins' level of digital skills continues to deteriorate. Montenegro continues to exceed the EU-27 average rate of early leavers from education and training, although the rate has started to decrease in the last year.

Employment remains the best route out of poverty. 38.9% of the population and 45.5% of children were at risk of poverty or social exclusion in 2021, both representing a decrease compared to 2020. The planned National Social and Child Protection Strategy based on the Roadmap of reforms of the social and child protection system is expected to address systemic shortcomings in a prioritised and budgeted way. Montenegro continued to exceed the EU-27 average on the cost of housing, and has now also surpassed the EU-27 average on self-reported unmet medical needs.

The collection of timely and reliable data needs to be sustained and strengthened. The Statistical Office of Montenegro is the main producer of primary data, however it is constrained by limited resources. Efforts should continue to bring the employment and social statistics more in line with EU standards and to send statistics to Eurostat systematically and on time. The lack of interoperability between databases and the lack of official data collection, such as on social welfare and the gender pay gap, makes it difficult to monitor several important indicators, such as children's enrolment rates in education. It is also an added hurdle in designing active labour market policies, developing individual activation plans and distributing social benefits.

([49]) The table includes 16 headline indicators of the Social Scoreboard, used to compare performance of EU Member States (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators). The indicators are also compared for the Western Balkan countries and Türkiye. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2021 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). For data see Annex B. NEET: not in employment nor in education and training; GDHI: gross disposable household income.

* No data available for 2021 for Montenegro. The trend is based on 2019-2020 comparison.

** No data on the percentage of children enrolled in formal childcare available. The enrolment numbers have improved from 2020 to 2021.

3.5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2022

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye has adopted targeted policy guidance for all partners in the region. The guidance represents the participants' shared view on the policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The underlying rationale of the policy guidance is similar to that of the country-specific recommendations usually adopted under the European Semester for EU Member States. Implementation of the policy guidance is evaluated by the Commission in the following year's ERP assessments. The following table accordingly presents the Commission's assessment of the implementation of the 2022 policy guidance jointly adopted by the EU and the Western Balkans and Türkiye at their Economic and Financial Dialogue at Ministerial level on 24 May 2022.

Overall: limited implementation (33.3%) ([50])	
2022 policy guidance (PG)	**Summary assessment**
PG 1:	There was **limited implementation** of PG 1:
Strengthen fiscal sustainability by reintroducing the initially planned revenue measures of the 2022 budget while providing additional targeted support to vulnerable households and firms if needed to cushion the impact of adverse shocks.	1) **No implementation:** Although the 2022 budget was rebalanced twice, revenue-increasing measures have not been introduced. On the contrary, temporary cuts to excise duties on fuel and VAT on basic food products were adopted ([51]). The budget rebalance of September 2022 significantly raised spending on a number of new social benefits (including new allowances for all children and for mothers of three or more children, large increases in minimum pensions) which were generally not well targeted and which increased spending permanently.
Use any excess revenues to contain the 2022 deficit.	2) **Substantial implementation:** Strong economic growth led to a surge in revenue, mainly from VAT which, coupled with lower-than-planned expenditure, led to a total budget deficit of 4.8% of GDP, significantly lower than projected in the revised budget and slightly below the original 2022 budget target.
Adopt a new medium-term fiscal strategy with the 2023 budget, including concrete consolidation measures and targeting a primary surplus as of 2024 and continued public debt reduction over the medium-term, should the recovery be firmly entrenched.	3) **No implementation:** After two governments lost a vote of no confidence in the parliament (in April and August 2022), resulting in a government in a caretaker role, a comprehensive fiscal strategy was not prepared.

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

([51]) After reducing the amount of excise duty for the sale of unleaded fuel and gas oils by 50% in June 2022, the government extended this decision, but kept decreasing the percentage of reduction (40%, 25% and 15%) mirroring the stabilisation in the prices of oil derivatives on the international market. The latest decision envisages a 15% reduction and is valid until 27 February 2023. The decision to reduce the VAT rate on the sale and import of basic foodstuff (flour, sunflower oil and salt) expired at the end of 2022, while the decision to reduce the VAT rate on bread (0%) and heating pellets (from 21% to 7%) is valid until the end of 2023.

PG 2: Implement the public investment management assessment (PIMA) recommendations, prioritising key public infrastructure works within the available fiscal space while avoiding exceptions regarding project selection. Adopt amendments to the Law on Budget and Fiscal Responsibility and take concrete steps towards setting up a fiscal council. Based on an analysis of the economic and fiscal impact of all tax expenditures, prepare concrete budgetary recommendations to reduce tax expenditure (like exemptions, deductions, credits, deferrals, etc.) and share this analysis with the Commission	There was **limited implementation** of PG2: 1) **No implementation:** After the IMF prepared the PIMA report in mid-2021, a PIMA action plan was included in the PFM reform strategy for 2022-2026. However, no concrete activities were undertaken to implement its recommendations aimed at improving public investment management. 2) **Partial implementation:** Amendments to the Law on budget and fiscal responsibility were prepared and shared with the Commission for comments in January 2023. The government aims to finalise the consultations and send the draft amendments to the parliamentary procedure. 3) **No implementation:** With technical support from the IMF, a review of Montenegro's tax exemptions was carried out in 2021. However, no concrete steps were taken on preparing an economic impact analysis/quantification of the scale of tax exemptions.
PG 3: Carefully assess and analyse price developments and stand ready to use the limited tools available under the chosen monetary framework to ensure price stability. Ensure a transparent and accurate reporting of asset quality and adequate provisioning as well as a timely follow up on findings from the Asset Quality Review, and continue to reduce data gaps in particular as regards the real estate sector. Continue to improve and implement legislations to further align with the EU framework on regulation and supervision, including on deposit insurance, and accelerate efforts to provide viable and timely solutions for swift and effective NPL resolution.	There was **substantial implementation** of PG 3: 1) **Partial implementation**: The central bank carefully monitored the evolution of price dynamics and observed some increases in lending rates arising from euro area monetary tightening. Fiscal policy that led to large net wage increases also added to underlying inflationary pressures, while the central bank did not use macroprudential tools to curb strong credit growth to help contain the excess demand pressures also contributing to the higher inflation, given the unilaterally euroised regime. 2) **Substantial implementation**: Non-performing loans (NPLs) have been on a declining trend after a rise following the 2021 Asset Quality Review (AQR), and all AQR follow-ups have been completed. NPL provisioning has been adequate. On the real estate sector, the central bank has asked banks to calculate loan-to-value and debt related to income ratios when providing loans, but data gaps remain for the real estate sector more broadly. 3) **Substantial implementation**: Progress was made with key legislation that further aligned Montenegro's regulation and supervision with the current EU framework, including amendments to the Law on the resolution of credit institutions. An EBRD credit line with the Deposit Protection Fund remains in place, which has incrementally raised the coverage ratio of insured deposits. The central bank has set up a Resolution Department, and all banks have submitted resolution plans. However, progress has been limited on legislation and on actions to strengthen the broad institutional framework for efficient insolvency. In a renewed attempt, the central bank is setting up a working group of key stakeholders to address shortcomings in the judicial process and the legal framework on the collection of receivables.

PG 4: Finalise an analysis of barriers to businesses at the local administration, propose improvements to the institutional and regulatory environment on this basis and start to implement them. Continue implementing digital services for micro, small and medium enterprises and prioritise the development and implementation of interactive e-government platform for transactional electronic services. Adopt a strategic plan for "Montenegro Works" and perform an analysis of Montenegrin state-owned enterprises to prepare a proposal for the optimal portfolio of state ownership.	There was **limited implementation** of PG 4: 1) **Partial implementation:** An analysis of support for the development of micro, small and medium enterprises (MSMEs) that focused on cooperation between local self-governments and national authorities, was published in April 2022. The analysis provided recommendations to improve the overall administrative and legislative framework for MSMEs and communication between municipalities and government, which are however not implemented. In parallel, the Competitiveness Council continued its work on identifying barriers to business and maintained a technical level of cooperation with the state administration. The document produced by the Council in 2022 identified 98 barriers, but did not lead to any concrete deliverables by the government. 2) **Limited implementation**: In the first half of 2022, the government offered e-payment opportunities and electronic identification (digital ID cards) for a selected number of services. The government also improved the user experience and the scope of the open data portal (data.gov.me). However, political instability and cyber attacks in the second half of 2022 stalled efforts to further develop interactive e-government platform and to make progress on the related ERP reforms. 3) **Limited implementation**: In July 2022, the government decided to overhaul its strategic approach to the reform of state-owned enterprises (SOEs) and closed down 'Montenegro Works', set up by the previous government. A small department in the Ministry of Finance was set up to monitor the fiscal risks of SOEs instead, while plans for the yet-to-be determined SOE reforms are to be prepared based on further analyses to be made in 2023. Current plans do not address the ownership strategy of the state and do not determine a portfolio of key companies that should remain in the state's possession.
PG 5: Complete the survey on informality and assess the short-term effects of the "Europe Now" programme. Analyse the results and feed them into a comprehensive action plan to tackle informality and start its implementation. Ensure structural cooperation between central and local authorities in the development and implementation of the plan, including on preventing measures and incentives to legalise informal businesses and employees.	There was **limited implementation** of PG 5: 1) **Substantial implementation:** A comprehensive survey on informality was completed in July 2022, but the analysis of the December 2021 tax reforms ('Europe Now' programme) on informality has not been finalised yet. 2) **No implementation:** The results of the informality survey have not been analysed yet. A working group to draft an action plan was set up in February 2023 but the timeline for adopting the document is the end of 2023, with the possible implementation starting only in 2024. 3) **No implementation:** As the drafting and implementation of the action plan has not yet started, the degree of cooperation cannot be assessed.

PG 6: Finalise, in co-operation with all relevant ministries, their agencies and stakeholders, a Youth Guarantee Implementation Plan, adopt it and initiate its implementation.	There was **limited implementation** of PG 6: 1) **Partial implementation:** The multi-stakeholder working group prepared a first draft of the Youth Guarantee implementation plan in mid-2022 and is currently working on finalising it following comments received. The Plan is expected to be adopted in 2023 and implementation to start in 2025.
Based on the Roadmap of Reforms on Social assistance and social and child protection services in Montenegro, establish a clear timeline and financial planning for its implementation and continue implementing the reforms.	2) **Limited implementation:** The terms of reference for the analysis of costs and the preparation of a financial plan for the social and child protection system reform was prepared, but not submitted due to the no-confidence vote of the previous government in Q2-2022. This work is expected to be integrated into the preparation of the new national strategy for social and child protection, expected to be prepared in 2023.
Continue efforts to reform the provision of active labour market policy measures with an emphasis on their labour market relevance, including work-based learning, and establish a continuous monitoring mechanism.	3) **Limited implementation:** Monitoring the implementation of the national strategy for employment remains a challenge, as with the previous strategy, because of the scarcity of data. Although studies were conducted on certain active labour market measures, a continuous monitoring mechanism of active labour market measures is still lacking. The effectiveness, cost-efficiency and coverage of active labour market policies thus remains insufficient.

3.6. POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TÜRKIYE

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

Brussels, 16 May 2023

[…]

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

1. Adopt an appropriately tight fiscal stance in 2023 to help disinflation, while providing targeted support to vulnerable households and firms, if needed. Adopt a new medium-term fiscal strategy with the 2024 budget, including concrete consolidation measures supporting the achievement of a non-negative primary balance from 2025, and a reduction of the public debt ratio over the medium-term. Ensure proper costing of new fiscal initiatives before considering them for adoption.

2. Implement the public investment management assessment (PIMA) recommendations, prioritising key public infrastructure works within the available fiscal space while avoiding exceptions regarding project selection. Adopt the planned amendments to the Law on Budget and Fiscal Responsibility and take concrete steps towards setting up a fiscal council. Based on an analysis of the economic and fiscal impact of all tax expenditures to be shared with the Commission, prepare concrete budgetary recommendations to reduce tax expenditure (such as exemptions, deductions, credits, deferrals).

3. Continue to carefully assess and analyse price developments, stand ready to use the limited tools available under the chosen monetary framework to ensure price stability. Strengthen further the reporting and risk management frameworks across the banking system to ensure an accurate reporting of asset quality and continue to reduce data gaps in particular as regards the real estate sector. Continue to improve and implement legislations to further align with the EU framework on regulation and supervision, including on deposit insurance, and accelerate efforts to provide viable and timely solutions for swift and effective NPL resolution.

4. Improve the institutional and regulatory environment and enhance energy resilience and transition to implement the Green Agenda. Further digitalise and simplify administrative procedures for micro, small and medium enterprises and prioritise cybersecurity, data protection and business continuity for e-government services. Prepare a roadmap for reforming state-owned enterprises (SOEs), prepare a framework for the monitoring and management of SOEs and develop objective criteria for the selection of their management bodies.

5. Based on the results of the informal economy survey, establish an action plan to reduce informality. Ensure cooperation between central and local authorities to implement the plan, including prevention and incentives to legalise informal businesses and employees. Develop an analysis of the inspection services and of the relevant legal framework to optimise the inspector’s work, minimising discretionary decisions and inconsistences in the inspection powers.

6. Prepare activities for the implementation of the Youth Guarantee pilot planned for 2025, analyse its performance, and in parallel identify and implement necessary structural, operational and organisational changes to ensure that the Employment Agency of Montenegro is prepared for the service delivery of the fully-fledged Youth Guarantee as well as its other functions. Continue efforts to reform the provision of active labour market policy measures with an emphasis on their labour market relevance, including work-based learning, and establish a continuous monitoring mechanism that will enable evidence-based active labour market policy design. Based on the Roadmap of reforms on social assistance and social and child protection services in Montenegro, establish a clear timeline and financial planning for the reform of the social and child protection system and start implementing the reforms.

ANNEX A: ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE 2023-2025 ERP

Public financial management

Reforms of public financial management (PFM) over the last 2 years led to the introduction of programme-based budgeting, including the first elements of performance budgeting. Additional legislative changes are needed to complete these reforms, such as setting up a Fiscal Council and switching to accrual accounting. A new PFM strategy for 2022-2026 was adopted in December 2022. Capital budgeting, debt management and asset management require further reforms. The lack of interoperability of the various IT systems remains an obstacle to some reforms. Some progress was made in 2021 on budget transparency. However, the monitoring and reporting framework is still not operational, due to IT issues. Finally, civil society is not systematically involved in monitoring the implementation of the PFM reforms.

Reform measure 12 – 'Improving management of state-owned enterprises' is analysed under the key challenge on strengthening the regulatory environment.

Green transition

Montenegro committed to the Green Agenda for the Western Balkans and to achieving carbon neutrality by 2050. It is in the process of drawing up a national energy and climate plan, due in 2024. The country needs to address significant challenges in the areas of energy, transport and Trans-European Networks, and in particular the future of the coal power plant in Plevlja, which produces approximately 50% of the country's electricity.

The environmental impact of the construction and exploitation of the next sections of Bar-Boljare highway needs to be neutralised. Waste management and wastewater treatment is another area requiring significant work. Air pollution remains a major concern in the regions of Plevlja, Podgorica and Niksic. A moderate improvement was made on protecting nature and biodiversity in recent years, but further progress is needed to align the country with EU standards.

Reform Measure 18 - 'Reducing release into circulation of lightweight carrier plastic bags and single-use plastic products' continues on from the 2022-2024 ERP and remains relevant, given Montenegro's numerous environmental concerns. Activities planned for 2022 were postponed to 2023. The timely implementation of the reform depends on the adoption of the Law on waste management and of the related secondary legislation, which would e.g. target plastic producers. The impacts of the reform may be difficult to measure in the short term, as statistical data on plastic waste and its recycling are not available.

Digital transformation

The digitalisation of the public sector and the development of transactional e-government services for the public and businesses has featured prominently among the government's priority reforms in recent years. The process gained additional momentum during the COVID-19 pandemic, but a series of cyberattacks in the second half of 2022 seriously disrupted the government's digital services and brought the issue of cybersecurity, previously somewhat neglected, to the forefront. Access to broadband networks is key to digitalising the economy and public services, and to implementing Montenegro's smart specialisation strategy in the ICT sector. By May 2022, some 82% of Montenegrin households were located in areas with high-speed broadband connection available(defined as 30 Mbit/s), but actual take-up was much lower at only around 48% of households. Meanwhile, 19% of households were still without internet access in 2021, despite it being technically available, with the figure increasing to 37% in rural areas.

The reform measures that address the digital transformation are analysed in the section covering the key challenge to strengthen the regulatory environment.

Business environment and the reduction of the informal economy

The analysis of these areas and of their relevant reform measures is provided in the section on the key challenge to strengthen the regulatory environment and the key challenge on formalisation of the economy.

Research, development and innovation

Public and private investments in research, development and innovation are low. Montenegro is nonetheless considered an emerging innovator in the European Innovation Scoreboard for 2022, with a summary innovation index of 47.5% relative to EU 100%. However, the country's performance gap with the EU is widening. The links between academia, research institutes and business are still weak. Only 2.2% of Montenegrin micro, small and medium enterprises invest in R&D, compared to 22% at regional level. Research staff are employed almost exclusively by the government or in the higher education sector. With a rate of 0.36% of GDP invested in R&D (2019), Montenegro's spending is just over one sixth of the EU-28 average (2.18% of GDP in 2019). The adoption of a smart specialisation strategy (S3) in June 2019 allows Montenegro to concentrate its scarce R&D resources on specific sectors in order to strengthen innovation in key areas such as agriculture and food processing, energy and sustainable environment, sustainable health tourism and ICT.

Reform Measure 8 - *'Strengthening the national innovation and research ecosystem'*, is analysed under the key challenge on strengthening the regulatory environment.

Economic integration reforms

The low level of processing local products and the small size of businesses undermine the country's competitiveness on the export market. Montenegro's largest exports are low value-added bulk products - aluminium, bauxite, metal scraps and electricity. Manufactured goods, construction materials, machinery, transport equipment and food are the main imports. There is significant potential to increase intra-regional trade under the Central European Free Trade Agreement (CEFTA) and with the EU, as trade preferences granting access to the EU market without customs duties apply to 98.6% of Montenegrin products.

In 2021, Montenegro's foreign trade in goods increased by 20.5% compared to the previous year and almost recovered to the pre-pandemic level. The EU remains Montenegro's main foreign trade partner, accounting for 43% of all trade (31.1% of exports and 45.7% of imports of goods). This compares to some 30.5% of trade with CEFTA countries. The EU remains the main source of foreign direct investment inflows for Montenegro.

Reform Measure 13 – *'Facilitation of trade in goods and services through implementation of CEFTA Additional Protocols 5, 6 and 7'* is analysed under the key challenge on strengthening the regulatory environment.

Energy market reforms

Strategic decisions are needed to transform the structure of the energy market and address energy efficiency. Montenegro's energy comes mainly from a coal (lignite) thermal power plant (TPP) in Pljevlja and hydropower. The former provides around 50% of the country's overall energy production and is vital for security of supply and the stability and reliability of the country's power system. However, TPP Plevlja remains the main polluter in Montenegro and operates in breach of the Directive on large combustion plants, having reached its maximum operating hours in November 2020. Finding an alternative solution for energy production or supply is imperative, but any decisions in this regard are not expected until the government has adopted the National Energy and Climate Plan in early 2024. The use of renewable energy is high. In 2020, some 44% of the country's electricity production came from renewable sources, mostly hydropower and biomass. In recent years, investments were made in wind power plants, but the high wind potential is far from fully utilised. Major solar plant projects were also launched, but having encountered initial land ownership and technical problems, most of them are facing significant delays.

Reform Measure 17 - *'Financial assistance to the households with the aim of implementing energy efficiency measures'* continues on from previous ERP cycles. The reform remains relevant and credible, though its impact, given the scale of energy efficiency needs, is limited. The annual activities (cyclical in nature) were implemented on time. However, financing for the programme for the coming years has been significantly reduced.

Transport market reforms

Montenegro would benefit greatly from developing and improving transport infrastructure and from ensuring a good connection with the European transport corridors. The country's geographical situation makes it particularly important to improve transport links with the wider region and with the rest of Europe. However, the strategic steer for developing the sector should be revised to reflect EU development priorities and Transport Community Treaty commitments (sustainable and smart mobility) and move away from the current emphasis on road transport. Montenegro scores very low on connectivity. Progress on improving and modernising short sections of the road and rail networks is slow and mainly thanks to EU funding. The prioritisation of further investments must reflect the available fiscal space and be sustainable. Further action is needed to open the rail market up to competition and to complete regulatory reforms that have been neglected for years. The (currently suspended) tender for a concession to maintain and upgrade the country's two main airports in Podgorica and Tivat could help address the country's limited accessibility by air.

Reform Measure 17 - *'Improving border crossings-opening of the joint railway border station Bijelo Polje'* is new and relevant, but not ambitious enough for a strategic reform in the transport sector. It addresses only a small project in the larger plan (TEN-T network extension in the Western Balkans). The reform appears achievable already in 2024. The main risk – a lack of coordination between the Ministry of Capital Investments, the Ministry of Finance and the Railway Infrastructure of Montenegro and lack of engagement of the latter in the reform - is not sufficiently addressed and not mitigated.

Agriculture, industry and services

Montenegro is a net importer of food, importing on average a value of EUR 500 million a year and exporting EUR 50 million. Agricultural exports to the EU remain mostly untapped due to the limited scale of agricultural production and the need to meet EU veterinary and plant health requirements. Agricultural production is largely made up of small, often family-run holdings with high production costs, limited organisation and a lack of suitable equipment. Developing ecological farming, local and regional brands and food processing are among the priorities of the smart specialisation strategy.

The industrial base remains modest and hampered by low product diversification and low labour productivity. The production of higher value-added products remains limited and local industry has a low degree of exposure to European and global supply chains. The government's efforts focus on providing support to SMEs and SME-related policies, a natural choice in a small economy. Industrial policy receives continuous support from the state, but access to finance remains a significant obstacle for micro and small enterprises.

Services, particularly tourism services, are the country's main export. They accounted for around 80% of total exports in 2019, with the country's tourism revenues recovering to pre-pandemic levels at the end of 2022. The sector provided over 73% of gross value added in 2021 and employed close to three quarters of the workforce. The country's 2019 Smart Specialisation Strategy identified health tourism as an area to develop, which would partially offset the seasonal aspect of tourism. Further diversifying the services sector away from tourism would reduce the economy's vulnerability to external factors, such as the pandemic, geopolitical risks, and climate change.

Reform Measure 16 - 'Investments aimed at the development of agriculture and rural areas' continues on from previous ERP cycles and incorporates elements of the Green Agenda for the Western Balkans. The reform is cyclical in nature, linked to IPARD implementation and dependent on IPARD funding. The measure is relevant, of good quality, and well developed and explained. The timing and planning of activities in 2023-2024 appears somewhat optimistic, given the specifics of EU funding.

Reform Measure 15 - 'Sustainable green tourism' continues on from previous ERP cycles. Activities planned for 2022 were not carried out and have been brought forward to 2023. The measure includes a 'greening' component, focused on developing 'green' accommodation (incorporating environmentally-friendly technologies, emission standards, energy efficiency, renewable energy sources, etc). The measure is relevant and justified, but the description and activities read like a high-level summary of an action plan, given the diversity and broad scope of the various actions. The indicators, funding section and risks therefore remain very generic and do not provide the information needed to verify the credibility and progress of the reform.

Education and skills

This area and Reform Measures 3 and 4 are analysed above in Section 4, under Key Challenge 1.

Employment and the labour market

This area and Reform Measures 1 and 2 are analysed above in Section 4, under Key Challenge 1.

Social dialogue

Montenegro has continued to consult social partners regularly, but further efforts are needed to ensure that consultations are consistent across sectors and institutions. The tripartite Social Council continued its meetings and was regularly consulted on relevant decisions. However, the effectiveness of social dialogue and the mainstreaming of the consultation of social partners across all relevant ministries and departments remains limited. Awareness of the work of and support to the Social Council remains limited and hinders the mainstreaming of consultations of social partners. After some delays, and following the adoption of the new Labour Law in 2019, the updated general collective bargaining agreement came into force on 31 December 2022.

Social protection and inclusion

This area and Reform Measure 5 are analysed above in Section 4, under Key Challenge 1.

Healthcare

Although the availability of healthcare services is adequate, primary healthcare provision is insufficient. According to the Law on Compulsory Health Insurance every citizen is entitled to healthcare. Although data on real coverage is scarce, with estimates ranging from 99.3% (for people aged 65 and over) to 81.3% (18-24-year-olds) (CeMI, 2017), it is estimated that nearly 100% of the population is covered thanks to the 2017 reform that extended coverage based on residence (WHO, 2022).

Nonetheless, out-of-pocket payments are high, accounting for around 39% in 2019 (WHO, 2022), compared to 14.39% in the EU in 2020. The World Health Organization (WHO) found that almost 10% of all households experienced catastrophic health spending in 2017 (WHO, 2022). At the same time, healthcare system financing has increased, reaching 11% of GDP in 2019, which suggests an inefficient use of the funding (WHO, 2022). Montenegro moved to a fully tax-funded health insurance system in 2022, but there are concerns about its long-term financial sustainability (WHO, 2022).

Although the availability of healthcare services (number of hospital beds and medical staff) is comparable to the EU average, primary healthcare provision and prevention measures remain underdeveloped. Self-reported unmet medical needs remain below the EU average. After rising to 3.1% in 2019, the rate dropped to 1.6% in 2020, compared with the EU rate of 4.8% in 2021. Self-reported unmet needs for dental care stood at 3.3% in 2020, compared with the EU rate of 5.0% in 2021. The relatively low rates of unmet needs are likely due to the broad health coverage in the country, while unmet needs are largely due to out-of-pocket costs (WHO, 2022). The government adopted a Strategy for Improving the Quality of Health Care and Patient Safety (2019-2023) in 2019 focused on improving and monitoring the quality of healthcare. However, Montenegro lacks an operational monitoring system which would allow data-based decision-making in healthcare (WHO, 2022).

Reform Measure 6 on 'Digitalisation of the healthcare system in Montenegro' builds on Measure 8 from the previous year, expanding it beyond telemedicine and e-health to encompass a broader digitalisation of the healthcare system. The aim is to improve the existing healthcare services and add new ones to ensure better accessibility, availability and affordability. The activities planned under the measure are ambitious and adequate.

ANNEX B: OVERVIEW OF THE MAIN INDICATORS PER AREA/SECTOR OF THE ECONOMY

Area/Sector	2017	2018	2019	2020	2021	EU-27 Average (2021 or most recent year)
Energy						
Energy imports dependency (%)	40.5%	31.1%	32.9%	27.4%	N/A	55.60%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	263.25	259.50	258.14	280.25	N/A	110.35
Share of renewable energy sources (RES) in final energy consumption (%)	39.69%	38.80%	37.72%	43.77%	39.89%	21.7%
Transport						
Railway Network Density (meters of line per km^2 of land area)	18.1 ^{w}	18.1 ^{w}	18.1 ^{w}	N/A	N/A	N/A
Motorization rate (Passenger cars per 1000 inhabitants)	310.6 ^{w}	331.7 ^{w}	350.3 ^{w}	N/A	356.7 ^{w}	N/A
Agriculture						
Share of gross value added (Agriculture, Forestry and Fishing)	8.4%	8.2%	7.9%	9.1%	8.0%	1.8%
Share of employment (Agriculture, Forestry and Fishing)	7.9%	8.0%	7.1%	7.5%	6.4% ^{w}	4.3% $^{(2020)}$
Utilised agricultural area (% of total land area)	18.6% ^{w}	18.6% ^{w}	18.6% ^{w}	18.7% ^{w}	18.7% ^{w}	40.6%$^{(2020)}$
Industry						
Share of gross value added (except construction)	11.3%	12.5%	11.9%	13.5%	12.5%	19.9%
Contribution to employment (% of total employment)	9.5%	9.9%	9.5%	10.1%	10.2% ^{w}	16.1%
Services						
Share of gross value added	73.4%	72.3%	72.3%	70.1%	73.8%	79.2%
Contribution to employment (% of total employment)	75.0%	73.1%	73.4%	74.1%	76.7% ^{w}	70.9%

Research, Development and Innovation						
R&D intensity of GDP (R&D expenditure as % of GDP)	0.35%	0.50%	0.36% [w]	N/A	N/A	2.26%
R&D expenditure – EUR per inhabitant	24.10€	37.7€	28.7€ [w]	N/A	N/A	734.5
Digital Economy						
Percentage of households who have internet access at home	71%	72%	74%	80%	81%	92.5%(2022)
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	71.3%	71.5%	73.5%	78%	82.2%	90%(2022)
Trade						
Export of goods and services (as % of GDP)	41.1%	42.9%	43.8%	26.0%	42.8%	50.4%
Import of goods and services (as % of GDP)	64.5%	66.7%	65.0%	61.0%	62.2%	46.7%
Trade balance (as % of GDP)	-44.9%	-46.2%	-44.1%	-41.5%	-41.7%	N/A
Education and Skills						
Early leavers from education and training (% of population aged 18-24)	5.4%	4.6%	5.0%	3.6%	6.7%	9.7%
Young people neither in employment nor in education and training (NEET) (% of population aged 15-29)	21.4%	21.0%	21.3%	26.6%	26.5%	13.1%
Children aged less than 3 years in formal child care (% of under 3-years-olds)	32.89% [w]	34.13% [w]	37.21% [w]	N/A	N/A	36.2%
Individuals who have basic or above basic overall digital skills (% of population 16-74)	50%	N/A	52.2%	U	47.2%	53.92%

Employment and Labour Market						
Employment Rate (% of population aged 20-64)	58.2%	59.8%	60.8%	55.2%	54.2%	73.1%
Unemployment rate (% of labour force aged 15-74)	16.1%	15.2%	15.2%	17.9%	16.6%	7%
Long term unemployment rate (% of labour force aged 15-74)	12.5%	11.4%	12.0%	13.4%	11.0%	2.8%
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	13.8 pps.	13.8 pps.	13.3 pps.	12.9 pps.	11.1pps.	10.8 pps.
Disability employment gap (Percentage points difference in employment rates between people with and without a disability)	25.8 pps.	21.2 pps.	18.7 pps.	28.0 pps.	N/A	23.1 pps.
Real gross disposable income of households (Per capita increase, Index = 2008)	N/A	4.234	4.241	4.449	4.338	110.27
Social Protection System						
At-risk-of-poverty or social exclusion rate (AROPE) (% of population)	42.2%	41.2%	36.6%	37.8%	38.9%	21.7%
At-risk-of-poverty or social exclusion rate of children (% of population 0-17)	49.0%	48.5%	43.5%	45.0%	45.5%	24.4%
Impact of social transfers (Other than pensions) on poverty reduction	24.84%	23.72%	16.95%	18.71%	27.2%	37.08%

Income quintile share ratio S80/S20 for disposable income by sex and age group (Comparison ratio of total income received by the 20% with the highest income to that received by the 20% with the lowest income)	7.57	7.37	6.72	5.96	5.8	4.97
Housing cost overburden (% of population)	15.1%	14.7%	11.7%	9.4%	8.0%	8.3%
Healthcare						
Self-reported unmet need for medical care (of people over 16)	2.7%	2.3%	3.1%	2.1%	1.6%	4.8%
Out-of-pocket expenditure on healthcare (% of total health expenditure)	42.17%	39.61%	38.56%	N/A	N/A	14.39%$^{(2020)}$

Source of data in Annex B: EUROSTAT, unless otherwise indicated

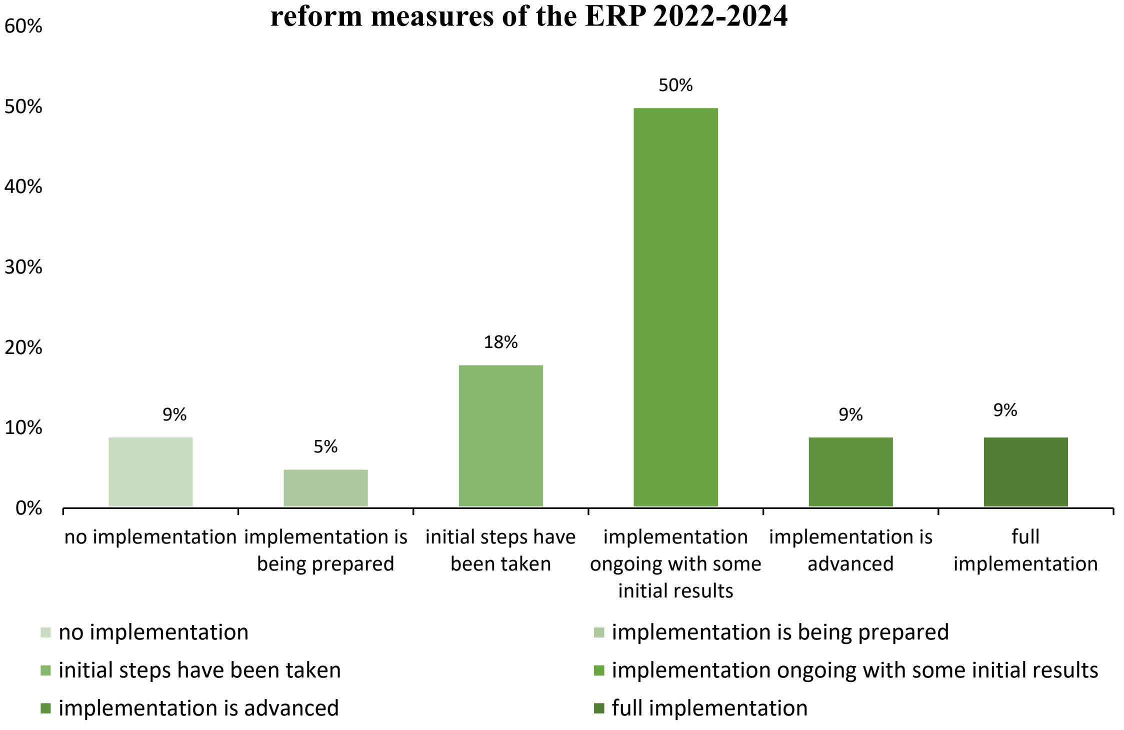
w: data supplied by and under the responsibility of the national statistical authority and published on an "as is" basis and without any assurance as regards their quality and adherence to EU statistical methodology'

ANNEX C: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM 2022-2024 ERP

Montenegro made limited progress on the measures planned for 2022, with an average score of **2.85** out of 5. Reporting on the 2022 structural reform measures is generally of good quality, with sufficient information provided on the progress of the reforms. An assessment using the performance indicators was provided for almost all reforms.

Implementation was strong for some measures, such as Measure 2 on new work schemes and work-life balance and Measure 20 on financial support to households aimed at applying energy efficiency measures. Implementation was weaker for many other measures, such as Measure 3 on introducing the Youth Guarantee Programme in Montenegro and Measure 9 on establishing a full electronic registration of enterprises. There was no implementation for Measures 4 and 21 – on increasing employability of adults by improving their skills and competences needed at the labour market and on reducing release into circulation of lightweight carrier plastic bags and single-use plastic products.

Graph II.3.2: **Montenegro - Implementation of the structural reform measures of the ERP 2022-2024**



ANNEX D: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government of Montenegro submitted the 2023-2025 Economic Reform Programme to the Commission on 25 January 2023.

Inter-ministerial coordination

The Ministry of Finance and Social Welfare coordinated the work to prepare the 2023 ERP. An inter-ministerial working group involved all relevant ministries.

Stakeholder consultation

The national ERP coordinator organised an initial consultation on the design of the ERP measures in September 2022. Another public consultation on the draft ERPtook place in December 2022, including a round table public discussion.

Macro framework

The programme presents a clear and concise picture of past economic developments and covers all relevant data available at the time of submission. The information provided is coherent, concise and well structured. Statistical tables are complete with almost all the relevant data covered, but weaknesses remain, for instance on the balance of payment capital and financial account table. The macroeconomic framework is coherent, consistent and sufficiently comprehensive and provides a good basis for policy evaluation and discussions.

Fiscal framework

The fiscal framework is well detailed, in line with stated policy objectives and consistent with the ERP macroeconomic framework. However, the programme is somewhat vague on medium-term developments, in particular on the impact of one-off measures which were recently adopted. Overall, the factors behind the ERP's projected revenues and expenditures are based on existing legislative measures, and they are presented clearly. Some revenue measures, which are not included in the ERP's macro and fiscal scenarios, were adopted after the ERP submission and might improve the budget revenue performance. Montenegro's fiscal reporting does not follow ESA2010 standards, and therefore does not meet the Commission's fiscal notification requirements.

Structural reforms

The structural reform parts of the ERP respect the guidance note. A dedicated section provides information on the implementation of the policy guidance for 2022. Reporting on the progress of 2022 structural reform measures is generally of good quality. The 2023-2025 ERP sets out 19 reform measures and structures almost all of them well in terms of scope, timeline and the budget for the planned activities. However, the page limit for structural reforms is significantly exceeded.

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4. NORTH MACEDONIA

4.1. EXECUTIVE SUMMARY

Following a slowdown in growth in 2022 as the economy of North Macedonia was hit heavily by the surge in global energy prices, the economic reform programme (ERP) projects that growth will gradually accelerate in 2023-25 due to an increase in public and private investment. Economic activity slowed down throughout 2022, as domestic demand weakened and GDP growth dropped to an estimated 2.1%. Inflation rose to a record level, mainly as a result of increases in global energy and commodity prices. The country's heavy dependence on energy imports led to a sharp deterioration in its current account. The ERP's baseline scenario is that output growth will accelerate due to strengthening foreign demand and a large surge in investment. The latter will be due to a marked increase in public capital expenditure supported by measures to improve implementation capacity. Annual real GDP growth is expected to gradually accelerate to an average of 4% in 2023-2025. Net exports are set to have a negative impact on growth, but to a gradually diminishing extent. The ERP's growth scenario seems somewhat optimistic given significant downward risks to growth (e.g. uncertainties about the future course of the Russian war of aggression, of global energy and commodity prices, and of global financial market conditions; domestic pressures on inflation, such as high wage growth; and major implementation and management risks for both private and public investment).

Public finances improved in 2022 despite large-scale energy support, but the government's plans for medium-term fiscal consolidation are back-loaded, thus postponing the return to the pre-pandemic primary balance until after the programme period. Inflation and other factors caused income from taxes and contributions to rise above the planned levels in 2022 and the fiscal deficit was lower than targeted at 4.5% of GDP. The ERP projects that fiscal consolidation will continue in 2023-2025, with the overall government deficit dropping to 2.9% of GDP in 2025. However, the primary balance is projected to return to its pre-pandemic level only in 2027. Consolidation would initially be driven by increased revenue based on tax reforms that streamline preferential tax treatments and exemptions and, pending adoption by the parliament, would apply as of January 2023. On the expenditure side, the intended savings are not well specified. The public debt level is expected to remain above 60% of GDP throughout the programme's lifetime.

North Macedonia is facing a number of key challenges:

- **The need to restore fiscal space means that consolidation could be brought forward with the help of tax and governance reforms.** As regards the 2023 budget, any excess revenues (e.g. any generated through the planned solidarity tax) as well as potential underspending on the energy support budget should be used to reduce the deficit. Untargeted support measures should be gradually withdrawn. The 2022 tax reform package is an important step towards increasing public revenue and should be extended with further tax base-broadening measures. In parallel, shortcomings in staffing and technical capacities in the Public Revenue Office need to be addressed. Strengthening fiscal governance would facilitate the return to a more prudent fiscal position. The provisions of the new Organic Budget Law (OBL) and particularly the fiscal rules should be swiftly implemented. The fiscal council should be enabled to start working in the course of 2023.

- **The execution of the government's large investment agenda is vulnerable to risks stemming from deficiencies in public investment management (PIM) and in the monitoring of fiscal risks inherent in the operations of public sector entities**. The implementation of the 2021 PIM Action Plan therefore needs to be accelerated and the new PIM unit in the Ministry of Finance must become operational and start to develop joint methodologies and criteria for the appraisal, selection and monitoring of investment projects applicable to all public sector entities. The need to raise additional private financing for these projects requires the development of new financing structures and controlling the associated fiscal risks. This particularly includes a new legal framework for public-private partnerships.

- **A challenging business environment is undermining the competitiveness of domestic companies, investment and global value chain (GVC) integration.** This applies to a large part to the informal economy and involves a lack of skills, innovation and technology adoption; a complex legal and regulatory environment; low productivity; and the need to make progress with the digital transition. The impact of the COVID-19 pandemic and Russia's invasion of Ukraine (including high energy, commodity and food prices, combined with supply chain disruptions) has exacerbated these structural challenges and impaired competitiveness. Companies are also affected by vulnerabilities in GVCs. The need to accelerate structural reforms has become even more important in order to promote a sustainable recovery in the medium term. Improving the competitiveness of local companies and benefiting from the post-crisis restructuring of GVCs will require improvements to human and physical capital and the business environment (including better enforcement of business regulation and corporate governance; addressing the informal economy; promoting the digital transition; a more focused investment and export promotion strategy; and less complex state aid rules). Greater investment in research and innovation as well as progress in regional integration could further support competitiveness.

- **Russia's aggression against Ukraine and the energy crisis clearly demonstrate that the green transition is the country's best chance to reduce its vulnerability to external shocks and become more energy-independent**. The economy of North Macedonia is currently characterised by high energy intensity; inefficiencies in the ageing energy production system; persistently high dependence on highly polluting lignite coal; and inefficient energy use. The energy supply is unreliable and needs to be further diversified. The clean energy transition can help to lower energy prices over time and reduce reliance on imports. Renewable energy still accounts for only a relatively small share of power generation. Energy efficiency can significantly reduce the impact of energy costs on the economy's competitiveness by reducing the overall need for energy, but measures to improve energy efficiency will have to make significant progress. The energy transition and the sustainability of the energy system are priorities in various strategies and action plans adopted by the country, thus demonstrating the government's commitment to the green transition. However, implementation is a challenge and requires enhanced institutional capacity and coordination (including a governance mechanism, an action plan and a monitoring mechanism for a 'just transition' process).

- **The education system does not adequately equip young people with the key competences – skills and knowledge – that they need to actively participate in the labour market.** North Macedonia has made good progress in terms of raising the number of people with higher education, but an inadequate quality of education and business structures is contributing to the persistently high level of unemployment and a still significant share of young people not in employment, education or training (NEET). The education strategy and related action plan prioritise equipping young people with high-quality skills to prepare them for the labour market, but state financial support is insufficient and intersectoral coordination still needs further improvement. Students and families receive limited career guidance when making important choices and curricula are not always consistent with labour market needs.

The policy guidance jointly adopted at the Economic and Financial Dialogue of May 2022 has been partially implemented. The government has adopted two sets of fiscal measures to mitigate the impact of the energy and cost of living crisis on vulnerable households and firms. It has presented fiscal consolidation plans, which project a return to the pre-pandemic primary balance by 2027. It has secured important amendments to tax laws in order to increase public revenue by broadening the tax base for direct taxation and VAT. The government has started work on secondary legislation to the new Organic Budget Law, which was adopted by the parliament in September 2022, and has launched the appointment procedure for the new Fiscal Council. It has set up a dedicated unit in the Ministry of Finance for public investment management and has made progress towards the adoption of a new law on public-private partnerships. The central bank has tightened monetary policy in line with developments in inflation and taken further measures to take forward its strategy to increase the use of the local currency (denarisation). Efforts continued to improve the national e-services portal (www.uslugi.gov.mk) which provides electronic services to citizens, but progress is below expectations. The country is showing a continued commitment to streamlining para-fiscal charges, but progress in implementation is slow. As regards the green energy transition, the adopted National Energy Action Plan sets out clear commitments and timelines, including the delayed establishment of the Energy Efficiency Fund (the legal and regulatory framework is still missing) and the much needed adoption of secondary legislation in the area of energy efficiency. Progress in increasing the technical and engineering capacity of the Energy Department in the Ministry of Economy and the Energy Agency was limited. North Macedonia has focused the development of a new financing formula on primary and secondary education and is planning to review the financing of the vocational education and training (VET) system. For higher education, a new formula has not yet been developed. The new law on VET has been drafted but its final adoption is pending. Staff have received training in order to improve the Centres of Social Work. As regards active labour market policies, North Macedonia is providing more targeted solutions. However, no new measures specifically for low-skilled and vulnerable unemployed individuals have been introduced. The structural reform measures set out in last year's ERP (2022-2024) have only been partially implemented.

The key challenges identified in the ERP match those identified by the European Commission. The planned structural reform measures almost entirely focus on addressing these identified key challenges. The structural reform measures, often rolled over from last year's ERP, follow a fairly consistent approach for the country's economic development and are to a good extent coherent with other national plans and strategies. In an effort to better support the post-pandemic economic recovery and to deal with the fallout of Russia's war against Ukraine, the ERP has proposed various measures to promote inclusive and sustainable economic growth in line with the EU's priorities of the green transition and (albeit to a more limited extent) digitalisation. The impact assessment for the structural reform measures could be further improved to make it possible to prioritise the measures on the basis of their economic, social and environmental impact. The common EU growth model for the green and digital transitions will also have to be further strengthened in the ERP process for North Macedonia (particularly in the current geo-political context).

4.2. ECONOMIC OUTLOOK AND RISKS

Following a partial recovery from the recession caused by the COVID-19 pandemic recession, North Macedonia has been severely hit by the fallout from Russia's war of aggression against Ukraine. Annual GDP growth dropped to 2.1% in 2022 ([52]) from 3.9% in 2021 as external demand weakened, disruptions in global supply chains persisted, and global food and energy prices rose rapidly. Headline inflation surged to 19.8% in October 2022, reflecting the economy's high sensitivity to the global energy and food price shock, before abating somewhat in November and December.

The programme's baseline scenario predicts that real GDP growth will accelerate during the ERP's lifetime. Growth is projected to average 4% per year in 2023-2025 (about one percentage point lower than in the previous programme) mainly due to a larger negative contribution from the external side. Investment is expected to increase by 7.1% annually on average, while private consumption is set to expand at a more moderate rate of 3.2% per year. The output gap is projected to stay negative for longer than anticipated in the previous programme, and will only close in 2024-2025. Exports are projected to pick up from 2024 in line with strengthening foreign demand. This, together with accelerated investment growth, will also spur imports (+6.6% year on year on average in 2023 -2025) but by less than exports (+7%). Overall, the negative contribution to growth from the external side is set to gradually diminish over the programme's lifetime.

The programme presents two alternative macroeconomic scenarios based on risks to the baseline projection. The materialisation of unfavourable external risks, assuming that annual export growth turns out lower by 1.9 percentage points (pps) compared to the baseline scenario, would result in average annual output growth of 3% between 2023 and 2025 (compared with 4% in the baseline scenario). The domestic risks scenario assumes weaker growth of investment in response to lower implementation of public infrastructure projects and withdrawal of fiscal support for private enterprises. This would lead to lower average annual output growth of 0.4 pps when compared with the baseline scenario.

The ERP baseline scenario seems overly optimistic. The expected surge in investment might be hampered by significant deficiencies in public investment management that obstruct the planned implementation of budgeted capital expenditure. This also concerns the planned introduction of structural financing instruments, such as public-private partnerships. The large build-up of inventories by private-sector companies in 2022 (in anticipation of possible further input price increases) may keep private investment lower than expected for a time, at least in 2023. Moreover, the macroeconomic and fiscal outlooks continue to be affected by high uncertainty related to the further economic fallout from Russia's war of aggression against Ukraine (particularly on energy supply and inflation) and tighter financing conditions that are further limiting domestic demand. North Macedonia has limited direct exposure to Russia or Ukraine, but its economy is sensitive to rising commodity prices.

([52]) Macroeconomic and fiscal estimates and forecasts covering the period 2022-25 have been taken from the ERPs themselves; if available, preliminary macroeconomic and fiscal outturn data for 2022 have been taken from the relevant national sources (national statistical office, ministry of finance, central bank).

Table II.4.1:
North Macedonia - Comparison of macroeconomic developments and forecasts

	2021		2022		2023		2024		2025	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	4.0	**3.9**	2.3	**2.7**	2.5	**2.9**	2.8	**4.1**	n.a.	**5.0**
Contributions:										
- Final domestic demand	5.6	**5.5**	6.3	**7.2**	3.4	**3.6**	3.0	**5.3**	n.a.	**5.8**
- Change in inventories	1.1	**n.a.**	1.5	**n.a.**	-0.5	**n.a.**	0.0	**n.a.**	n.a.	**n.a.**
- External balance of goods and services	-2.8	**-1.6**	-5.4	**-4.5**	-0.4	**-0.7**	-0.2	**-1.2**	n.a.	**-0.8**
Employment (% change)	1.1	**n.a.**	1.1	**n.a.**	0.9	**n.a.**	0.7	**n.a.**	n.a.	**n.a.**
Unemployment rate (%)	15.5	**n.a.**	14.8	**n.a.**	14.7	**n.a.**	14.6	**n.a.**	n.a.	**n.a.**
GDP deflator (% change)	6.1	**3.6**	10.3	**12.4**	7.3	**7.5**	2.3	**2.4**	n.a.	**2.0**
CPI inflation (%)	3.2	**3.2**	12.7	**14.3**	7.9	**8.5**	4.0	**2.4**	n.a.	**2.0**
Current account balance (% of GDP)	-3.5	**-3.1**	-7.8	**-7.4**	-4.8	**-5.6**	-3.6	**-2.1**	n.a.	**-1.2**
General government balance (% of GDP)	-5.4	**-5.4**	-5.4	**-5.1**	-4.4	**-4.6**	-3.3	**-3.4**	n.a.	**-2.9**
Government gross debt (% of GDP)	51.8	**52.0**	51.4	**49.5**	51.6	**51.0**	52.5	**51.8**	n.a.	**51.4**

Sources: Economic Reform Programme (ERP) 2023, Commission Autumn 2022 forecast.

The import-driven inflationary pressures of 2022 are expected to subside during the ERP period, but domestic factors may pose a risk to price stability. Inflation increased significantly in 2022 due to higher prices for food, energy and transport that were themselves mainly due to increasing global prices. Average annual inflation rose to 14.2% in 2022 (3.2% in 2021). The central bank tightened its monetary stance by raising the key policy rate from 1.25% to 5.25% in nine consecutive steps between April 2022 and February 2023. Headline inflation started to decline in November, due to decelerating price rises for food and energy products ([53]), but core inflation did not slow down and only stabilised somewhat in January 2023. Food and energy together account for almost 60% of the domestic CPI structure and price increases for these two categories explain about 75% of headline inflation. The country's industry (particularly its food producers) are heavily dependent on imports and not only for energy. The programme projects that annual average consumer price inflation will fall to 8.5% in 2023 and back to its long-term average of about 2% in 2025. This is based on a projected slowdown in the growth of energy prices and decreasing price pressures for primary goods. North Macedonia is a small and open economy with a de facto currency peg, so its price level is largely determined by international price developments. However, although the programme's assumptions about global price developments seem plausible in the medium term, domestic factors (e.g. further strong increases in nominal wages that may potentially lead to a wage-price spiral) may nevertheless pose a risk to price stability. The government raised the minimum wage by 12% starting from April. It is also planning to raise public sector wages further this year. Higher average nominal wages would also accelerate the increase in pensions under the new indexation formula, thus creating additional demand pressures.

The current account deficit is projected to narrow gradually to 1.2% of GDP in 2025. The current account deficit rose markedly in 2022, to 6% of GDP, on account of a widening energy trade deficit that reflected the country's high dependence on energy imports. A marked increase in private transfers (remittances) and in the services surplus, helped by a rebound in tourism, partly offset the deterioration in the energy trade balance. The projected narrowing of the current account deficit over the ERP cycle will be mainly due to a significant improvement in the trade in goods balance (by a total of 7.6 pps in 2022-2025) which is itself due to stronger external demand and lower import prices. The surplus in the trade in services balance is predicted to increase until 2024 but to fall after that. Inflows from remittances are forecast to continue fluctuating considerably between years but will hover around their pre-COVID-19 five-year average (16.7% of GDP) throughout the programme's lifetime. The programme does not

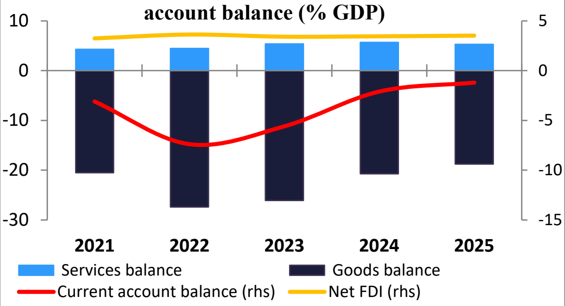
([53]) This was driven by global price developments and was supported by government subsidies and regulatory measures to contain food price inflation.

explain the uneven movement of current transfers. The primary income deficit would widen markedly in 2024 and remain at that level in 2025. Here, too, the programme would have benefited from more explanation. Overall, the drop in the current account balance seems plausible given the background projections of strengthening export demand and declining global commodities prices, but it is still quite optimistic regarding its size of the fall.

Inflows from foreign direct investment (FDI) are projected to fully cover the current account deficit in 2024 and 2025. FDI inflows recovered after a fall triggered by the COVID-19 pandemic and increased to 5.8% of GDP in 2022 (+1.8 pps year on year based on revised FDI data for 2021). This reflected a strong rise in intercompany debt. However, FDI did not fully finance the surging current account deficit in 2022. The programme expects FDI to remain at about its pre-COVID-19 five-year average (3.5% of GDP) throughout the programme's lifetime, reflecting the gradual strengthening of the global economy as well as further 'nearshoring' (foreign companies relocating production facilities closer to their main markets in the EU). Projected FDI inflows in 2023 (3.3% of projected GDP) would again not be sufficient to finance the current account deficit. External debt was 12% higher at the end of the third quarter of 2022 than a year earlier. This was largely due to a rise in private intercompany lending, which is an important instrument for improving liquidity for foreign-owned companies in the country, and which occurred despite a decrease in general government external debt. External debt stood at 85.7% of GDP (+1.5 pps year on year) with long-term debt accounting for the bulk of the total (70%). A high level (some 40%) of total external debt is made up of intercompany loans and trade credits, which are a less risky and more flexible category of debt. External competitiveness (as measured by the real effective exchange rate (REER) deflated by the CPI) slightly decreased. The REER rose by 1.1% due to an increase in the nominal effective exchange rate, with relative prices remaining stable. Nominal unit labour cost (ULC) rose by some 7% in 2022, reflecting the stark increase in nominal wages in a context of subdued productivity growth. The programme contains an external debt sustainability analysis that is based on the IMF approach. This analysis projects a slight rise in overall external debt between 2022 and 2025 (+1 pp). Foreign reserves shrank heavily in the first half of 2022 but recovered later in the year. Foreign reserves were more than 14% lower at the end of June 2022 compared with a year earlier, mainly on account of higher conversion of domestic denar-denominated savings into euro-denominated deposits; the surge in energy imports; and high external debt payments. The exchange markets stabilised somewhat over the summer, with seasonally high inflows of foreign currency that exceeded the central bank's expectations and were supported by a EUR 250 million private placement of government securities in Germany in September 2022. The reserve levels at the end of December 2022 were equivalent to almost 4 months of prospective imports.

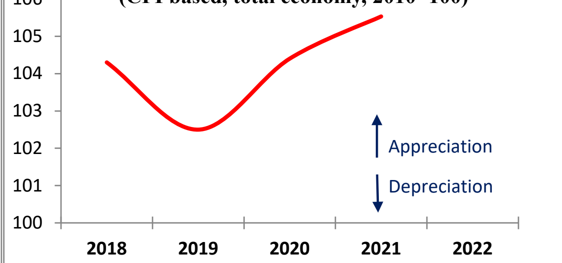
External competitiveness and current account

Graph II.4.1a: **North Macedonia - Current account balance (% GDP)**



Source: Economic Reform Programme (ERP) 2023.

Graph II.4.1b: **North Macedonia - Real effective exchange rate, (CPI based, total economy, 2010=100)**



Source: Economic Reform Programme (ERP) 2023, Central Bank.

The country's banks remain well-capitalised and liquid. Banks continue to dominate the financial sector of North Macedonia, accounting for some 79% of the sector's assets. Banking sector concentration remains moderate, with some 57% of assets held by the three biggest banks in 2022. 10 of the sector's 13 banks are predominantly under foreign ownership, accounting for some 75% of the sector's assets. The banking sector's tier-1 capital amounted to 16.3% of risk-weighted assets at the end of the third quarter of 2022 (+0.4 pps year on year). Liquidity indicators point to a slight deterioration, compared with one year earlier, but remain at a high level. The funding of bank loans by deposits (the main funding source for banks) dropped slightly, with the loan-to-deposit ratio higher at the end of the third quarter than one year earlier (+5.4 pps year on year to 87.7%). The ratio of non-performing loans (NPL) to total loans decreased year on year (by -0.3 pps to 3.2% at the end of the third quarter of 2022) and loan-loss provisioning improved. The central bank's strategy to apply different reserve requirements for bank deposits in foreign and local currency contributed to households' denar deposits posting annual increases since November 2022. Private-sector credit growth accelerated in 2022 (by +3.8 pps to 9.6% year on year). Overall, the ratio of loans denominated in foreign currency to total loans had increased at the end of the third quarter (by 1.2 pps year on year to 43%), partly because corporations needed extra liquidity to cover their energy purchases. The currency denomination of domestic credit nevertheless moved further towards denar-denominated loans towards the end of the year. The central bank's key macroprudential role was reinforced by the passing of the Financial Stability Law in the parliament in July 2022. The Law also formally establishes the Financial Stability Committee, an interinstitutional body that monitors the financial system. A number of other key legislative acts in the financial sector are planned for adoption by the government in 2023. There appears to be scope to increase the financial sector's role in reaching climate and energy targets in line with European and international commitments by adopting policy measures in the area of sustainable finance (such as sustainability disclosures, sustainable finance taxonomies etc.).

Table II.4.2:
North Macedonia - Financial sector indicators

	2018	2019	2020	2021	2022
Total assets of the banking system (EUR million)	8 187	8 945	9 490	10 363	11 103
Foreign ownership of banking system (%)	71.4	72.8	75.0	76.3	77.7
Credit growth (aop)*	6.6	7.2	6.4	5.8	9.6
Deposit growth (aop)	8.6	9.6	7.8	8.3	4.2
Loan-to-deposit ratio (eop)	91.5	88.4	87.1	86.9	90.4
Financial soundness indicators (%, eop)					
- non-performing loans to total loans**	5.2	4.8	3.4	3.2	2.9
- regulatory capital to risk-weighted assets	15.0	14.8	15.3	15.8	16.6
- liquid assets to total assets	30.6	31.9	32.5	32.4	30.0
- return on equity	16.0	11.7	11.3	12.9	12.2
- forex loans to total loans	41.4	42.3	42.3	41.2	43.2

* corrected for the write-offs.
** including the impact of write-offs.
Sources: National Central Bank, IMF.

4.3. PUBLIC FINANCE

The budget deficit was lower than planned in 2022 due to higher than expected revenue and under-execution of expenditure. The revised budget passed by the parliament in July raised the target for the central government fiscal deficit from 4.3% to 5.3% of GDP, mainly to reflect anti-crisis measures to mitigate the impact of rising food and energy prices on households and to support companies' liquidity. Allocations for subsidies and transfers were raised by 40%, but capital expenditure was lowered by 15.7% (compared with the original plan). The actual fiscal deficit of 4.5% of GDP was lower than the revised target. This came on account of an inflation-driven boost to tax income, on the one hand, and of under-execution of several expenditure categories, most notably transfers to the state-owned electricity company ESM and capital expenditure, on the other hand. In addition, public arrears accumulated during 2022. Central government revenue rose by 11.3% compared with 2021, with VAT receipts posting the largest annual increase (+22.4%). Income from social contributions, which temporarily benefited from fiscal support to employer contributions in the case of wage increases, rose by 9.9%. Current expenditure increased by 6.9%, which was less than the 8.3% increase in total expenditure. At 89.2% of budget, implementation of capital expenditure was higher than the average for the previous 5 years (2021: 79%). Over 70% of the actual deficit financing in 2022 came from foreign loans (including a private placement in Germany in the autumn) and from donor support (including the first tranche of a precautionary and liquidity line (PLL) from the IMF to a value of EUR 110 million) ([54]).

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

	2021	2022	2023	2024	2025	Change: 2022-25
Revenues	32.4	31.8	32.8	32.5	32.4	0.6
- Taxes and social security contributions	28.8	27.8	28.6	28.7	28.7	0.9
- Other (residual)	3.6	4.0	4.2	3.8	3.7	-0.3
Expenditure	37.8	36.9	37.4	35.9	35.3	-1.6
- Primary expenditure	36.6	35.7	36.0	34.3	33.7	-2.0
of which:						
Gross fixed capital formation	4.2	4.4	6.3	6.2	6.2	1.8
Consumption	10.8	10.9	10.1	9.7	9.3	-1.6
Transfers & subsidies	21.5	20.5	19.7	18.5	18.3	-2.2
Other (residual)	0.0	0.0	0.0	0.0	0.0	0.0
- Interest payments	1.3	1.2	1.4	1.6	1.6	0.4
Budget balance	-5.4	-5.1	-4.6	-3.4	-2.9	2.2
- Cyclically adjusted	-4.6	-4.7	-4.2	-3.2	-3.2	1.5
Primary balance	-4.2	-3.9	-3.2	-1.8	-1.3	2.6
- Cyclically adjusted	-3.3	-3.5	-2.7	-1.6	-1.6	1.9
Gross debt level	52.0	49.5	51.0	51.8	51.4	1.9

Sources: Economic Reform Programme (ERP) 2023, Commission calculations.

The programme's fiscal scenario projects gradual consolidation based primarily on a significant lowering of the current spending-to-GDP ratio. The programme expects the fiscal balance to improve by 2.2 pps between 2022 and 2025 ([55]) to 2.9% of GDP. Consolidation would start later than stated in the

([54]) Table 4.6. in the ERP, which is based on the July budget revision, does not reflect the actual outcome of financing in 2022. The amount of foreign loans in 2022 was significantly lower than projected in Table 4.6. This meant that the government had to draw down its deposits at the central bank – rather than replenishing them, as anticipated, in view of the large foreign debt repayments due in 2023.

([55]) As the fiscal deficit was 4.5% of GDP in 2022 (below the programme's projection), the expected consolidation in the fiscal balance between 2022 and 2025 would be closer to 1.9 pps.

consolidation plan presented in the previous year's ERP (when the fiscal deficit was projected to already reach 2.9% in 2024). This is plausible because GDP growth in 2022 was lower than anticipated in the 2021 programme and also because of the energy crisis. A major share (1 pp) of the projected improvement in the general government fiscal balance would come from the revenue side in 2023. The ERP projects that the overall revenue ratio will then begin to decline again, but that tax revenue will remain broadly stable as a share of GDP ([56]). The expenditure-to-GDP ratio is also projected to rise in 2023 (by +0.5 pps year on year), albeit by less than the revenue ratio. Consolidation of expenditure would be strongest in 2024. Overall, the revenue ratio (total revenue to GDP) is expected to rise by 0.6 pps in 2022-2025. The expenditure ratio is projected to fall by 1.6 pps in this period despite a large increase in capital expenditure (+1.8 pps). This places the burden of adjustment on current expenditure, which is projected to be significantly reined in (falling by 2.2pps between 2022 and 2025) – due largely to a decline in government consumption (-1.6 pps) that is not explained further in the programme. The 2025 deficit would nevertheless remain larger than the pre-crisis 2019 deficit of 2.2%. The primary deficit is projected to decline from 4.2% of GDP in 2021 to 1.3% in 2025, but would remain above its pre-crisis level (0.8%) throughout the programme's lifetime. The latter would only be reached in 2027 according to the programme. The ERP's projection for the narrowing of the cyclically-adjusted primary budget deficit between 2022 and 2024 points to a fiscal tightening of around 1 pp in 2023 and also in 2024, even as the output gap is projected to remain negative. The programme expects the output gap to close and the fiscal stance to become neutral in 2025.

The 2023 budget benefits from revenue reforms and provides for continued energy crisis support and a surge in public investment. The general government fiscal deficit is projected to drop only moderately in 2023 to 4.6% of GDP (down from an actual deficit of 4.5% of GDP in 2022). The programme expects the general government's total revenue to amount to 32.8% of projected GDP, which is 2.2 pps higher than the actual 2022 outcome. In addition to benefitting from a level of inflation that is still high, revenues would be boosted by 0.5% of GDP in 2023 on account of the tax reforms adopted by the government in December 2022. These reforms broaden the tax base for direct taxation and VAT, and, pending full adoption by the parliament, would be applied as of January 2023. The reduced VAT rate on electricity for households has been increased from 5% to 10% on 1 January 2023, as planned, and it is expected to be fully normalized to 18% by 1 July. ([57]) Additional revenue amounting to another 0.5% of projected GDP would be raised from the EU's energy support grant (EUR 80 million or 1.6% of projected 2023 total revenue, of which EUR 72 million are disbursed in 2023). Total expenditure would amount to 37.4% of projected GDP in 2023, which is 2.4 pps above the 2022 level. The government plans to achieve some savings from the phasing-out of untargeted crisis support measures and from cutting government consumption, while at the same time strengthening support to the vulnerable and scaling up public investment. Social transfers are projected to rise by 9.7% in 2023 due to an expected increase in healthcare cost (mainly due to the government plan to settle the large payment arrears accumulated by the health fund). The 2023 budget contains allocations for energy subsidies to the domestic electricity producer ESM (EUR 250 million or 1.7% of projected GDP). This suggests that there may be some potential for reallocations or savings because the budgeted amount seems overly generous against the background of the recent and further projected drop in global electricity prices. However, the government has phased out some untargeted support measures: VAT reductions on oil derivatives and gas were already discontinued in 2022, as well as subsidies for social contributions on pay increases that had been introduced in 2019 (the IMF expects that the latter will produce fiscal savings of 0.5 pps of GDP in 2023). The programme also refers to further savings (0.2% of GDP) from a reduction in government operating costs, but without identifying concrete sources. Capital expenditure would increase by over

([56]) This assumption is plausible because 2023 revenue will be boosted by the one-off EU energy support grant (EUR 72 million out of a total of 80 million, or 0.5% of projected GDP).
([57]) The government estimates that the fiscal cost of this measure will amount to some 0.3% of total expenditure in 2023.

70% compared with 2022 (+2.4 pps in terms of GDP). This amount includes substantial funds for the continuation of Road Corridor VIII and X-D construction (58).

Box II.4.1: Debt dynamics

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

	2021	2022	2023	2024	2025
Gross debt ratio [1]	**52.0**	**49.5**	**51.0**	**51.8**	**51.4**
Change in the ratio	1.2	-2.5	1.5	0.8	-0.3
Contributions [2]:					
1. Primary balance	**4.2**	**3.9**	**3.2**	**1.8**	**1.3**
2. "Snowball" effect	**-2.3**	**-5.6**	**-3.3**	**-1.5**	**-1.8**
Of which:					
Interest expenditure	1.3	1.2	1.4	1.6	1.6
Growth effect	-1.9	-1.2	-1.3	-2.0	-2.4
Inflation effect	-1.7	-5.6	-3.4	-1.1	-1.0
3. Stock-flow adjustment	**-0.7**	**-0.8**	**1.5**	**0.4**	**0.1**

[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) 2023, Commission calculations.

The ERP projects that general government gross debt will peak in 2024 at 51.8% of GDP before declining slightly to 51.4% by the end of 2025. The primary budget deficit is projected to narrow by a total of 2.6 pps in 2022-2025, which indicates that its impact on the change in the debt-to-GDP ratio will decline. In line with expectations for a gradually more benign price environment, the debt-decreasing impact of inflation is projected to diminish, while the effect from real growth is forecast to increase and to become the main debt-reducing factor. An anticipated rise in yields means that interest payments are expected to have a stronger debt-driving impact, while the contribution from stock-flow adjustments is projected to turn positive in 2023-2025, partly in response to government plans to replenish its deposits at the central bank.

General government debt is projected to remain above 50% of GDP and public debt to remain above 60% of GDP during the programme's lifetime. A negative primary balance as well as stock-flow adjustments will lead to an increase in the debt ratio in 2023 and 2024 (see the box above). The public debt level, which includes the debt of public enterprises, is set to rise to 60.6% in 2023. Public enterprise debt, most of it external public debt with government guarantees, is expected to peak at 9.5% in 2024 (one year later than expected by the previous programme) and to decline to 8.4% in 2025. The maturity structure of public debt implies important refinancing requirements over the medium term. The ERP estimates that gross financing requirements in 2023 will amount to 10.3% of projected GDP, mainly on account of the repayment of the 2016 Eurobond due in July (3% of GDP) and the still high fiscal deficit (4.6% of GDP). Financing needs would drop to 6.4% of GDP in 2024 but rise slightly to 7.7% of GDP in 2025, when the 2018 Eurobond (EUR 500 million) matures. These figures do not include potential calls on contingent liabilities that the government has assumed by guaranteeing the debt of public enterprises. Financing is expected to be ensured through domestic and foreign borrowing (including Eurobonds), donor support from international financial institutions (IFI), EU macro-financial assistance, and new financing instruments such as green bonds. In March 2023, the government issued a Eurobond in the amount of EUR 500 million.

The structure of general government debt implies moderate risks. External debt accounted for some 60% of total general government debt at the end of 2022. This has remained unchanged since the end of 2020. Compared with the end of 2021, the share of fixed interest rate debt in total debt decreased by 4.2

(58) The 2023 budget includes EUR 215 million earmarked for the construction of part of Road Corridor VIII and X-D by the Bechtel-Enka consortium. A special law that replaces standard public procurement rules for this project has been adopted. To solidify the fiscal cost and manage fiscal risks, the IMF had requested the authorities to undertake an independent and comprehensive feasibility study as a structural benchmark under the 2022 PLL for North Macedonia.

pps year on year to 75.3% at the end of the third quarter of 2022 (still comfortably above the 60% threshold set in the Public Debt Management Strategy). Foreign currency debt accounted for 76% of total debt (unchanged from last year) and the share of euro-denominated debt as a proportion of total general government debt rose to 92.3% (+ 0.5 pps year on year). Risks stemming from exchange rate depreciation are mitigated by the de facto currency peg to the euro. The government's continuing strategy of extending the maturities of domestic issues is likely to enable it to gradually refinance more of the maturing external debt by issuing new domestic debt.

Box II.4.2: **Sensitivity analysis**

The programme includes a sensitivity analysis of the fiscal deficit based on three parameters, in line with the alternative macroeconomic scenarios. The first parameter is GDP growth. If average annual real GDP growth is lower than projected, by 1.1 pps in 2023-2027, the budget deficit would increase by an average of 0.8 pps per year compared with the baseline projections. The second parameter is capital expenditure. Lower capital expenditure (about 70% realisation compared with the baseline) would imply an annual reduction in GDP growth of 0.5 pps and an average annual increase in the deficit of 0.4 pps, mainly on account of the negative impact on tax revenue. The third parameter is tax collection. If tax collection falls by 5% per year, this would increase the budget deficit to 4.2% on average in 2023-2027 (compared with 3.5% in the baseline scenario and 4% in the same risk scenario set out in last year's programme for the period 2022-2026). The programme also assesses the exposure of the debt portfolio to interest rate risks (if interest rates rise in 2023 by 1pp more than assumed in the baseline scenario, the debt-servicing cost would surge by 5.4%), and the impact of a 10% depreciation of the euro with respect to other currencies in the portfolio (leading to a 0.1% increase in debt-servicing cost in 2023).

Ongoing tax reforms are supporting fiscal consolidation, but the planned consolidation of expenditure needs to be underpinned with sufficiently concrete measures. The programme outlines revenue-increasing measures (some of which have yet to be adopted) but remains vague on options for streamlining expenditures, even though a large fall in the current spending ratio is projected to drive the planned deficit reduction over the ERP period. On the expenditure side, the government is bolstering targeted fiscal support to vulnerable households to deal with the rising cost of living, while at the same time adhering to a number of broad-based, untargeted energy support measures. The mandatory indexation of minimum wages, which is raising average wages (and therefore also public sector wages) and the indexation of pensions ([59]) will probably reduce expected savings. Furthermore, potential savings in the biggest category of subsidies (in agriculture, which accounted on average for 1.2% of GDP in 2015-2022) have not been considered in the consolidation plans. At the same time, the planned large increase in capital expenditure, which as a percentage of GDP is expected to rise from an estimated 3.4% of GDP in 2022 to 5.3% in 2023, seems overly ambitious in view of the government's poor track record in executing its public investment plans and the deficient framework governing public investment. Plans to attract more private funds to finance public capital projects (as set out in the October 2021 Fiscal Sustainability and Economic Growth Support Plan) have made little progress. These plans include improving the legal framework for public-private partnerships (PPP), which suffers from fragmented terms and conditions and a lack of central oversight of fiscal risks. Currently, fiscal risks, such as contingent liabilities arising from PPPs financed by municipalities, are not systematically reported to the central government ([60]). Such ambitious plans for capital spending might therefore imply an upside risk for the budget balance, though not necessarily for an improved public expenditure structure. On the upside, the government's December 2022 tax reforms provide for a 'solidarity tax' (a one-off tax on

([59]) The government has budgeted a 10% rise in pension payments for 2023 compared with 2022, to take account of the new indexation formula. The actual increase turned out to be 8.4% in March 2023, which may alleviate pressures on the expenditure side.

([60]) The new Organic Budget Law requires the government to include a description of fiscal risks (at a minimum, those pertaining to the government's contingent liabilities) in the annual fiscal strategy; and the Fiscal Council to assess fiscal risks relating to a number of bodies, including public enterprises and public-private partnerships.

excess corporate profits), which is currently in the parliamentary adoption phase. The government estimates that the revenue from this tax, which is not included in the 2023 budget, could amount to an additional 0.5% of GDP (EUR 76 million), though only as a one-off measure. In addition, the inclusion in the 2023 budget of sizeable allocations for energy subsidies to the domestic electricity producer may not be needed in full and could serve as a buffer to ensure that the public investment budget would not need to be cut mid-year. They could alternatively be used to lower the 2023 deficit and accelerate mid-term consolidation.

The structure of current expenditure will remain focused on social transfers over the programme's lifetime. Social transfers, including pension payments (taking into account the new pension indexation formula and the planned ad hoc pension increase in 2023), ([61]) amounted to some 52% of total current expenditure in 2023. Social transfers are expected to decline as a share of GDP from 16% in 2022 to 15.3% in 2025. The share of subsidies (primarily agricultural subsidies followed by subsidies to public and private enterprises) is projected to drop from 4.5% of GDP to 3% during this period. Capital expenditure is nevertheless expected to rise gradually over the programme's lifetime from 10% of total expenditure in 2022 to 17.5% in 2025. However, to improve the public expenditure structure, the focus from current to capital spending in the budget would require the implementation of the planned improvements in the selection and management of public investment.

The new Organic Budget Law (OBL) greatly improves the fiscal framework, but progress on other issues is slow. In September 2022, the parliament passed the draft OBL, which provides for the introduction of fiscal rules and a fiscal council and strengthens the medium-term budget procedure. Work on the by-laws and preparations for the new fiscal council to begin work in 2023 is progressing. However, the implementation of wider-ranging measures to improve the planning, allocation and execution of investment projects (as presented by the government in its 2021 Action Plan on the basis of the IMF's 2020 Public Investment Management Assessment (PIMA)) is progressing only slowly. The government has set up a dedicated unit in the Ministry of Finance to ensure centralised oversight of public sector investment, including public enterprises. This unit now needs to start developing a harmonised appraisal methodology for project selection. The new OBL also gives the Ministry of Finance a central role in selecting new investment projects, but this has been delayed by staff shortages. To improve the legal framework for PPP, the government has finalised a draft law, which includes provisions for better management of fiscal risks. This draft law has been submitted to the European Commission for review. It addresses a number of shortcomings in the current legal framework governing PPPs and concessions, such as a lack of detailed administrative guidelines on selecting, implementing and managing PPP projects; and also limited central oversight (each contracting authority sets its own contract formats and terms and conditions).

4.4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

This chapter sets out the Commission's independent analysis of the economy of North Macedonia and identifies the country's main structural challenges. Addressing the immediate impact of the COVID-19 pandemic as well as risks stemming from Russia's invasion of Ukraine has been a priority for the government. However, medium- to longer-term prospects for both economic growth and resilience to external shocks will depend on the country's ability to implement structural reforms. Each of the country's main challenges influences overall competitiveness in its own way. These challenges very often reinforce each other, however, so it will be essential to address them in order to boost productivity and inclusive growth in the medium- to long-term.

([61]) Pension expenditure accounted for 31.4% of total current expenditure in 2022 and 27% in the 2023 budget. Budget transfers to the Pension and Disability Fund increased by 37% in 2015-2022, but the Fund's pension expenditure rose by 40%.

The three most significant challenges identified by the Commission – and overall shared by North Macedonia – are:

(i) improving the quality and relevance of the education system to increase employment and mitigate skills mismatches;

(ii) improving the competitiveness of domestic companies (including digital transition), integration into GVCs and reducing the informal economy;

(iii) modernising the energy sector and transitioning to clean energy.

Education outcomes do not sufficiently meet the needs of the labour market. This prolongs the transition from school to work and therefore feeds the informal economy, out-migration and poverty. Key factors that undermine the country's competitiveness, investment and global value chains (GVC) integration include a challenging business environment, a lack of skills, innovation and technology adoption, low productivity, a distortive effect of subsidies on competition and the need to modernise and digitalise public administration. A sustainable post COVID-19 recovery and the need to tackle the economic fallout of Russia's war of aggression against Ukraine points to the need to advance the longer term transition to green growth (particularly in the context of geo-political shocks exacerbating the energy crisis). Such a green transition entails significantly improving energy efficiency, promoting the distribution of less polluting energy production sources and investing in renewable energy sources.

North Macedonia also needs to continue to tackle corruption, improve the rule of law and strengthen its institutions in order to promote competitiveness. Addressing these fundamental needs is a prerequisite for successfully transforming the economy. The Commission is closely following issues to do with strengthening the rule of law and the fighting of corruption in its enlargement package, including the report on North Macedonia.

Furthermore, the country should proactively implement the Energy Community's Decarbonisation Roadmap to achieve the agreed climate and energy targets, and strive towards establishing a carbon pricing instrument compatible with the EU ETS.

Key challenge #1: Improving the quality and relevance of the education system to increase employment and mitigate skills mismatches

The relatively high resilience of the country's labour market during the COVID-19 pandemic gives reason to hope for a slow recovery. Employment has steadily improved over the last decade. The COVID-19 pandemic interrupted this trend, but recent figures suggest some positive developments that may indicate a recovery, though still below the pre-pandemic levels. In the third quarter of 2022, the employment rate (20-64) increased by 2.1 pps to 61.9% and the activity rate by 1.3 pps to 72.1%, compared with the third quarter of 2021. This is corroborated by the slightly shrinking unemployment rate (20-64), which fell from 15.5% to 14.2% in the same period but is still well above the EU-27 average (5.9%). The impact of the COVID-19 pandemic, as demonstrated by the main socio-economic indicators, has so far been partially mitigated by the package of measures adopted by the government. However, long-lasting negative effects of the pandemic are still possible due to limited fiscal space. The COVID-19 pandemic primarily hit low-skilled workers, especially people working in agriculture, transport and manufacturing, while employment continued to increase among those with tertiary education. The ERP acknowledges the deficiencies of the labour market under the key challenge 'Strengthening of human capital for inclusive development', but the proposed measures only address some aspects and no new relevant measures have been added to those that were included in the previous ERPs.

Some fundamental structural weaknesses of the labour market remain. Women and young people are particularly exposed to unemployment and inactivity, as are people with disabilities and the low-skilled (particularly Roma). The population is also ageing and regional differences are causing unbalanced development with high unemployment rates in the North-East (32% in 2020), Polog (25%) and South-West regions (24%), including for young people. Nationally, 75.4% of all unemployed had been unemployed for more than 12 months in 2020. This is more than twice the rate in the EU-27 (35.8%) and higher than in the other countries in the region. The quality of available jobs remains an important issue to address in order to increase the opportunities for higher educated people and tackling possible 'brain-drain'. 27.6% of young people in employment have jobs that do not correspond to their level of education (World Bank, 2020). Regional disparities are strong and the employment gap remains high between the South-East (the best-performing region) and the North-East (the worst-performing region). The government developed the 2021-2027 National Employment Strategy with the ILO's support to promote more and better jobs for all. The strategy, together with the 2021-2023 action plan sets three key objectives: (1) improving the quality of learning outcomes at all levels; (2) strengthening the role of the policies for the development of the economy and enterprises in the creation of decent jobs; and (3) strengthening the inclusiveness of labour market policies. The strategy was adopted in November 2021 and aims not only to address the structural challenges affecting employment growth but also to mitigate the consequences of the COVID-19 pandemic. The government also works on a law on labour market regulation, planned for adoption in 2023, in order to improve its active labour market policies. The law is expected to provide for the contracting of external service providers; introduce lifelong career counselling; and permit social partners to establish foundations to promote employment opportunities.

Young people in particular continue to face obstacles to entering the labour market. Youth unemployment (15-24) remains high and had stagnated at 35.7% in 2021. Many young people have only informal jobs, are low paid and do temporary or part-time work. North Macedonia adopted a new implementation plan in 2022 to reinforce the Youth Guarantee which has been in place since 2018 and led to a significant reduction of youth unemployment from 45.4% in 2018 to 35.6% in 2019 (albeit slowed down by the COVID-19 pandemic). Notwithstanding this success, 26.2% of the total youth population (15-29) were not in employment, education or training (NEET) in 2021. The NEET rate decreased by 2 pps compared to 2020, which was also due in part to an assumed decline in the youth population (ILO, 2022). Youth unemployment and NEET rates both remain substantially above the EU-27 averages of 16.6% and 13.1% respectively. In 2021, around 40% of NEETs had been looking for employment for longer than one year. 64.1% of all NEETs had a secondary education in 2021 – compared with 50.2% in 2016 (ILO, 2022). The employment rate of recent graduates (20-34) was only 54.5%, which was one of the lowest rates in the region and in the EU as a whole (the EU-27 average was 79.6%). 39.7% had been unemployed for more than one year in 2021. NEET rates are higher for women (26.1% in 2021) than for men (22.4). The gender gap reflects the social conventions and pressures which prioritise women's roles within the family (OECD, 2020). 22.1% of all NEETs are disengaged from the labour market by care and family responsibilities (ILO, 2022). The further success of Youth Guarantee will hinge to a significant extent on improving the public employment service's capacity (particularly in terms of human and financial resources) as well as that of providers of other key services such as social protection and education. In addition, pending reforms should be accelerated, including the Law on VET and the Law on Adult Education.

Spending on active labour market policies is relatively high, compared to the region, but lower than the EU average. Spending reached 0.27% of GDP in 2020 (the EU-27 average was 0.61% of GDP in 2020). Despite the countrywide implementation of the Youth Guarantee, there has been no comprehensive impact assessment of the effectiveness of active labour market policies for many years. Active labour market policies have a limited scope and cover less than 25% of the poor. However, 66.8% of young unemployed aged 15-29 were involved in some type of active labour market programme in 2020. Better targeting of the most vulnerable categories could involve a combination of additional benefits and specific labour market activation and skills development or the establishment of mobile units to reach out to and work with vulnerable groups (also taking into consideration the experience gained from previous outreach support). Recent progress notwithstanding, the public employment service's capacity is constrained by limited specialised human resources; insufficient staff training; limited national funding for active labour market policies that are increasingly dependent on EU funding; and limited investment in infrastructure (OECD 2021).

Reform measure 2 of the ERP ('Increasing the flexibility of the labour market') continues from the previous year and aims to extend labour legislation (including active employment programmes) to non-standard forms of work. As part of a new law on labour relations that is planned for adoption in 2022, the measure is needed in order to address the current lack of legislation on remote working and working from home. Furthermore, specific active labour market measures will be directed at people in an unfavourable social position and primarily the recipients of guaranteed minimum assistance. Reform measure 2 is intended to help increase the employment rate, decrease unemployment, and reduce poverty and social exclusion. However, the measure only partly addresses the key challenges.

The insufficient relevance and quality of education continues to contribute to skills mismatches, leading to persistent unemployment and underuse of young people's potential. The education system contributes to the lengthy school-to-work transition by failing to identify and meet the needs of the labour market. Some of the issues related to the quality of education in North Macedonia that had already been identified in the past are still evident. The skills mismatch continues to be a major obstacle to people finding work. Job mismatches in terms of young tertiary graduates aged 15-34 working in jobs below their education level stood at 35% in 2019 (ETF, 2019). According to a survey of the OECD, 24% disagree with the claim that skills learned in the education system meet the needs of their job and 50% of surveyed firms identify applicants' lack of skills as a reason for unfilled vacancies (OECD 2022). However, new school and VET curricula do focus more on the needs of the labour market. In addition, North Macedonia has put in place an institutionalised process and tools for monitoring/forecasting skills needs in order to properly align VET, higher education, and upskilling and reskilling offers with labour market needs. The 2021-2027 National Employment Strategy and the 2021-2023 Employment Action Plan are intended to reduce the skills mismatch (15-64) by 5%; to improve the average score of students in North Macedonia in the Programme for International Student Assessment (PISA) 2025 assessment; and to increase the share of adults (25-64) in training to 16%.

The education system of North Macedonia does not provide young people with the key competences and skills they need to actively participate in the labour market. International student assessments show substantial weaknesses for students in North Macedonia and reveal disparities in learning outcomes based on the place of residence, ethnicity, socio-economic status and gender. This continues to constrain companies' competitiveness and their deeper integration into the global economy. The country's PISA results were significantly better in 2018 than in 2015, but it still ranks low among the other participating countries (68th place out of 78) and lower than its regional peers. The TIMSS 2019 survey results show a similar situation, with the country's students coming 45th in mathematics and 51st in science out of the 58 assessed countries. The gender gap is a particular issue because boys are performing worse than girls. This gender gap is far greater than the international average (North Macedonia has the third largest global gender gap in reading performance). Other significant gaps are linked to students' socio-economic status, educational path and the language of instruction. The OECD has signalled that there is a specific problem in fostering a 'growth mind-set'. PISA data also highlight the need for improvements in the quality of teaching because half of all students do not achieve basic literacy and numeracy skills by the age of 15, A positive trend is that percentage of low performers in each subject shrank by at least 9 percentage points between the 2015 and 2018 PISA assessments.

A reform of the education system was planned in the 2018-2025 education strategy but requires increased funding. The education strategy and the related action plan both prioritise the provision of quality skills to young people to prepare them for the labour market. However, these two documents also state that financial support is currently insufficient and that there is no intersectoral coordination. Public spending on education is clearly insufficient. North Macedonia has steadily reduced its spending on education from 4.62% of GDP in 2011 to 3.9% in 2020. This level is currently below the EU-27 average of 5.0% in 2020 and also below peer-country averages. The education system is also impaired by the inefficiency of public spending (World Bank, 2019). Discrepancies in student-teacher ratios in schools are also significant and are reducing the overall quality of education. North Macedonia has developed a new financing model that aims to make the funding of primary and secondary education more transparent and to regulate how the municipalities redistribute funds from the Ministry of Education and Science.

Major reforms are being made in VET, but important legislation is still pending to improve the quality of teaching. Approximately 56% of upper-secondary students in North Macedonia follow a vocational pathway (42 641 students in 2019/2020). This proportion is comparable to that in the rest of the Western Balkans and higher than the EU-27 average (43%). In 2019, 79% of the country's VET graduates later enrolled in tertiary education – compared with 53% of students from general schools (World Bank, 2019). The low rate of transition of students from general upper-secondary education to higher education means that almost half of those who leave secondary school have not acquired a specialisation that equips them to participate in the labour market. The country's reforms particularly focus on the establishment of new regional VET centres, but the operationalisation of the three regional VET centres (in Tetovo, Kumanovo and Ohrid) is hampered by their weak capacity to implement large infrastructure projects and by the slow parliamentary adoption of the necessary legislation (particularly the Law on VET and the Law on Adult Education). The lack of technical skills among vocational-school graduates is seen as a major bottleneck by companies in North Macedonia. This lack arises because VET schools use teaching and learning methods that are largely theoretical; offer limited practical training; and suffer from a lack of teaching and learning materials (OECD, 2019).

Reform Measure 1 of the ERP ('further development of the qualification system'), which has been rolled over from previous years, addresses the key bottleneck in the education system and builds on the activities implemented in 2022 (e.g. the adoption of the new curricula and the establishment of a National Council for Higher Education and Scientific Research that contributes to the development of new norms and standards). A national assessment of the education system will be included into the Law on Primary Education; regional VET centres will be further developed; and there are plans to adopt a new Law on VET and a new Law for a National Qualifications Framework. The government also envisages closer cooperation with companies to establish new VET curricula. The modernisation of the three regional VET centres will be key to implementing this measure and such centres of excellence need to be further developed throughout the country. The modernisation of VET has led to more students enrolling in VET and participating in work-based learning. The number of classes which incorporated dual training components has grown from 97 in the school year 2021-2022 to 225 in 2022-2023. The ERP signals that education is among the government's top priorities, but the measure's expected impact on competitiveness could be further strengthened.

Adults' participation in learning is low. The percentage of adults participating in learning was 2.6% in 2020, which is significantly below the EU-27 average of 10.8% in 2021. Further development of qualifications, arrangements for validation of non-formal and informal learning and upskilling/reskilling programmes throughout the country are key to bringing medium-skilled and low-skilled people into the labour market. Promoting lifelong learning and the strengthening of non-formal education should help to improve workers' technical and managerial skills. This can support fast productivity growth in companies and industry.

The continuing gender gap undermines the overall economic potential of North Macedonia. The gender employment gap (the difference between the employment rates of men and women aged 20-64) was 19.9 pps in 2020 (the gender gap in EU-27 was 10.8 pps in 2021). The low level of employment activity of females (20-64) is characterised by a high level of inactivity among low-educated women (79% in 2020). This is largely due to women's traditionally lower presence in the labour market; disincentives for women to work; caring and household duties; women's lack of confidence in their skills and labour market prospects (OECD 2021). In 2019, 36% of women in the working-age population (15-64) were only educated up to lower secondary education, compared to 26% of men (OECD 2022). Women are much more likely to be low paid. Estimates of earnings indicate a significant gender pay gap and the potential for discrimination in the labour market against women. Women in North Macedonia also have a working life that is on average 10.6 years shorter than that of men (2020).

Emigration and population ageing are further contributing to the weakening of skilled workforce of North Macedonia. Emigration of workers is a serious impediment to business. The shortage of jobs – and secure well-paid jobs in particular – is the greatest obstacle to preventing young people from leaving the country and causes a substantial brain-drain. According to projections, the share of the population aged 65 and above will double from 12.5% in 2015 to 25.4% in 2050, thus placing significant strain on the social protection system. This trend will gradually reduce the share of the working-age population (those aged 15-64) from 70.6% in 2015 to 60.4% in 2050 (ILO, Decent Work Programme, 2019). About 59% of businesses struggle to find workers with appropriate skills (OECD 2020). Available analysis recommends that all labour market policies should be mutually consistent and contribute to keeping workers in the country, including by regularly analysing and monitoring emerging skills gaps at the national, regional and local levels and by recognising skills acquired outside the formal system or abroad (ETF 2021).

Key challenge #2: Improving the competitiveness of domestic companies (including digital transition, integration in GVCs and reducing the informal economy)

North Macedonia presents ten measures related to this key challenge 2 in its ERP. Those measures that are more closely linked to the European Commission's assessment of this key challenge are analysed in this section. The others are analysed in Annex A.

A challenging business environment is undermining the competitiveness of domestic companies, investment and integration into the GVC. This includes a large informal economy, a complex legal and regulatory environment and a skills shortage. It also requires the enhancing of innovation, technology adoption, business-academia collaboration, access to finance and investment in greening the economy. Digitalisation of the economy has not proceeded enough. The future success of the economy and of domestic companies mainly depends on the success of a broad range of structural economic reforms in these areas. Prioritising and strengthening targeted public policies to address the underlying structural obstacles to domestic companies' competitiveness could help promote productivity, integrate more domestic enterprises into GVCs and continue to attract FDI ([62]). Some progress has been made, but the country's policies to increase competitiveness need to be effectively and continuously implemented as well as stepped up in order to have a more lasting impact (OECD 2021), particularly since existing structural weaknesses have been exacerbated by the economic fallout from Russia's war of aggression against Ukraine.

Competition from the large informal sector continues to represent an important constraint for domestic businesses. The informal economy operates on unequal terms with formal businesses and is regularly ranked among top obstacles for doing business in North Macedonia ([63]). The most prominent forms of the informal economy are unregistered labour and partially undeclared wages. Estimates vary according to definitions and methodology but essentially range from 38% of GDP (according to IMF estimates) to 23.3% (Finance Think, 2022). The strategy and the action plan to formalise the informal economy require the high-level political commitment of all relevant institutions and will have to be more vigorously implemented, assessed and reviewed, with specific attention being paid to the business environment component. Informal workers remain a high proportion of the total workforce, but this has declined to around 12% in 2021. Designing policies to increase productivity (e.g. by reducing regulation, addressing the skills mismatch and further digitalising public administration) will reduce the informal

([62]) National laws (including the Law on Trading Companies, the Law on Technological Industrial Development Zones, the Law on Financial Support of Investments, the Law on State Aid Control, and the Law on Strategic Investment) have no unified definition of a foreign investor

([63]) www.enterprisesurveys.org

sector (Finance Think, 2022). Over and above the tax legislation adopted at the end of 2022, it will be necessary to continue implementing the country's Tax System Reform Strategy and rationalising parafiscal charges.

Measure 11 of the ERP, 'Streamline the use of parafiscal charges', which has been rolled over from 2022 and linked to the policy guidance, envisages activities to optimise, consolidate and streamline parafiscal charges. The relevant methodology was developed with EU support. Piloting amendments from the list of 377 parafiscal charges as well as the establishment of a web-portal in view of enhanced transparency are planned from 2023 onward. The government has assigned the Ministry of the Economy to coordinate the process, but the decision to streamline 100 selected parafiscal charges will have to be adopted by the government as a whole. Political commitment will be important because streamlining the parafiscal charges will most probably reduce the income of the public bodies concerned. The measure has potential in terms of fighting the informal economy. Its impact on competitiveness should be further clarified.

Measure 15 of the ERP, which has been rolled over from the previous year and linked to the policy guidance, aims at introducing mechanisms for formalising informal work in sectors with a high incidence of undeclared activity. The measure is relevant but is somewhat limited in scope as action continues to be based on two donor-funded projects and the focus is primarily on temporary workers. The measure looks at the employment part of policies but ignores other important aspects contributing to the informal economy (e.g. the overall business environment and taxation, including social security contributions). The measure could benefit from the planned adoption of a new 2023-2025 strategy. It does not take into account the medium-term impact of the COVID-19 pandemic on the labour market and undeclared work. Its impact on competitiveness has not been quantified and the impact on employment and gender has not been sufficiently considered.

The operational environment for companies can be improved by digitalising public administration, deploying digital technologies (high capacity networks and 5G) and developing digital skills. A fixed broadband connection to the internet is used by 92% of enterprises with 10 or more employees, but smaller companies still face obstacles. Work is ongoing to upgrade the e-portal in order to develop a more user-oriented service delivery. The number of registered users and completed services on the portal is increasing but remains below expectations. Many of these services remain purely informational and cannot be fully performed online (OECD, 2022). The use of the interoperability system is still constrained by a lack of communications software in many institutions and a reluctance to fully exploit its capabilities. A comparatively high 10% of businesses surveyed in the Balkan Barometer 2022 indicate that they do not have the skills required to use online services. The Commission's country report notes the need to develop and adopt a strategy for developing digital skills and a reference framework for digital literacy throughout the society. Digitalisation can reduce corruption (ÖGfE, 2022).Transparency through enhanced digital services is also an important way to reduce the country's informal economy. Overall, there is a particular need to increase access to broadband; expand available e-government services; and develop digital skills. The ERP includes measure 10 which aims to broaden the scope for digital services (see Annex A).

The lack of skills is holding back economic growth and the development of a knowledge society, so increasing investment in human resources is vital. Major skills shortages persist with regard to labour market needs, entailing long school-to-work transition. Analysis of systematic training needs is lacking. Businesses have major concerns regarding the appropriateness of skills taught in the education system and labour shortages (World Bank, 2022; Balkan Barometer 2022). A weak education system that has failed to respond to labour market demand is an incentive for emigration, especially among the young (OECD, 2022). Data from the 2021 population census shows a large outflow of young workers from the labour force. Ongoing reforms that focus on revamping the vocational education system could help address this problem.

The regulatory framework's lack of transparency and predictability continues to affect the business environment and the competitiveness of domestic companies. The government's approach to simplifying the business environment is not sufficiently systematic and consistent. In the Balkan Barometer 2022, transparency of government regulations and decision-making, predictability and stability of policies and rules, as well as consultation processes on proposed legislation are perceived as relatively problematic. Strategic documents place business and industrial policy principles under the competence of different authorities that have overlapping and conflicting mandates. This makes for a complex and inefficient institutional set-up. Existing strategies often lack proper evaluation mechanisms, indicators and systematic impact assessment.

Transparency and effectiveness of state aid remains insufficient. This is due in part to the large number of state aid providers, the lack of an updated registry and the still insufficient competences of the Commission for the Protection of Competition in state aid supervision. Instead of tackling the country's underlying structural challenges and business environment issues, the government's flagship policy to attract FDI and improve domestic firms' competitiveness relies on providing various forms of state aid to businesses. In the 2019 Global Competitiveness Index, the country ranked 112 (out of 141 countries) when it came to the 'distortive effect of taxes and subsidies on competition'. The effects of state aid on efficiency and competition have not yet been assessed (Finance Think, 2021). There is no strategy to adequately determine priorities, goals and policies for investment activities in the country's Technological Industrial Development Zones (TIDZ). Policy regarding special economic zones should be targeted and time-limited, and not distort competition for domestic firms attempting to enter similar value chains. Sustainable development of these zones requires competitiveness anchored in a friendly business environment, instead of mainly targeting investment in labour-intensive production (World Bank, 2022).

As a precondition for the establishment of a state aid registry, measure 14 of the ERP aims at setting up a management information system on state aid that connects different institutions. The state aid registry and the information system are still not in place, although efforts have been made to develop the electronic information system. The measure is relevant and is prioritised by the Commission for Protection of Competition as a regulator: it will build a network of the relevant institutions, has the potential to enhance transparency for the general public and to create a level playing field for companies. The expected impact on competitiveness is not quantified.

North Macedonia remains an emerging innovator according to the EU innovation scoreboard, but innovation activity remains low overall. At 0.4 % of GDP (including a small share from the private sector), the economy's expenditure on research and innovation remains significantly below the EU average. In particular, the private sector's participation in overall research spending remains low at 0.1% of GDP. Allocations to the Fund for Innovation and Technological Development (FITD) and its programmes have increased, but their effectiveness, design and methodology can be improved by an independent evaluation. Links between enterprises and other innovation actors are very weak. To overcome the lack of strategic direction towards innovation, North Macedonia plans to adopt a smart specialisation strategy in 2023 and to develop measures for its implementation. Measure 16 aims at supporting the innovation environment (see Annex A).

The impact of the COVID-19 pandemic, the economic fallout from Russia's war of aggression against Ukraine (particularly the energy crisis) and supply chain disruptions have exacerbated existing structural challenges and reduced competitiveness. Inflation and the price of energy are seen as the most serious risks for companies' operations in 2023 (Economic Chamber survey, 2022). Tackling immediate crisis-related challenges has been a priority, but reforms fostering competitiveness need to be strengthened (also because growth prospects could be compromised if the war further aggravates global trade and energy prices). A prolonged crisis will probably hurt the industry even more as demand from EU countries declines amidst possible recessionary developments (including important trade partners).**Strengthening targeted public policies to address structural obstacles to domestic companies' competitiveness could help to further integrate domestic enterprises into GVCs.** In spite of efforts, such as setting up an online business-to-business portal to match businesses with local suppliers, linkages between the FDI sector and the rest of the economy ([64]) need to be further improved to continue the structural transformation of the economy (e.g. the spill-over effects of FDI into local know-how and technology), economic growth and job creation (OECD 2021). The ERP has also recognised this. The focus should be on attracting FDI that can source more content locally. The high-end segments of regional and global supply chains have potential, but harnessing this requires a sufficient level of investment in innovation and meeting quality standards. This is a critical barrier to GVC integration for many industries, including the automotive sector (OECD 2021).

Concrete policy actions in export promotion and sustainable integration into GVCs require enhanced capacities to meet the quality standards of relevant industries and GVCs. Over the past decade, FDI has driven some change in the country's export structure towards higher value-added products such as chemicals and machinery and transport, and away from traditional food and clothes exports. North Macedonia could nevertheless benefit from a transition to a more sophisticated participation in GVCs (i.e. advanced manufacturing and services). 43% of non-exporting companies surveyed in the Balkan Barometer 2022 indicated that their goods and services are not suitable for exports. This percentage is slightly above the regional average. The Strategies for Export Promotion and Smart Specialisation, which are due to be adopted in the near future, and enhanced opening of digital sales channels ([65]) will further help domestic companies to transition to higher value-added activities and to diversify their export base – thereby benefiting from a possible post-crisis realignment of production networks. Services have been the engine of the post-COVID-19 recovery (World Bank, 2022) and further developing certain service sectors such as logistics, transportation, and information and communication technologies could be an opportunity for domestic companies.

North Macedonia could benefit from a realignment of global production networks. A trend towards 'nearshoring' has recently been discerned, with foreign companies relocating their production capacity to North Macedonia from more distant locations as part of an effort to reorganise their global supply chains. The ERP also refers to higher annual inflows of FDI, ongoing policies to attract new FDI, reforms of the business environment and an ongoing regrouping of global supply chains towards nearby locations. For instance, in an FDI survey conducted by the Economic Chamber of North Macedonia at the end of 2022, some of the surveyed companies reported a transfer of businesses from Ukraine as well as new investment in North Macedonia.

The Economic and Investment Plan for the Western Balkans, the further development of a common regional market and the digital and green transitions will increase the economy's competitiveness. There is further potential in regional cooperation in digital transformation (including e-government) and in strengthening energy resilience (including by transition to energy efficiency and renewable energy sources). Moving towards a greener/more circular economy represents a new source of revenues, cost savings and job creation for SMEs in particular. At present, however, most businesses have taken no action or only minor steps to change their operations into more environmentally friendly operations and investments (World Bank, 2022). A range of financial initiatives ([66]) such as the 2022-2026 Plan for Accelerated Growth exist to support the private sector in its greening efforts.

([64]) The country has made some progress in fostering linkages between local firms and multinational firms. The Law on Financial Support of Investments encourages these linkages, providing financial support for the establishment and promotion of co-operation with suppliers registered in North Macedonia.

([65]) Online sales account for only a small portion of business sales. According to the Balkan Barometer 2022, 39% of respondents from North Macedonia who sell over the internet claimed that less than 5% of their sales were made online.

([66]) Still, various proposed financing instruments have yet to be established.

Key challenge #3: Energy sector modernisation and transition to clean energy

North Macedonia has four measures related to this key challenge 3 in its ERP. Two of them, which are more closely linked to the European Commission's assessment of this key challenge, are analysed in this section. The other two are analysed in Annex A.

The economy of North Macedonia is characterised by its heavy dependence on energy imports; high energy intensity; inefficiencies in the ageing energy production system; a persistently high dependence on highly polluting lignite coal; and inefficient energy use. Energy supply is not sufficiently secure. North Macedonia imports over 30% of its domestic energy needs, is fully reliant on imports for gas and oil, and has limited quantities of coal. The country's gas network is only connected to Bulgaria (with obvious risks of gas delivery interruption bearing in mind complete reliance of North Macedonia on Russia for gas imports) and the work of connecting up to regional gas pipelines is progressing only slowly. Approximately 67% of electricity is domestically produced and 33% is imported. Import needs in 2022 were further exacerbated by the lower outputs of hydro plants due to drought. Domestic electricity production relies heavily on lignite and fuel oil (57%) ([67]) followed by hydro (22.5%), gas (16.7%), wind (2%), biogas (1%) and solar (1%). Electricity prices in North Macedonia are regulated for universal service suppliers ([68]) and have remained below the import price, as well as below the European market price. This contributes to gaps in energy infrastructure and catering for the utility providers' financial losses puts additional pressure on the government's budget.

Pre-existing challenges have been exacerbated by Russia's invasion of Ukraine. The economy's high level of reliance on imports and the high degree of trade openness directly affect domestic inflation. The impact of high energy prices, inflation, supply chain disruptions, rising debt levels and increased borrowing costs for businesses and households is considerable. Businesses have identified rising energy costs as their biggest challenge (Economic Chamber, 2022) and these continue to have an impact on the country's policies, competitiveness and public finances. Inflation is showing signs of slowing down, but sharply rising food and energy prices pushed inflation to almost 20% by the autumn of 2022 ([69]), which was more than in peer countries in the region. Direct trade and financial links with Russia and Ukraine are limited, but there is significant energy exposure to Russia (particularly in terms of natural gas imports from Russia (through Bulgaria) which accounts for close to 10% of the energy mix of North Macedonia) ([70]).

The strategic framework for green energy transition is well-developed, but progress in implementation is limited. The authorities are designing policies and strategies to support the transition towards a low-carbon economy/clean energy. This includes required investment in new renewable energy sources; the gas interconnection with Greece; completion of gasification of the country; and investment in energy efficiency. **In 2019,** North Macedonia adopted the 'Strategy for Energy Development up to 2040', which sets out the basic principles of the energy and climate policy of North Macedonia. North Macedonia signed the Sofia Declaration on the Green Agenda for the Western Balkans in 2020, which commits it to decarbonisation. North Macedonia submitted the enhanced nationally determined contribution (NDC) to the United Nations Framework Convention on Climate Change (UNFCCC) in 2021 and in the same year adopted the Long-term Strategy on Climate Action, as well as the Decarbonisation Roadmap within the Energy Community. The National Energy and Climate Plan (NECP) was adopted in 2022 ([71]). North Macedonia has adopted numerous plans and strategies, but there has been limited progress in implementing green policies. This has resulted in poor air quality, limited

([67]) The decline in domestic coal reserves means that electricity generation is heavily dependent on imports of coal and fuel oil.
([68]) Essentially all households are provided electricity in the regulated electricity market (from the universal supplier), at subsidized prices, which are among the lowest in Europe adjusted for purchasing power parity. This leads to inefficient use of electricity, and likely hampers investments in future electricity generation, including from renewables and cleaner production facilities.
([69]) The 2022 inflation rate was 14.2%.
([70]) Diversification is reflected in project pipelines including new interconnections.
([71]) The Government is considering updating 2022 NECP and Action Plan.

waste and water management, and a low use of renewable energy sources (IMF, 2022). One reason for this is the complex institutional set-up, which has a number of weaknesses. Responsibilities at policy level are shared by different stakeholders with conflicting political agenda. This has a negative impact on energy supply and security, and the sector's performance and operational effectiveness. The lack of capacity and skilled staff in the state-owned companies and governmental institutions is causing poor planning on how to tackle the energy crises. North Macedonia established a Sector Working Group on Energy in 2022 to address these institutional issues, but this still needs to prove its effectiveness.

The immediate focus is on helping households and companies to cope with the increase in energy and electricity prices, but longer-term green challenges will also have to be addressed, so that the country and its businesses are better prepared for a prolonged or new energy crisis in the medium term. A state of energy crisis has been put in place in expectation of a very difficult and unpredictable winter (at this stage until April 2023). The government adopted two packages of measures totalling about EUR 750 million in 2022 to respond to the energy crisis. However, the policy of subsidising and maintaining affordable prices for households and SMEs can only be a temporary measure. Objectives of promoting competitive sustainability in line with the green transition and the targets set under the Green Agenda for the Western Balkans (such as decarbonisation, energy diversification, renewable energy generation, energy efficiency, connectivity of electricity and gas networks, and interconnectors) remain unchanged. North Macedonia is therefore and in parallel with these temporary measures planning institutional and legislative reforms coupled with significant investment in line with the Green Agenda. This is also reflected in the more recently adopted National Energy Crisis Action Plan, which contains short-term measures to address the energy crisis and to incentivise renewables and energy efficiency measures; as well as medium-term measures related to the strategic, legislative and institutional framework to promote the transition to green energy and increase energy security. Electricity block tariffs introduced in July 2022 incentivise energy savings and can reduce costly electricity imports (IMF 2022). By contrast, increasing coal extraction, increased imports of coal and fuel oil and even investment in new coalmines and potential extension of the work of TPP Bitola are providing some short-term mitigation, but are not in line with the strategic decarbonisation goals (the country's international commitments require it to phase out coal by 2027 ([72]). Such an approach risks contributing further to environmental degradation, including reducing the already low level of air quality.

The transition towards a low-carbon economy and clean energy requires significant investment to close large gaps in the energy infrastructure that continue to restrict growth and competitiveness. The government's 2021-27 Intervention Investment Plan states that it will invest a total of EUR 3.1 billion in the energy sector, mostly in renewables (EBRD, 2021). However, improving public investment management, including adoption of draft legislation on public-private partnerships, has been delayed. An improved Public Investment Management system, also incorporating climate related information, could further support prioritization of investment projects, including in renewables. Energy diversification needs are pressing and the country's ERP recognises that greater use of renewable energy sources (RES) and energy efficiency improvement is one of the main strategic goals in the energy sector.

Renewables can be produced domestically and reduce the country's need for energy imports. North Macedonia has not yet improved its legal and regulatory framework for the uptake of renewables (ECS, 2022). The amended national renewable energy action plan is in line with the revised binding target of 23% of energy coming from renewable energy sources by 2020 and 24% by 2025. However, renewable energy still accounted for only 17.3% of energy sources in 2021 and – as the planned law on biofuels has not yet been adopted – the share of renewables in transport remains negligible (0.15% in 2020). The capacity cap per type of renewable energy technology has to be removed. An electronic system for issuing, transferring and cancelling guarantees of origin is not yet in place, even though the market operator has been appointed as an issuing body. The rulebook on renewables opens up opportunities for electricity prosumers (both households and small businesses) in principle, but several administrative

([72]) National Energy and Climate Plan.

obstacles still remain in practice. The renewable energy portfolio is mainly based on hydropower, but hydrological conditions are risky and related investment will have to comply with the relevant EU law. Optimising balancing services and investments in energy transmission and energy storage will have to be promoted in order to improve the integration of renewable energy sources with the grid. North Macedonia has made some significant progress by attracting private investment in the construction of some wind parks and photovoltaics (PV). The Ministry of the Economy has prepared a programme for 2023 to promote renewable energy sources and encourage energy efficiency in households by installing PV and solar thermal systems and replacing windows and doors. There are plans to update the Energy Strategy by integrating hydrogen and investment in storage and batteries.

Measure 5, which has been rolled over from last year, is intended to promote renewable energy sources. It is very relevant to energy transition because it will help diversify energy generation and contribute to energy supply security – thereby benefiting the economy – by lowering electricity costs and creating green jobs. The measure foresees the adoption of a law on biofuels and the establishment of a renewable energy guarantees of origin scheme that will provide consumers with transparent information on the proportion of electricity that suppliers source from renewable generation. The measure also refers to new legislation aiming for instance at more simplified administrative procedures for renewable energy. The proposed result indicators do not reflect the specific activities (i.e. the use of biofuels). The impact assessment needs improvement.

Improving energy efficiency reduces the need for energy overall and can thus lower the economy's dependence on energy imports and significantly reduce the impact of high energy costs on competitiveness. The Law on Energy Efficiency of North Macedonia transposes the EU's Energy Efficiency Directive and Energy Performance of Buildings Directive into national law. However, partly on account of limited technical capacity in the Energy Department of the Ministry of the Economy and the Energy Agency, the government has not yet adopted the by-laws needed to implement this law (these are planned for the end of 2023). The long-term buildings renovation strategy and the assessment required by the Energy Efficiency Directive are planned for the second half of 2023. Moreover, incentives for energy efficiency (including the legal and regulatory framework for the establishment, operationalisation and financial sustainability of the Energy Efficiency Fund (EEF)) are lagging behind. Further improving energy efficiency is also a structural benchmark of the IMF's precautionary liquidity loan.

Measure 6, which has been rolled over from last year, is intended to improve energy efficiency. Activity under this measure is very relevant to address the key challenge three, including the adoption of delayed (secondary) legislation; the establishment of the EEF; and adoption of the strategy for the reconstruction of buildings. A refurbished and improved building stock will help pave the way for a decarbonised and clean energy system because the building sector is one of the largest energy consumers and is responsible for a significant proportion of greenhouse gas emissions and air pollution. The labour-intensive nature of the building sector, which is dominated by local businesses, means that renovation of buildings can also play a crucial role in economic development. However, as the ERP has rightly identified, the lack of capacity within public institutions (the Ministry of the Economy and the Energy Agency) for collecting and sharing information, monitoring progress and promoting energy efficiency remains an obstacle. The impact assessment needs improvement.

In line with the EIP and the Green Agenda for the Western Balkans, the EU supports the development of renewable energy sources and less polluting energy sources that will secure the energy supply. The platform for joint purchases of gas will pool demand; coordinate infrastructure use; negotiate with international partners; and prepare for joint gas, hydrogen and liquefied natural gas purchases. REPowerEU ([73]) also encourages energy diversification as part of enhancing energy security, including diversifying the natural gas supply. Consistent with the EIP and based on the National Energy

([73]) REPowerEU is about rapidly reducing our dependence on Russian fossil fuels by fast forwarding the clean transition and joining forces to achieve a more resilient energy system and a true Energy Union.

Action Plan adopted at the end of 2022 with short-term and medium-term measures to address the energy crisis, the new EU Energy Support Package provides immediate assistance in the form of budgetary support. It aims to mitigate the immediate socio-economic needs that result from the impact of rising energy prices on vulnerable households and SMEs, and to set the basis for energy transition and resilience.

The clean energy transition will help lower energy prices over time and reduce import dependence. The government needs to achieve affordable energy security by striking the right balance between imported natural gas, affordable renewable energy and energy storage technologies. Efforts to achieve energy and climate targets by 2030 by increasing energy efficiency and unlocking the potential of renewable energy can significantly contribute to reducing dependence on imported energy sources. The current overlap between different institutions' and stakeholders' remits means that a more coordinated approach is needed for key areas such as energy supply, energy efficiency and renewable energy. Digital technologies can boost the effectiveness of green transition policies. Investing in digital technologies such as smart IoT devices and meters, 5G and 6G connectivity, and digital twins of the energy system will facilitate the clean energy transition and also benefit citizens and companies ([74]). Last but not least, a 'just transition' for the planned phase-out of coal by 2027 will have to be ensured in order to mitigate the negative social and economic impacts. In line with the NECP's objective of phasing out coal consumption, a Just Transition Action Plan is planned to be adopted in 2023.

([74]) COM (2022) 552 final.

Box II.4.3: **Monitoring performance in light of the European Pillar of Social Rights** ([75])

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights concerning equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion for the benefit of citizens in the EU. The European Pillar of Social Rights Action Plan, adopted on 4 March 2021, aims at rallying all relevant forces to turn the principles into actions. Since the 20 principles provide a compass for upward convergence towards better working and living conditions in the EU, they are equally relevant for candidate countries and potential candidates. The new reinforced social dimension for the Western Balkans includes an increased focus on employment and social reforms through greater monitoring of relevant policies (EC, 2018). The Western Balkans Ministers' Declaration on improving social policy in the Western Balkans (6 November 2018) confirms that they will use the Pillar to guide the alignment of their labour markets and welfare systems with those of the EU.

NORTH MACEDONIA		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Better than EU avg., improving
	Individuals' level of digital skills (basic or above basic)	Worse than EU avg., no change
	Youth NEET (% of total population aged 15-29)	Worse than EU avg., improving
	Gender employment gap	Worse than EU avg., improving
	Income quintile ratio (S80/S20)	Worse than EU avg., improving
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-64)	Worse than EU avg., improving
	Unemployment rate (% of population aged 15-74)	Worse than EU avg., improving
	Long term unemployment rate (% of population 15-74)	Worse than EU avg., improving
	GDHI per capita growth	N/A
	At risk of poverty or social exclusion (in %)	Worse than EU avg., improving
	At risk of poverty or social exclusion rate for children (in %)	Worse than EU avg., no change

Relative to the EU-27 average, North Macedonia faces challenges on a number of indicators from the Social Scoreboard that supports the European Pillar of Social Rights.

North Macedonia has steadily improved its employment and unemployment rates (though they lag behind best performers in the region) and the labour market has been relativly resilient during the COVID-19 pandemic. Targeted measures to bring more people into the labour market are a step in the right direction, but spending on this active labour market policy (0.27% of GDP) remains too low to substantially improve the situation. Despite the favourable trends in employment observed before the COVID-19 pandemic, the unemployment rate remains high and has several distinctive structural characteristics, including long-term unemployment, inequality, and large regional disparities. Women and young people are particularly exposed to the risk of unemployment and inactivity. Despite significant improvements due to the implementation of the Youth Guarantee, the youth unemployment rate (15-24) was 35.7% in 2021, while the rate of NEETs (15-29) in 2021 was 26.2%. The rate of inactivity in the labour market is particularly high for women. 41.8% of the women aged 20-64 were out of the labour market in 2020.

The education system of North Macedonia does not equip young people with the necessary key skills and knowledge. The low quality of the education system contributes to the lengthy school-to-work transition and the skills mismatch continues to be a major impediment to people finding work. New school and VET curricula now focus more on the demands of the labour market, but legislative delays are impeding the operationalisation of the VET centres.

The reform of the social protection system is intended to better target those in need. Social assistance has had very little success in reducing poverty, because social benefits are very low and because of ineffective targeting. The groups most at risk of poverty remain young people, those without education and ethnic communities such as the Roma. North Macedonia plans to continue with its measures to strengthen the system for social inclusion of vulnerable groups, including by improving social services in local communities across the country.

North Macedonia has a well-developed statistical system. The State Statistical Office is the primary producer and coordinator of the country's statistical system. Since 2004, the Labour Force Survey (LFS) has been carried out every quarter, providing quarterly and annual statistics. The Survey on Income and Living Conditions (SILC) has been carried out every year since 2010.

([75]) The table includes 16 headline indicators of the Social Scoreboard, used to compare performance of EU Member States (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators). The indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2020 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). For data see Annex B. NEET: neither in employment nor in education and training; GDHI: gross disposable household income.

4.5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2022

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye has adopted targeted policy guidance for all partners in the region. The guidance represents the participants' shared view on the policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The underlying rationale for the policy guidance is similar to that of the country-specific recommendations usually adopted under the European Semester for the EU Member States. The Commission evaluates the work carried out to implement the policy guidance in the following year's ERP assessments. The table below presents the Commission's assessment of the implementation of the 2022 policy guidance jointly adopted by the EU and the Western Balkans and Türkiye at their Economic and Financial Dialogue at Ministerial level on 24 May 2022.

Overall: Partial implementation (48.6%) ([76])	
2022 policy guidance (PG)	**Summary assessment**
PG 1: If needed, use the available fiscal space in the 2022 budget to cushion the potential impact of adverse shocks through targeted support to vulnerable households and firms; foresee in the medium-term fiscal plan accompanying the 2023 budget a gradual reduction of the primary deficit-to-GDP ratio to its pre-crisis (2019) level.	There was **partial implementation** of PG1: 1) **Partial implementation**. The government adopted two sets of fiscal measures in 2022 providing support to vulnerable households to cope with the cost-of-living and energy crisis. At the same time, the introduction of block tariffs for electricity led to a more targeted manner of energy support. Some untargeted stimulus measures were suspended (wage subsidies introduced in 2019), others were continued into 2023 (reduced VAT rate on electricity). The government's medium-term fiscal plan foresees a gradual reduction of the general government fiscal deficit from an estimated 4.8% of projected GDP in 2022 to 2.9% in 2025. The primary deficit would, however, not reach its pre-crisis level (0.8%) before 2027.
Set up a central public investment management unit in the Ministry of Finance and ensure its proper functioning.	2) **Partial implementation**. The Ministry of Finance completed the systematization exercise to review its current structure in December 2022. A new Department on Public Investment Management has been created, but still needs to be staffed and made operational.
In line with the Tax System Reform Strategy, design comprehensive tax reforms and draft legislative changes that contribute to enhancing revenue by broadening the tax base, and accelerate the digital transformation of the Public Revenue Office.	3) **Substantial implementation**. In August 2022, the Ministry of Finance announced a set of legislative proposals in line with the Tax System Reform Strategy, aiming at broadening the tax base and streamlining the existing tax exemptions. In December 2022, the Law on personal income tax was amended, the key changes with effect from 1 January 2023 including taxation of capital gains from the sale of securities and stakes in investment funds; taxation of life premiums paid in the voluntary health and pension funds; deferral of taxation of interest gains on deposits by the time of accession to the EU. The laws on corporate taxation and

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

	on VAT were also amended. The draft laws are currently in the parliament awaiting to be passed. The government dropped initial plans to reintroduce progressive income taxation, which was first introduced in 2019 and then put on hold, with 10% tax rates remaining as flat rate for taxation of personal income tax and 15% for the income gained from games of chance. The forthcoming IFMIS project, includes a component on upgrading the tax IT System, which is expected to support and improve the business processes of the PRO and contribute towards its digital transformation. However, the results of this intervention cannot be expected immediately.
PG 2: Submit the new public-private partnership (PPP) law to the Parliament for adoption and ensure its implementation, including by setting up a fully functioning PPP registry.	There was **partial implementation** of PG 2: 1) **Partial implementation:** The draft law on public-private partnership has been submitted to the Secretariat of European Affairs for further submission to the European Commission for comments.
Ensure central monitoring of all fiscal risks related to state-owned enterprises, PPPs, and Local Government Units by the Ministry of Finance.	2) **Limited implementation:** There is limited progress in strengthening the monitoring of fiscal risks related to state-owned enterprises, PPPs and Local Government Units. The main action taken was the approval of the OBL. Art. 9 is about fiscal principles including prudent management of fiscal risks arising from macroeconomic shocks, guarantees given by the state and municipalities, ownership of public enterprises and other public corporations founded by the state and the municipalities or in which the state or the municipality is a majority owner, public private partnership, etc. The budget department still needs to develop a comprehensive registry of SOEs and a methodology to assess related risks.
Implement the new organic Budget law as soon as it is passed by the Parliament and take the necessary legislative and organisational steps to enable the new Fiscal Council to take up operations.	3) **Substantial implementation:** The Organic Budget Law was passed by the Parliament in September 2022. The Ministry of Finance has started the process of implementation. As required by the OBL, the Academy of Arts and Sciences, the State Audit Office and the National Bank have been invited to nominate candidates for the Fiscal Council and the Ministry of Finance is currently working on relevant bylaws to make the Fiscal Council operational.
PG 3: Carefully assess and analyse price developments and stand ready to tighten monetary policy, if needed, to preserve price stability in the medium term.	There was **partial implementation** of PG3: 1) **Full implementation.** The central bank has carefully monitored the evolution of price dynamics. To curb inflation, the central bank has withdrawn liquidity, and raised policy rates by more than the increases in the euro area, thus also maintaining a substantive interest rate differential in support of the currency peg.
Maintain a transparent and accurate reporting of asset quality and adequate provisioning, further reduce	2) **Substantial implementation.** Key legislations and regulations improved. The Financial Stability law was

institutional and legal obstacles to swift and effective NPL resolution, all relevant institutions to continue to reduce data gaps in particular as regards the real estate sector and further implement measures to promote the role of the local currency.	passed, which formalised the Financial Stability Committee and set up the macroprudential framework for the various entities in the system. Nevertheless, the law on the national bank still needs to be amended to clearly establish the central bank's macroprudential mandate. To further harmonise with EU regulations, a new Banking Law and Law on Bank Resolution are planned to be adopted by end 2023. Provisioning is broadly adequate. Data gaps remain in the real estate sector, but the central bank has announced raising the counter-cyclical capital buffer to partially address concerns of rising real estate prices. The central bank adjusted banks' denar and foreign currency required reserve requirements on a differentiated basis, also in line with its denarisation strategy.
Safeguard the national bank's independence in its key statutory tasks, including in staffing issues, in line with the law on the national bank, and to this end exclude the national bank from the scope of the new law on administrative servants and the law on public sector employees.	3) **Limited implementation.** The government proposed amendments to the national bank law to exclude central bank staff from the status of administrative servants, which is pending parliamentary passage, but thus far did not exclude the central bank from the law on administrative servants and public sector employees. In addition, a new law on a public sector wage grid has been introduced for public consultation which includes the central bank. Therefore, despite some efforts, concerns remain about adequately safeguarding the central bank's independence, including in staffing issues.
PG 4:	There was **partial implementation** of PG 4:
Use the list of mapped para-fiscal charges to evaluate, optimise and rationalise para-fiscal charges at the central and local levels	1) **Limited implementation**: The Ministry of Economy started evaluating how to optimise 100 para-fiscal charges at the central level. Based on a completed assessment of and a drafted proposal for the legal, institutional and operational framework for para-fiscal charges (including best EU and regional practices), a methodology has been drawn up for streamlining up to100 para-fiscal charges.
Continue the digitalisation of public services for businesses and citizens by upgrading and enhancing the use of the e-portal for services.	2) **Partial implementation:** Digitalisation of public services for businesses and citizens was continued by upgrading and enhancing the use of the e-portal www.uslugi.gov.mk. The number of registered users and completed services on the portal is increasing, but remains below expectations. Many of these services remain purely informational and cannot be carried out fully on line.
Adopt a comprehensive new strategy and Action Plan for formalisation of the informal economy 2023-2025 and ensure high-level political commitment by all institutions relevant for the coordination and implementation.	3) **Partial implementation**: In order to enable better and more efficient coordination between all relevant institutions and stakeholders in implementing planned measures and activities, the government decided in October 2022 that the Ministry of Finance will take over responsibility for preparing the new 2023 - 2025 Strategy for Formalization of the Informal Economy with an Action Plan. The preparation of the new strategy is under way and is due to be submitted to the government by April 2023. Some progress was made with EU support in detecting, measuring and monitoring the informal economy. The government adopted tax legislation at the end of 2022 to strengthen the tax paying culture and

	thereby fight the informal economy. According to the data from the State Statistical Office, informal employees as a proportion of total number of employees decreased from 18.6% in 2018 to 12.1% in2021.
PG 5: Increase the number of staff and the technical/engineering capacity of the Energy Department in the Ministry of Economy and the Energy Agency.	There was **limited implementation** of PG 5: 1) **Limited implementation**: The Energy Department in the Ministry of the Economy was reorganised in the summer of 2022 and a few individuals were employed. However, the technical capacities of both the Energy Department in the Ministry of the Economy and the Energy Agency remain insufficient to meet legal obligations. For instance, there is a separate section for energy efficiency but it contains only one member of staff. Staffing of the Energy Agency does not even reach half the systematised work places. North Macedonia has plans to employ five additional staff in 2023 in the Ministry of Economy (Energy Department).
In line with the commitments of the Green Agenda for the Western Balkans: Adopt and implement energy efficiency legislation, including bylaws to the energy efficiency law.	2) **Partial implementation**: North Macedonia has made some progress in drafting rulebooks for energy efficiency in buildings and the assessment of building renovation and heating and cooling potential. According to the Energy Community Secretariat, adoption of the drafted secondary legislation required for the implementation of the Energy Efficiency Law remains of the highest priority for North Macedonia. Adoption of secondary legislation in accordance with the Law on Energy Efficiency is – according to the government's National Energy Crisis Action Plan - planned for the fourth quarter of 2023. The long term buildings renovation strategy and the assessment required by the Energy Efficiency Directive are planned for the second half of 2023. The 2030 energy efficiency targets and policy measures were introduced in the Energy Strategy and the country's NECP adopted in May 2022.
Following the development and adoption of the legal and regulatory framework, establish the envisaged Energy Efficiency Fund.	3) **Limited implementation**: The government provides financial initiatives through the state programme for renewables and energy efficiency, while several international financial institutions are implementing renovation programmes in buildings. With the support of the World Bank, North Macedonia analysed options for the establishment of the National Energy Efficiency Fund and agreement on the institutional model of the Fund was reached (i.e. within the framework of the Development Bank). However, the legal and regulatory framework for its establishment and operationalisation remains to be adopted. According to the National Energy Crisis Action Plan, establishment and operationalisation of the Fund is planned for the second quarter of 2024. EUR 5 million is available for initial financing of the Fund.

PG 6: Develop new vocational education and training (VET) legislation with a focus on inclusion, labour market needs and a new methodology of financing VET as well as provide a yearly report for improving higher education, including recommendations for a new formula for the financing of higher education.	There was **partial implementation** of PG 6: 1) **Limited implementation:** The VET law and adult education law have been drafted and adopted by the government but have not been adopted by the parliament. The annual report, which includes recommendations for a new formula for the financing of higher education, has not yet been issued.
Continue efforts to strengthen access to active labour market policies, particularly for low-skilled unemployed and people in vulnerable situations.	2) **Partial implementation:** The government continued with the implementation of active labour market policies. However, no new measures targeting specifically low skilled and vulnerable people have been introduced. Limited resources (human, financial) for PES and ALMPs implementation remain a point of concern. The Employment Service Agency has started preparing the piloting of the IPA-funded 'second chance' programme.
Further increase the capacity of and cooperation between the employment agencies and centres for social work as well as education and training institutions to provide integrated services and measures for improvement of inclusion in the labour market.	3) **Partial implementation:** Work to improve cooperation had continued. With the addendum to the IPA-funded project implemented by the Employment Service Agency, additional capacity building activities have been added for the Agency and the Social Work Centres. Activities will allow them to work better with low-skilled and vulnerable people on increasing their employability and employment prospects.

4.6. THE POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TÜRKIYE

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

Brussels, 16 May 2023

[…]

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

1. Continue to provide targeted and temporary support to vulnerable households and firms to cushion the impact of the energy crisis, if needed, and at the same time start to phase out untargeted subsidies to the energy sector. Use any revenue overperformance or spending under-execution compared to the 2023 budget to reduce the deficit. Foresee in the medium-term fiscal plan accompanying the 2024 budget a gradual reduction of the primary deficit-to-GDP ratio to its pre-crisis (2019) level by the end of the ERP period.

2. Accelerate the implementation of the Public Investment Management Action Plan, in particular by ensuring the new Department for Public Investment Management in the Ministry of Finance becomes fully staffed and operational, and submit the new public-private partnership (PPP) law and the Law on concessions of goods of general interest to the Parliament for adoption. Adopt and submit to the parliament the next set of revenue-enhancing measures, as announced by the Concept for Tax Policy Reforms. Take the necessary legislative and organisational steps to enable the new Fiscal Council to take up operations with regard to the 2024 budget and the new fiscal strategy, in particular by swift appointment of its three members and provision of premises and administrative services.

3. Continue to carefully assess and analyse price developments and ensure a sufficiently tight monetary policy stance to preserve price stability in the medium term, including by further tightening monetary policy, if needed. Strengthen further the reporting and risk management frameworks across the banking system to ensure an accurate reporting of asset quality, further reduce institutional and legal obstacles to swift and effective NPL resolution, continue to reduce data gaps in particular as regards the real estate sector and further implement measures to promote the role of the domestic currency, involving all relevant stakeholders. Safeguard the National bank's independence in its key statutory tasks, including in staffing and wage issues, by adopting the amended law on the National bank, and excluding the National bank from the scope of all related laws on administrative servants and public sector employees.

4. Adopt and commence with the implementation of the new Strategy for formalizing the informal economy 2023-2025, with an action plan and ensure high-level political commitment. Adopt and start implementing the Export Promotion Strategy and Smart Specialisation Strategy/Action Plan to enhance competitiveness and integration in global value chains of domestic companies. Continue the digitalisation of public services for businesses and citizens by upgrading the e-portal for services.

5. To enhance energy resilience and transition towards implementing the Green Agenda, re-organise and strengthen state institutions dealing with energy policy and in particular increase the technical/engineering capacity of the Energy Department in the Ministry of Economy and the Energy Agency. Adopt the law on biofuels, secondary legislation to the energy efficiency law, the long term

buildings renovation strategy and the legal and regulatory framework for the establishment of the Energy Efficiency Fund as well as establish a Renewable Energy Guarantee of Origin scheme. Establish a governance mechanism for Just Transition from Coal, including an operational Inter-ministerial Committee with involvement of local actors.

6. Finalise the new Law on vocational education and training (VET), Law on secondary education and the Law on adult education as well as provide a yearly report for improving higher education, including recommendations for a new formula for the financing of higher education. Building on the steps taken, strengthen access to active labour market policies, in particular for low-skilled unemployed and people in vulnerable situations. Continue to increase the capacity of and cooperation between the employment agencies and centres for social work as well as education and training institutions to provide integrated services and measures for improvement of inclusion in the labour market.

ANNEX A: ASSESSMENT OF THE OTHER AREA/SECTOR AND STRUCTURAL REFORM MEASURES INCLUDED IN THE 2023-2025 ERP

Public financial management (PFM)

North Macedonia, like most WB6 countries has considerable room for PFM improvement. Various strategic documents related to PFM ([77]), public administration and public investment management (PIM) are in place, but their coordinated implementation will be important. The Organic Budget Law (OBL) introduces fiscal rules, a Fiscal Council, a multiannual expenditure framework and programme-based budgeting, and its long delayed adoption in September 2022 has paved the way for many PFM reforms in the future. Although a step in the right direction to strengthen PFM, many of these measures may only have an impact in the medium-term, beyond the scope of the current ERP (2023-2025). Important provisions in the OBL, especially with respect to public investment management, will come into effect in 2025; multiple bylaws for the implementation of the OBL are yet to be drafted; key components of the Integrated Financial Management Information System (IFMIS) are being designed and its rollout will take time. These factors reduce the likelihood of tangible impacts on PFM during the duration of this ERP. The digitalisation of PFM helps to promote transparency, efficiency and accountability in PFM. Planned reforms to strengthen PIM management and budgeting practices should, in conjunction with the new OBL, help to reduce the under-execution of the capital investment budget (IMF, 2022). Adoption of draft legislation on public-private partnerships has been delayed. The public internal financial control (PIFC) law to strengthen managerial accountability and internal audit functions is still awaiting adoption. Implementation of the PIFC paper and action plan has been hindered by the COVID-19 pandemic and key stakeholders' limited capacities. Financial inspection is still not functioning properly. The national constitution does not yet guarantee the independence of the State Audit Office and parliamentary oversight of public funds management needs to improve.

Measure 19: PRO digital transformation by setting up ITIS

This measure was first introduced in 2022 and the first preparatory steps towards its implementation have started. The measure addresses the long-standing issue of the Public Revenue Office's (PRO) obsolete and fragmented IT system, which impairs its administrative and operational capacities. The digital transformation of the Public Revenue Office (setting up a modern database, a disaster recovery centre and an advanced information management structure) is intended to improve the effectiveness of revenue management, reduce the informal economy and enhance tax compliance. As the ERP indicates, the PRO is taking an active part in implementing the Action Plan to combat the grey economy at the level of the Ministry of Finance. The European Commission's 2022 country report recommends improvements to the PRO's business processes, the development of a new integrated IT tax system for the PRO, improving its compliance risk management and further extending e-services for taxpayers. The 2021 IMF Tax Administration Diagnostic Assessment Tool (TADAT) assessment concluded that the PRO had developed strengths in the area of taxpayer's services. However, the benefits of these strengths do not fully materialise due to the poor state of its IT system. To this end, measure 19 is relevant, well drafted and describes the key functionalities of the system. The potential risks are well identified and will need to be addressed in order to minimise their impact on the process of implementing the measure (e.g. insufficient institutional ownership and very weak human resources capacities, especially in the IT sector). The IT system is one of the key preconditions for improving revenue collection and features in the updated 2021-2025 Tax System Reform Strategy and the new 2022-2025 PFM Strategy. Measure 19, which will be implemented with national funds to the amount of EUR 5 million and is currently planned for 2023-2025, marks a significant advance in this area after a long period of hesitation and inactivity. The description of the measure's expected impact on competitiveness could be improved further.

([77]) PFM Reform Programme 2022-2025 was adopted in 2022.

Green transition

This reform area is closely linked to key challenge 3 and is analysed in Section 4 above. In addition to this analysis and as recognised in the ERP, North Macedonia also needs to unlock the potential of the circular economy, with recycling and reuse becoming the rule and with a significant reduction in the use of natural resources. This will be a challenge given that 51% of the respondents to the Balkan Barometer 2022 indicated that they had not taken any steps to reduce the environmental impact of their respective businesses. Contrary to most of its peer countries, North Macedonia has not yet adopted a circular economy roadmap.

The heavy reliance of municipal waste management and wastewater treatment on donor funds impedes regular maintenance. The national plan for waste management (2021-2031) and the national waste prevention plan (2021-2027) are in place. As the ERP mentions, less than 1% of solid waste is recycled – so almost 99% goes into landfills. Work has begun to build a regional waste management system in several regions. Regional waste management structures are not yet operational, however, and separate collection of waste streams and economic instruments to promote recycling, reuse and waste prevention remains limited. Management of the water supply and the sanitation system remains undeveloped. Work to align with EU law is continuing, but implementing and enforcing existing legislation remains a challenge.

Measure 7: Building wastewater collection and treatment infrastructure in line with EU requirements

This measure has been largely rolled over from last year and remains relevant. Essential structural reforms for the financial sustainability and good governance of the sector have been planned, but the plan is not realistic and no action was undertaken in 2022. To sustainably operate and maintain the significant infrastructure investment that is planned, a real effort should be made to implement and enforce the full-cost-recovery and polluter-pays principles enshrined in the Water Law of 2008. Moreover, decisive steps should be taken to enable the institutional architecture and market design to evolve. Infrastructure development is focused exclusively on IPA and WBIF projects. One positive development for the sector is the recent signature of a EUR 50 million EIB loan to the country. The intermediate targets of the result indicators are unrealistic because substantial delays have arisen in procuring related works. The impact analysis is rather superficial. The circular economy is mentioned as a project objective, but the text does not go into any detail as regards the benefits for the country’s competitiveness.

Measure 8: Establishing an integrated and financially self-sustainable waste management system

This measure, which is supported by EU funding, has been rolled over from previous years. Modernising waste management systems and increasing recycling rates can reduce pollution, make the circular economy possible and align the country’s environmental standards with the EU’s. Measure 8 nevertheless lacks some critical elements related to its implementation and investment sustainability. For example, a cost-reflective waste tariff policy is considered to be one of the key elements to ensuring proper quality services and the sustainability of the waste treatment system and should therefore be seen as part of the structural reform in this sector. Another important milestone is the establishment of the Regional Waste Management Company (RWMC), but this has not been fully completed due to resistance from the Municipality of Sveti Nikole where the central facility should be situated. The completion of the formal process for its establishment should have been listed among the planned activities in 2023. The activities planned for execution in 2022 related to the start of the project to support the implementation of waste management structures in the North-East and East region and the preparation of waste planning documents has been postponed to 2023. The impact analysis is rather generic and needs to be improved.

The circular economy is mentioned as a project objective, but the benefits for the country's competitiveness are addressed in only a superficial way.

Business environment and reduction of the informal economy

This area is analysed above in Section 4 as a crucial element of key challenge 2. Structural weaknesses in the business environment continue to be an obstacle for domestic companies, even though North Macedonia was ranked 17 out of 190 economies in the latest World Bank *Doing Business 2020* report. The ERP refers to the growth acceleration plan (GAP), which was adopted in the autumn of 2021 and is intended to boost the private sector's competitiveness and investment in physical and human capital over 5 years. The GAP aims to support fast and sustainable growth, while also maintaining fiscal stability by mobilising capital from the private sector (in addition to the funds received from the state budget). One of the ERP's measures that is mentioned in the GAP is to create a hybrid fund for green and digital start-ups and innovative SMEs.

Measure 13: Hybrid investment fund for start-ups and innovative micro, small and medium-sized enterprises

This measure had been rolled over from previous years and remains relevant. As noted by the OECD competitiveness outlook and SME policy review, the lack of diversification of sources of funding (especially for micro and small businesses) is a major constraint on the local business environment. Commercial loans from local commercial banks are the predominant source of funding. The concept of a hybrid fund was included in the GAP and may point to a new policy trend towards more market-oriented financing of SMEs (as opposed to the cross-policy state aid approach that has been applied to date). However, implementation is facing delays and the government is still considering options for the establishment fund and methods of financing. Leveraging funding for green and digital start-ups and innovative SMEs may be supported by: i) the need to support private capital mobilization, given the reduced fiscal space of the Government; ii) the need to broaden the investor base, both the domestic and foreign one; iii) the importance to continue building the domestic innovation ecosystem; and iv) the significance to leverage existing structures and rely on simple solutions to facilitate implementation and increased feasibility. Measure 13's description should be clearer and more detailed regarding the role of EU funding in the measure's implementation. The government could further quantify the measure's impact on competitiveness.

Measure 14: Financial support for Roma entrepreneurs

This measure is very relevant (including from a social point of view) because it targets a very disadvantaged part of the country's society. It is based on the country's experience with labour market activation measures and receives EU funding. Implementation of the measure is still at an early stage but some progress has already been noted – including the establishment of a competent team of business facilitators; completion of a study to identify the support needed to access finance and available governmental programmes as well as online information sessions for Roma entrepreneurs. While implementation is proceeding relatively well at this stage, the support provided so far consists mainly of soft measures (e.g. mentoring) and does not always meet the specific needs of the target group. The impact analysis of the social outcome includes some quantification, but the impact on competitiveness should be further developed. Indicators from the previous ERP have been rolled over for the years 2023-2025.

Research, development and innovation (R&D&I)

The Fund for Innovation and Technological Development has evaluated the implementation of the 2015-2020 strategy for research and innovation. Despite some progress, investment in research and innovation remains low at 0.38% of GDP. Participation by the private sector in overall research spending remains particularly low at 0.1% of GDP. Increasing the budget in this area would boost competitiveness and sustainable growth of North Macedonia (especially given the relevance of innovation to the Economic and Investment Plan for the Western Balkans). The Smart Specialisation Strategy (S3) to be adopted in 2023 is planned to serve as the new innovation strategy. Four vertical priorities (smart agriculture and food with higher added value; electro-mechanical industry – Industry 4.0; ICT; and sustainable materials and smart buildings) and two horizontal priorities (energy for the future; and tourism) have been identified. Measures for closer cooperation between academia and the private sector are being implemented and subsidies are being provided to companies to strengthen their research and innovation capacities. The government's support for R&D&I is being provided mainly through state aid schemes implemented by the Fund for Innovation and Technology Development (FITD). A comprehensive evaluation of the impact, efficiency and effectiveness of FITD programmes is lacking. The involvement of several ministries has complicated the coordination of innovation policy (OECD, 2022).

Measure 16: Support for the development of the innovation ecosystem

This measure has been significantly redesigned and extended by the welcome addition of a component related to the Smart Specialisation Strategy. The strategy is planned to be adopted in 2023. The other component of the measure still consists of setting the institutional infrastructure for support of academic-business collaboration – the establishment of a science technology park (STP). Overall, the measure is relevant because it is intended to promote academic-business cooperation, the commercialisation of innovation and RDI investment, albeit not in a very clear and structured way. A clear approach to the design and function of the STP will be important (OECD, 2022). The second part of the measures, the STP, was a measure in several previous ERPs, but adaptation of premises and operational activities has been delayed so that contracts between business and academia will not be concluded until 2025. No progress has been made in the past 3 years. Re-introducing this point in the ERP at a later stage may therefore be considered, once funding for the STP and its ownership have been secured, and specific fields of operation and specialisation have been clarified (including its complementarity with the FITD). Measure 16's expected impact on competitiveness has not been quantified and its impact on employment and gender has not been sufficiently considered.

Digital transformation

An analysis of this area is partly included in the analysis of key challenge 2 in Section 5.1. In line with the regional results of the Balkan Barometer 2022, 52% of surveyed businesses reported some or great satisfaction with digital services for businesses. This improvement also shows that digital services became particularly relevant and increasingly in demand during the COVID-19 pandemic. However, the survey also showed that businesses are not doing enough to improve their employees' digital skills. North Macedonia has continued to successfully implement the Digital Agenda for the Western Balkan and the Regional Roaming Agreement, but further efforts are needed to unlock the full potential of the country's digital transformation. North Macedonia still needs to adopt its ICT strategy, and modernising and digitalising the public sector will require more effort and better cooperation between institutions. Successful e-services include the e-tax system that has simplified tax reporting, and mobile applications like e-VAT that makes it possible for individual taxpayers to file their VAT returns online. E-commerce in the country is growing slowly. Further digitalisation is still hampered by the relatively high cost of digital services and by the low level of digital skills in the population.

Building on the 2018 Digital Agenda for the Western Balkans, the economic and investment plan provides an opportunity to accelerate the digitalisation of government, public services and businesses in a manner that is consistent with the EU's values and legal framework. The ERP's analysis of this sector mainly covers EU-projects related to e-government services to citizens and businesses. Information on the country's strategic investment in, and approach to, digital transformation is largely lacking. However, some of the measures in the ERP (and particularly the following measure) include activities linked to digitalisation.

Measure 10: Broadening the scope of digital services provided on the national e-service portal

This measure has been rolled over from 2022 and the portal has been in place for several years. It has an important role to play in improving the overall business environment and the ease of doing business. A large-scale, EU-funded project to upgrade the e-services portal with new services for companies and businesses started in August 2020. The project identified most of the services that are to be included in this project, as well as the registers that need to be digitalised in order to allow e-service delivery. The number of registered users and, to a lesser extent, the number of applications submitted through this portal appears to be increasing, albeit at a slower rate than expected. The ERP contains a good explanation of the measure's purpose, timeline, impact and potential implementation risks. These risks stem from inefficient coordination and communication between state institutions, a lack of human resources in the IT area and a lack of commitment at operational level. Those risks could significantly compromise the measure's implementation and should be clearly monitored and countered with mitigating actions. The digital transformation aspect is linked to EU support related to e-government services to citizens and businesses. The aspects of national strategic investment, of the strategic approach towards digital skills and of access to broadband (meeting targets set in the National Broadband Plan) are lacking.

Economic integration performance

The economy posted a large increase in trade openness (exports and imports in goods and services as a share of GDP) to 148% of GDP in 2021 after a drop in 2020 to 130 %. The country's trade integration relies on a narrow export base, which incorporates little domestic value added. It is therefore necessary to boost SMEs' internationalisation, productivity and competitiveness. Exporting companies and particularly SMEs still face major obstacles to trade. These obstacles include not only non-tariff barriers (including technical standards) but also administrative obstacles to trade in services (OECD, 2021/2022). The EU is still the country's largest trading partner by far. The EU accounted for 61% of the country's total trade in goods in 2021 (79% of total exports and 46% of total imports). After the EU, the UK is the second biggest trade partner of North Macedonia with 13% of total trade in goods, followed by Serbia, China and Türkiye (5%, 4% and 3.5% of total trade respectively). Since the last quarter of 2021, the merchandise trade balance has deteriorated steadily, largely on account of rising energy prices and reflecting the country's high dependence on energy imports. Exports have been impacted by weaker external demand and by ongoing supply chain disruptions (particularly to the production of automotive components - one of the country's main export sectors). North Macedonia is less exposed to shocks in terms of direct falls in trade with Russia and Ukraine as these were and remain relatively minor trade partners. However, there were relatively high imports of fertilisers from Russia, which reveals vulnerabilities in the current context of Russia's war of aggression against Ukraine(DG ECFIN, 2022). In July 2022, North Macedonia re-introduced export restrictions on wheat, wheat flour and sunflower seeds and extended these restrictions to certain types of wood until the end of 2022. In October 2022, the government decided to lift the ban on exports of wheat, wheat flour and sunflower seeds. The EU is also the country's main provider of FDI. EU companies dominate FDI and accounted for over 95% of FDI inflows into North Macedonia in 2021 (EUR 450 million) – a significant increase on previous years. Significant FDI came from Germany, the Netherlands, Austria and Slovenia. The economic and investment plan, and deepening the regional integration of the common regional market can both increase trade and further enable competitiveness and growth.

Measure 17: Strengthening the market rules in North Macedonia

This measure has been rolled over from 2022. It is implemented with EU funding to strengthen market surveillance. The measure is relevant for further integration of North Macedonia in the EU's single market as provided for by the Economic and Investment Plan, by harmonising its legislation with the EU's on free movement of goods, free movement of services and market surveillance. When referring to further legislative alignment in this area, information should be added about the planned adoption of developed legislation. The expected impact on competitiveness and the environment is only described in general terms. Quantified targets could be provided.

Energy market reforms

An analysis of this area is largely included in the analysis of key challenge 3 in Section 5.1 (energy sector modernisation and the transition to clean energy). The electricity ([78]) and gas markets are open to competition. The Energy Law adopted in May 2018 transposed the EU's Third Energy Package into national law in the electricity and natural gas sector, as well as part of the Renewable Energy Directive. It establishes, among other points, the rules for organising and structuring the electricity and natural gas markets, as well as the rights and obligations of all market participants. The electricity Market Operator has been designated as a NEMO ([79]) and day-ahead market establishment is planned for the second quarter of 2023. Recent amendments to the Energy Law advanced alignment with the REMIT regulation (on wholesale energy market integrity and transparency), the CACM Regulation (establishing a guideline on capacity allocation and congestion management) and the TEN-E Regulations (guidelines for trans-European energy infrastructure). The electricity transmission and distribution network operators have been unbundled in accordance with the EU law. Bulgaria and North Macedonia have put in place a new gas interconnection agreement to release exit capacity for the gas pipeline at the cross-border node Kyustendil-Zidilovo that had been booked with Gazprom but not used. The agreement is key to diversifying and securing gas supplies to North Macedonia. The country is laying the foundation for the long delayed unbundling of the gas transmission system operator (Energy Community, 2022), which is now planned for the end of 2023. The February 2020 Energy Efficiency Law transposes the EU's Energy Efficiency Directive, Energy Performance of Buildings Directive, Regulation on Labelling of Energy-related Products, and Directive on Eco-design of Energy-related Products into national law. The implementing rules are not yet fully in place.

In line with the economic and investment plan, the Commission will support the development of renewable energy sources and less polluting energy sources that will secure energy supply in line with the commitments of the Green Agenda for the Western Balkans.

Measure 9: Increasing the competitiveness of the electricity market

This measure was discontinued on the grounds that it had been largely implemented. However, day-ahead market rules are still to be adopted following the amendments to the Energy Law which transposed provisions of the CACM Regulation that enables market coupling (ECS, 2022). Operationalisation of the day-ahead market is now planned for the second quarter of 2023.

Transport market reforms

Road transport continues to dominate the transport sector. There is limited investment in other means of transportation and no consistent and intelligent system to manage and control transport traffic. Road maintenance is carried out by state companies that operate with old equipment. In 2020, the transport sector's contribution to gross value added was 3.5%, which is lower than the EU average of around 5%. The World Economic Forum's 2019 Global Competitiveness Report ranks the country 84th out of 138 economies for transport infrastructure. Relatively low-quality transport infrastructure, as well as weak trade and transport logistics continue to present barriers for foreign companies aiming to invest in the country. These issues are also causing difficulties for domestic companies. The flagship policy of the economic and investment plan is the further development of the Trans-European Transport Railway

([78]) While there is de-jure competition in the electricity market, there is de-facto no competition in the regulated electricity market, as the state-owned electricity generator, ESM, supplies 100 percent of the demand of the regulated market, at subsidized electricity prices.

([79]) Nominated electricity market operator.

Corridor 8, which links North Macedonia with Albania and Bulgaria. This corridor will give the country's companies an alternative export option via Albanian and Bulgarian ports. To start the construction of the Corridor 8/10d highway, an independent and comprehensive feasibility study was undertaken to establish the fiscal cost and to manage fiscal risks (also as a structural benchmark under the IMF's Precautionary Liquidity Loan to North Macedonia). North Macedonia will have to amend legislation to rectify breaches of the provisions of the Transport Community Treaty regarding the opening up of the rail market at the national level. The 32% fatality rate in traffic accidents is high and above the EU average. The law for the creation of a Road Safety Agency still needs to be adopted. Road transport has a significantly higher modal share than rail: 96.7% compared to 3.3%. Road freight has a high 86% share of total freight in North Macedonia; this is higher than the EU average and has a negative environmental impact. Combined transport, which is more environmentally friendly and cost-efficient, is increasing but still accounts for only 1.3% of total freight (OECD, 2021). The ERP largely fails to analyse this sector but does include a related measure – Measure 10.

Measure 10: Implementation of an intelligent transport system (ITS) along Corridor X

This measure, which is also linked to the digital economy policy, has been repeatedly rolled over due to delays. Further work is required to align national legislation with the ITS Directive. An overall strategy for ITS (combined with accompanying resources) is still needed. The ITS should be put in place along Road Corridor X from Tabanovce to Gevgelija, which is a strategic objective of the 2018-2030 national transport strategy. Finalisation of the national ITS strategy and tender documentation have been delayed and are now expected in 2023. The measure aims to improve the safety of road transport and ease traffic flow along Corridor X. The ERP states that expected outcomes include a 17% reduction in travel time and improved safety (i.e. a reduction in traffic incidents by 16.6%). The actual impact on travel time along the corridor remains uncertain, however, because the main bottlenecks are at border crossings and toll stations, which have significantly increased in number in recent years. In addition, the current analysis does not allow to determine the measure's full potential impact on competitiveness and growth.

Agriculture, industry and services

The share of agriculture in the output structure dropped further in 2021 to 9% (-0.8 pps). Its share in total employment also dropped further in 2021 (11.5% – down from 12% in 2020 and 16.6% in 2016). The **agricultural sector** is characterised by an unfavourable farming structure (a large number of very small semi-subsistence farms – the average size of agricultural plots is 1.75 hectares for individual farmers) with mixed agricultural production on small and scattered land plots. The sector's efficiency and productivity are low. The sector was already severely affected by the COVID-19 pandemic, market constraints, a lack of seasonal workers, movement restrictions and difficulties in organising transport and logistics (OECD, 2021). Following the outbreak of Russia's war of aggression against Ukraine and price hikes in energy and fertilisers led to a significant increase in prices for basic food. Data released by the State Statistical Office showed a yearly increase in these prices of almost 30%. The government has introduced subsidies and other mitigating measures. One of the major problems in the country's agricultural sector is the ageing of the labour force – only about 15% of agricultural workers are young (15-24 years old). Low incomes and unfavourable working conditions, as well as deteriorating living conditions in rural areas discourage young people from starting a career in agriculture (FAO, 2021). The sector receives the largest portion of state aid, and subsidies to the sector have been increasing while production has been going down. There needs to be a stronger link between agricultural policies and other sectoral policies such as those on trade, education and SMEs. On the positive side, there is a good level of preparation in the area of food safety, veterinary and phytosanitary policy; and absorption of EU funds under the Instrument for Pre-accession Assistance for rural development (IPARD II) has continued to improve. Advantages for the sector include good access and distribution links to other European markets and potential for structural improvement (e.g. land consolidation, producer groups and cooperatives). Several actions could be taken to increase productivity through innovation and the application of modern technologies (e.g. (i) investing in the skills and know-how of agricultural workers; (ii) strengthening agricultural advisory services; and (iii) connecting agriculture with research, education and tourism).

Measure 19: Modernisation of post-harvest technologies and processing of agricultural products

This measure has been rolled over from 2022, when no significant development took place. The comments from last year's assessment are still valid. The measure is relevant and is consistent with the national priorities set out in the 2021-2028 national strategy for agriculture and rural development. The measure is ambitious enough to impact on the income of the farmers, agriculture cooperatives and producer organisations that are involved. The activities planned under this measure are based on the analysis and recommendations provided earlier by an EU-funded project that helped establish the Common Market Organisation in North Macedonia. The measure's implementation is funded by a World Bank loan (the World Bank Agriculture Modernisation Project) that also foresees complementary activities for advising and training farmers as potential users of the facilities. There has been a substantial delay in establishing the project's management structure. The lack of a favourable legal and institutional framework for the establishment and operation of the agricultural cooperatives might have a serious negative impact on the project. Moreover, the law on the Common Market Organisation and the establishment of the relevant competent structure within the Ministry of Agriculture, Forestry and Water Economy remains an issue of concern. The exact locations of the purchase centres in Resen and Strumica and of the trading platform in Skopje are not yet known, and construction licences and permits had still not been issued. Activities need to be analysed further to individually reflect all aspects of the preparations for the construction. The estimated costs that concern existing EU funding including the 2019 grant scheme for the modernisation of agriculture in North Macedonia (already under implementation) could be included within the activities and possibly in the activity table. Result indicators are missing for the legal and institutional activities. The values of baseline result indicators are to be clarified.

Even in 2020 and 2021 (when economic activity was hampered by restrictions related to the COVID-19 pandemic), the sectoral and business structure continued their gradual transition towards a higher share of **services** (including trade) in value added and in employment. The output structure is also increasingly determined by the service industries, which together accounted for some 66% of total value added in 2021 (60.4% in 2016 and 64% in 2020). Employment in services remained robust despite the lockdowns. Services were badly hit by pandemic-related containment measures, but they still accounted for over half of total employment in 2021 (57.6%) – a marked increase compared with 5 years earlier (2016: 52.3%), and higher than in 2020 (57%). Tourism and transport continue to account for the largest part of the country's services exports (almost 40% of services exports). Exports of services have increased, but they still represent only around 20% of the value of the country's export basket – indicating the low level of companies' competitiveness (due to weak entrepreneurial skills and significant skills shortages). The ERP includes no measure for this area but does refer to the service sector's solid export prospects.

The main obstacles to competitiveness in the country's **industrial sector** include (i) low productivity and the slow growth rate of productivity; (ii) limited modernisation of production processes and obsolete technologies; and (iii) a significant skills gap. Employment in the industrial sector accounts for 24.1% of total employment (2021). The process of developing a smart specialisation strategy identified the following vertical priorities: the agriculture and food industry; industry 4.0 (including the mechanical, metal processing and automobile industries); ICT; and sustainable materials and smart buildings. Efforts are underway to continuously increase the industry's share of higher-value-added manufactured goods (machinery and equipment, and chemical products) whilst its share of basic goods (iron and steel, and clothing) falls. The country's industrial strategy focuses on the manufacturing industry without sectoral prioritisation. Manufacturing's share decreased slightly in 2021 after gaining ground in previous years. It stood at 14.8% of value added in 2021 (-0.3 pps year on year). Construction's share also declined to a lesser extent (5.8 % of value added, compared with 6.2% in 2020 and an average of 7.2% in 2016-2020) –

reflecting weak investment during the pandemic. No specific measure has been included for this area in the ERP.

Education and skills

This area and the relevant reform measure 1 are analysed above in Section 4 under key challenge #1.

Employment and the labour market

This area and the relevant reform measure 2 are analysed above in Section 4 under key challenge #1.

Social dialogue

Bipartite social dialogue in the private sector and the commitment of social partners to reinforce collective agreements remain weak. Only a few enterprises have collective agreements at company or branch level. The tripartite Economic and Social Council (ESC) is actively involved in the elaboration of relevant legislation before its adoption, but its participation is limited to proposals that fall under the responsibility of the Ministry of Labour and Social Policy. The ESC's visibility and impact is low. The ESC depends on the budget of the Ministry of Labour and Social Policy for the financing of its activities and its secretariat. At the local level, despite some progress in raising awareness of the benefits of social dialogue, the use of the local economic and social councils as an effective tool to formulate and implement local employment policies is still very limited. The 2021-2027 National Employment Strategy aims to strengthen the role of central and local social dialogue institutions (including by collective bargaining) by 2027.

Social protection and inclusion

The at-risk-of-poverty-after-social-transfer rate decreased slightly by 0.3 pps to 21.9% in 2020. However, research estimates show that child poverty has increased during the COVID-19 pandemic. Social transfers, particularly pensions, are a key way to keep individuals above the poverty line. The pension contribution rate has slightly increased since 2020 from 18% to 18.8%. The maximum allowed fee from pension contributions collected by private pension companies was reduced from 2.25% to 2% in the same period. The process of obtaining social protection benefits that require particular evidence such as disability allowances can be lengthy. The government has adopted the 2021-2027 national strategy for social entrepreneurship that aims to set up a favourable legal framework for social enterprises. However, the pandemic has hampered the updating of other national social protection strategies. The Law on Social Protection strengthens municipalities' responsibilities, but still does not sufficiently recognise their role in designing and adopting their own programmes in the field of social protection. The success of the social reforms package also depends on improving coordination between public employment service (PES) and other services like social work centres, associations, social service providers, health sector operators and municipalities which have legal obligations to provide additional forms of social protection support. The social impact of the COVID-19 pandemic has been mitigated by enabling access to guaranteed minimum assistance (GMA) for individuals who have lost their jobs during the pandemic.

Measure 3: Enhancing the system for social inclusion of vulnerable groups

Reform measure 3 aims to better target cash transfers and increase their effectiveness by connecting them to labour market activation and social services. This measure is crucial for tackling poverty in the country and has been rolled over from the previous year. The new Law on Social Protection was adopted in 2019 with accompanying by-laws providing the comprehensive legislative framework for social protection in North Macedonia. The measure includes the adoption of a Law on Employment and Insurance Against Unemployment to improve cooperation between the various social service providers. The measure also includes developing a new law to provide financial and technical support to social enterprises that focus on improving the employment prospects of vulnerable people, including people with disabilities. The measure also aims at a greater inclusion of people with disabilities in the open labour market and seeks to further deepen cooperation between PES and centres for social work in order to provide support and labour market activation of employable GMA beneficiaries.

Healthcare

The country's healthcare system covers 90% of the population but its capacity remains inadequate. The share of public expenditure on healthcare was 6.58% of GDP in 2018 (the EU-27 average was 6.9% in 2018). Social security contributions accounted for 52.4% of the total health budget in 2020. The contribution rate for the actively employed is 7.3% of their gross wage. The unemployed and those not covered by insurance from any other source pay 5.4% on 50% of the average national wage. Health insurance for injury at work and occupational diseases is paid by the employer (0.5% of the gross salary). The health insurance system provides a broad network of primary healthcare at the municipal level and an extensive network of secondary healthcare institutions. Categories lacking coverage include in particular farmers, people without identification documents and people in irregular jobs and with irregular incomes, most of whom are Roma (Unicef, 2016). Healthcare places a significant financial burden on households. Up to 20% of the average total costs of medical treatment is paid out-of-pocket by the patient. However, robust statistical data on what out-of-pocket payments are used for is missing. In addition, distance or transportation problems and long waiting lists are among the most relevant unmet needs. EU statistics on income and living conditions (EU-SILC) data show that 20.5% of people in the country have difficulty using the healthcare service. This figure is close to the official number of people at risk of poverty and suggests that most of those who have difficulty in accessing healthcare may also be at risk of poverty. The 'Moj Termin' eHealth system that was introduced in 2013 helped to significantly reduce waiting times and should be extended to primary care doctors. The 2021-2030 National Health Strategy identifies strategic goals and is complemented by a strategy and action plan to improve primary healthcare. However, low public expenditure on health and the major shortage of health professionals remain among the biggest challenges.

Measure 4: Strengthening the quality of primary healthcare

This measure has been rolled over from last year. Its main goal is to improve the quality of primary healthcare (PHC) by reforming the PHC payment model to ensure disease prevention, standard-setting and a reducing reliance on a higher level of healthcare, including by increasing the number of specialised general practitioners. The development of a platform is expected to facilitate appointments and ensure the traceability of health data.

ANNEX B: OVERVIEW OF THE MAIN INDICATORS PER AREA/SECTOR OF THE ECONOMY

Area/Sector	2017	2018	2019	2020	2021	EU-27 Average (2021 or most recent year)
Energy						
Energy imports dependency (%)	56.2%	58.4%	58.1%	63.3%	N/A	55.6% (2020)
Energy intensity: kilograms of oil equivalent (KGOE) per thousand euro	292,98	267.13	283.84	274.59	N/A	110.35
Share of renewable energy sources in final energy consumption (%)	19.64%	18.18%	17.49%	19.22%	17.29%	21.7%
Transport						
Railway network density (metres of line per km^2 of land area)	26.85[s]	26.85[s]	26.9[s]	26,9[s]	26.9[s]	N/A
Motorisation rate (Passenger cars per 1000 inhabitants)	194	200	205	206.7[s]	231.0[s]	N/A
Agriculture						
Share of gross value added (agriculture, forestry and fishing)	9.1%	9.8%	9.4%	9.8	8.4 (p)	1.8%
Share of employment (Agriculture, Forestry and Fishing)	16.2%[s]	15.7%[s]	13.9%[s]	12.0%[s]	11.5% (w)	4.3% (2020)
Utilised agricultural area (% of total land area)	49.8%	49.7%	49.7%	50.0%	N/A	40.6% (2020)
Industry						
Share of gross value added (except construction)	20.5%	21.5%	20.8%	19.8%	19.6% (p)	19.9%
Contribution to employment (% of total employment)	23.3%[s]	23.9%[s]	24.1%[s]	23.9%[s]	23.9% (w)	16.1%
Services						
Share of gross value added	62.9%[s]	62.6%[s]	63.4%[s]	64.1%[s]	65.7%[s]	79.2%
Contribution to employment (% of total employment)	53.2%[s]	52.9%[s]	55.0%[s]	57.1[s]	57.7 (w)	70,9%

Research, development and innovation						
R&D intensity of GDP (R&D expenditure as % of GDP)	0.35%	0.36%	0.37%	0.38%	N/A	2,26%
R&D expenditure – EUR per inhabitant	17.20€	18.8€	19.9€	19.5€	N/A	EUR 734.5
Digital economy						
Percentage of households who have internet access at home	73.6%	79,3%	81.6%	79.4%	83.7%	92.5%(2022)
Share of total population using internet in the three months prior to the survey [% of population 16-74]	75%	79%	81%	81%	N/A	90%(2022)
Trade						
Export of goods and services (as % of GDP)	55.1%	60.4%	62.4%	57.8%	66.2% (p)	50.4%
Import of goods and services (as % of GDP)	69.0%	72.8%	76.2%	70.5%	82.3% (p)	46.7%
Trade balance (as % of GDP)	-18.1%	-16.8%	-18.1%	- 16.8% (p)	-23,2% (e)	N/A
Education and skills						
Early leavers from education and training (% of population aged 18-24)	8.5%	7.1%	7.1%	5.7%	N/A	9.7%
Young people neither in employment nor in education and training (NEET) (% of population aged 15-29)	31.1%	29.8%	24.5%	26.2%	24.2%	13.1%
Children aged less than 3 years in formal child care (% of under 3-years-olds)	10.3%	8.8%	13.0%	6.3%	N/A	36.2%
Individuals who have basic or above basic overall digital skills (% of population 16-74)	32%	N/A	32%	N/A	35%	54%

Employment and labour market						
Employment Rate (% of population aged 20-64)	54.8%	56.1%	59.2%	59.1%	N/A	74.7%
Unemployment rate (% of labour force aged 15-74)	22.4%	20.8%	17.3%	16.4%	N/A	6.1%
Long term unemployment rate (% of labour force aged 15-74)	17.4%	15.5%	12.4%	12.4%	N/A	2.4%
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	21.9%	21.4%	21.3%	19.9%	N/A	10.6%
Disability employment gap (Percentage points difference in employment rates between people with and without a disability)	29.4%	27.1%	28.6%	33.7%	N/A	23.1%
Real gross disposable income of households (Per capita increase, Index = 2008)	N/A	N/A	N/A	N/A	N/A	110.27
Social protection system						
At-risk-of-poverty or social exclusion rate (AROPE) (% of population)	37.0%	35.3%	34.1%	32.6%	N/A	21.7%
Impact of social transfers (other than pensions) on poverty reduction	14.29%	14.79%	15.00%	15.18%	N/A	37.08%
Income inequality - quintile share ratio (S80/S20) (Comparison ratio of total income received by the 20% of the population with the highest income to that received by the 20% with the lowest income)	6.38	6.16	5.56	5.92	N/A	4.97
Housing cost overburden (% of population)	11.7%	10.2%	9.9%	8.5%	N/A	8.3

Healthcare						
Self-reported unmet need for medical care (of people over 16)	2.5%	2.3%	2.5%	1.7%	N/A	2.0%
Out-of-pocket expenditure on healthcare (% of total health expenditure)	42.43% z	42.11% z	40.38% z	N/A	N/A	14.39% (2020)

w: *data supplied by and under the responsibility of the national statistical authority and published on an 'as is' basis and without any assurance as regards their quality and adherence to EU statistical methodology'*

e: estimated value

p: provisional (Eurostat)

s: Eurostat estimate

w= data supplied by and under the responsibility of the national statistical authority and published on an "as is" basis and without any assurance as regards their quality and adherence to EU statistical methodology

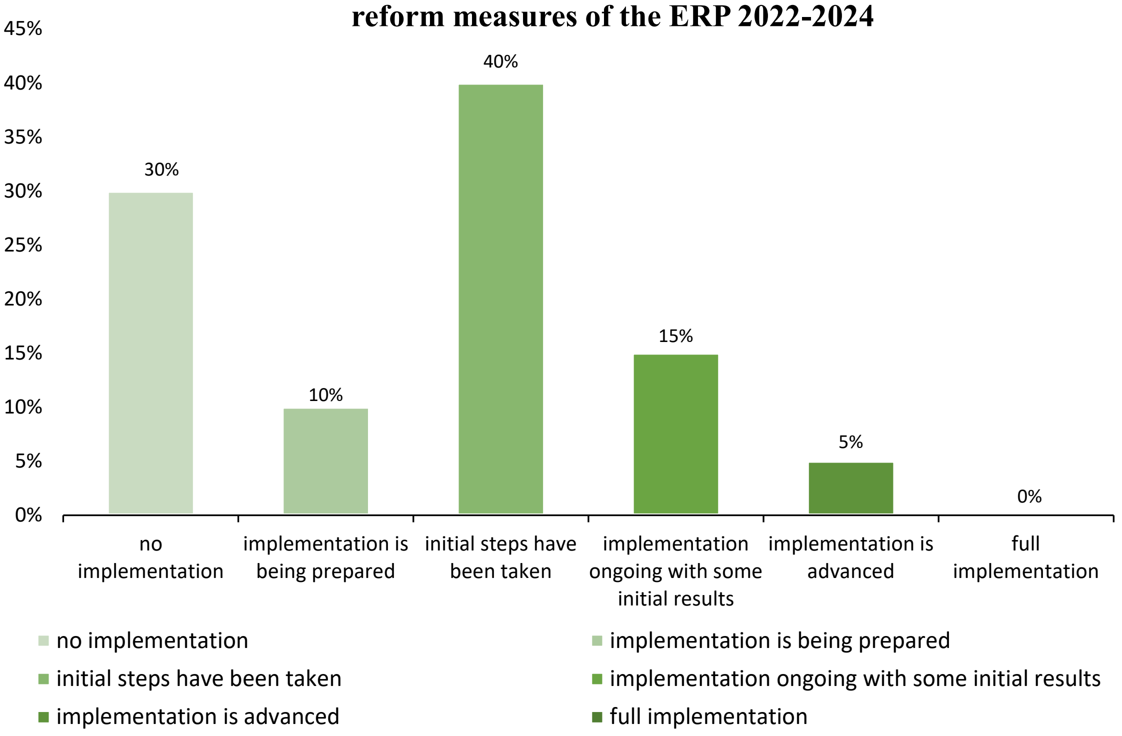
z: data from World Health Organisation

Source of data in Annex B: EUROSTAT, unless otherwise indicated.

ANNEX C: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM 2022-2024 ERP

Due to some capacity issues in the public institutions as well as the focus of North Macedonia on implementing short-term measures to mitigate the energy crisis, progress in implementing the measures from last year's ERP was mixed (the average score was 1.9 out of 5) and needs some improvement. Activity reports in Annex 11 provide a mostly accurate description of the level of implementation. Implementation is stronger for some measures, including measure 9 on increasing the competitiveness of the electricity market (the measure has been discontinued in the current ERP). By contrast, some measures have hardly been implemented, such as measure 4 (strengthening the quality of primary healthcare), measure 13 (hybrid fund for green and digital start-ups and innovative SMEs), measure 15 (establishment of a management information system for state aid) and measure 17 (enhancing cooperation between the academy and the industry – Science and Technology Park).

Graph II.4.2: **North Macedonia - Implementation of the structural reform measures of the ERP 2022-2024**



ANNEX D: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government of North Macedonia submitted the 2023-2025 ERP on 2 February 2023. None of its components are missing.

Inter-ministerial coordination

The Ministry of Finance of North Macedonia coordinated the preparation of the ERP and an inter-ministerial working group comprised of several ministries, agencies and other offices were involved in this work. The submitted ERP contains an annex with the list of institutions and individuals involved in the ERP preparation. The government formally endorsed the ERP on 1 February 2023. The coordination process worked well and the attendance to technical meetings was good.

Stakeholder consultation

The draft of the 2023-2025 ERP's structural reforms was posted on the Ministry of Finance's website from 15 to 29 December. Interested parties were invited to send written contributions. Comments and suggestions received in writing are attached as an annex to the ERP.

Macroeconomic framework

The macroeconomic framework is coherent and consistent, while somewhat optimistic. The ERP presents two alternative scenarios compared to the baseline: (i) assuming lower export growth; and (ii) assuming weaker investment. It does not include a low-growth scenario combining both domestic and external risks. The ERP's sensitivity analysis would have benefited from a more comprehensive impact assessment, including on employment, deficit and debt. The external sector outlook is described in detail and an analysis of external debt sustainability is provided in the annex.

Fiscal framework

The ERP is based on the latest budget projections following the latest budget revision and on the fiscal data available at the end of the third quarter of 2022. In line with the revised economic growth assumptions, the ERP has raised the deficit projections for 2023 and 2024, compared to previous year's program. It includes: (i) information on the expected budgetary impact of new policy measures; (ii) an analysis of the budget balance's sensitivity to lower GDP, lower execution of capital expenditure, and lower collection of revenue; (iii) an analysis of public debt's sensitivity to changes in interest rates and exchange rates; and (iv) a short assessment of the long-term sustainability of public finances based on a number of assumptions, including population ageing. The program also includes an external debt analysis, which presents results from stress tests for shocks to economic growth, to the primary current account and to interest rate changes.

Structural reforms

The chapter on structural reforms follows the ERP guidance note. Reform areas which have not or only partly been included as key challenges in Section 5.1. should have been analysed more in depth in Section 5.2. Reform areas are fully costed and integrated into the fiscal framework. Continued efforts are needed to quantify the impact for each measure. The description of the implementation risks and mitigation measures continues to improve. The ERP includes 19 measures and exceeds the page limit. Prioritisation of reform measures has focused on addressing the key structural challenges that were identified. Tables 9-11 in the annex have been properly completed. The implementation reports of the 2022-2024 ERP's policy guidance and Table 11 in the Annex are well prepared. The attributed scores largely reflect the implementation level. Though not expressly requested by the guidance note, additional useful information was provided in Annex 2a (on links between reform measures and ongoing or planned investments) or summarised in Annex 4 (result indicators for structural reform measures). Contributions received by external stakeholders during the consultation process were annexed to the ERP.

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5. SERBIA

5.1. EXECUTIVE SUMMARY

After a substantial slowdown in 2022, Serbia's economic reform programme (ERP) forecasts that economic growth will gradually accelerate in 2023-2025. Impacted by the economic fallout of the Russian war of aggression against Ukraine, in particular on inflation through energy and food prices, real GDP growth slowed to 2.3% in 2022, with private consumption and stockbuilding as the main growth drivers. The programme projects that economic growth will remain moderate at 2.5% in 2023 and gradually pick up to 3.5% in 2024 and 4.0% in 2025, thereby broadly returning to the pre-pandemic growth rates. Consumer price inflation continued to rise steadily throughout 2022 and beyond, reaching 16.2% in March 2023, but the ERP expects it to start declining in the first half of 2023 and to return to within the target range (3% ±1.5 percentage points (pps) towards the end of 2024. High energy import costs and production outages at the domestic electricity utility caused the current account deficit to increase sharply in 2022 and the programme projects it to stay above 6% of GDP throughout 2023-2025. In a context of continued high uncertainty, the growth outlook is, as elsewhere, subject to a series of downside risks associated with Russia's war of aggression against Ukraine and related geopolitical tensions, such as further fluctuations in energy prices and global trade restrictions, but also supply chain disruptions, persistent high inflation and further tightening of financial conditions.

The fiscal strategy projects a gradual improvement in the budget balance and continued debt reduction over the medium term. In 2022, the general government budget deficit fell by one percentage point (pp) to 3.1% of GDP as high fiscal support to state-owned energy utilities and a series of ad hoc expenditure measures were largely offset by the balance-improving effects of high inflation. The 2023 budget targets a moderate further reduction of the deficit, helped by lower energy support measures. Further gradual expenditure-based fiscal consolidation is projected to bring the budget into compliance with the new deficit rule([80]) that will be applicable from 2025. The debt-to-GDP ratio decreased by 1.5 pps to 55.6% in 2022 and is projected to moderately decline further in 2023-2025. There has been substantial progress in fiscal governance reforms in 2022, but some gaps remain unaddressed and have been further exposed by the energy crisis, especially as concerns the oversight and governance of state-owned enterprises (SOEs).

The main challenges Serbia faces are the following:

- **Fiscal sustainability needs to be better anchored by a consistent application of the new framework of fiscal rules and backed up by reforms.** Serbia has been able to very substantially mitigate the recent crises by using available fiscal buffers and is projected to go on achieving good macro-fiscal results. Given the high degree of uncertainty about the further repercussions of Russia's war of aggression against Ukraine, standing ready to provide further targeted and temporary energy crisis mitigation if needed seems appropriate. A gradual return to a more prudent fiscal position in line with the new fiscal rules is key to rebuilding fiscal space in the medium term, which could also be enhanced by further improvements in medium-term budgeting.

- **There is further scope for managing and addressing fiscal risks and improving revenue administration.** Greater transparency around fiscal risks would make them easier to address. This is particularly true for state-owned enterprises, where there are significant governance deficiencies and incomplete restructuring and privatisation that still represent a substantial risk to public finances. On

([80]) The deficit rule consists of a general government deficit ceiling set by reference to the level of debt (3% of GDP if debt is below 45% of GDP; 1.5% of GDP if debt is below 55% of GDP; 0.5% if debt is below 60% of GDP and 0% if debt is above 60% of GDP).

the revenue side, there is scope for further improvements in the tax administration and revenue collection.

- **Serbia's business environment is improving, with regulatory and administrative burdens easing, but significant structural challenges continue to hamper the competitiveness and growth potential of the private sector and of the economy as a whole.** The role of the state in the economy remains widespread, with privatisation efforts and measures to improve the management of state-owned enterprises lagging behind. Structural challenges remain for State aid, competition and public procurement, where existing legislation is good but is not implemented consistently enough and can still be circumvented through special procedures. Further efforts are still needed to improve the transparency, assessment and prioritisation of public investment. Businesses also continue to be affected by a lack of transparency and predictability in the way business-related legislation is adopted and this is only slowly improving. The informal economy remains a major impediment to the development of a strong business sector and the consolidation of a functioning market economy.

- **Serbia remains highly dependent on coal and a long-term strategy combining energy and climate targets is to be adopted in the course of 2023.** Serbia's competitiveness continues to be hampered by a polluting and inefficient energy sector that is not properly regulated. Inefficient energy use remains a big concern. Major investment is still needed to modernise the country's energy infrastructure and lower carbon emissions with a view to accelerating the green transition; avoiding being subject to the upcoming EU Carbon Border Adjustment Mechanism, diversifying supply and Serbia's overall energy mix and especially reducing its dependence on Russian energy supplies. The EU's energy support package and Serbia's associated action plan identify the reforms to be prioritised in the coming year as well as further reforms that must be accelerated. The IMF conditionality set out in the stand-by arrangement agreed in December 2022 is also relevant for the energy sector.

- **The share of young people not in employment, education or training (NEET) remains high.** School-to-work transitions remain as in other economies of the region more difficult than in the EU average. The introduction of the Youth Guarantee aims to address these challenges but the preparatory work for the introduction of the measure is not yet finalised, and the Youth Guarantee Implementation Plan is pending for adoption. Workers across the in all areas of employment are continuing to emigrate and the impact of the circular migration initiative cannot yet be quantified. The low labour market participation of women remains a priority issue. In addition, the number of people at risk of poverty remains high, and the social benefits for the needy part of the population do not cover the cost of living.

The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2022 has been partially implemented. The authorities have provided very substantial but mostly untargeted fiscal support to cushion the impact of the energy crisis while the 2023 budget and medium-term fiscal strategy effectively plan for gradual fiscal consolidation. Following declines in 2021 and 2022 due to high nominal GDP growth, overall spending on wages as a percentage of GDP is projected to remain stable at around 9.6% in line with the new fiscal rule adopted in 2022 setting its maximum share of GDP at 10%. A new set of fiscal rules with debt-level-dependent deficit ceilings as a cornerstone was adopted in December 2022 and is set to become fully effective in 2025. The new model of electronic fiscalisation and the transition to electronic invoicing have been successfully completed. The Ministry of Finance appears to have brought in a more robust fiscal risk analysis, but the results do not seem to have been made publicly available. The first steps in the action plan for the new state-owned enterprise ownership and management strategy have been substantially implemented. Serbia is still not prioritising investments in a harmonised manner based on relevant assessments, and issues remain in the areas of competition and State aid, as well as in the area of public procurement where the Law on special procedures for linear infrastructure projects and other exceptions to transparent public procurement remain in place. Serbia has committed to revoke the Law on special procedures for linear infrastructure projects in the course of the first half of 2023. The long-term energy and climate strategy is yet to be adopted in the course of 2023, and the renewable energy sources auction system continue to face delays. There was no measure to increase the adequacy of benefits for individuals and families under the financial social assistance scheme to reduce poverty. Partial progress has been made to facilitate school-to-work transitions by stepping up further vocational education and training and to develop a Youth Guarantee implementation plan.

The economic reform programme is partly aligned with the reform priorities identified by the European Commission. The macroeconomic and fiscal frameworks are sufficiently comprehensive and integrated with overall policy objectives, and provide a suitable basis for policy discussions and orientation. The ERP continues to lack ambitious reforms on the green transition including with regard to clean energy transition and energy efficiency, which has as in previous years been identified as one of the key structural challenges. The shared European growth model regarding green and digital transition will also have to be reinforced in the ERP process, even more so in the current geopolitical context. Regarding digital transformation, Serbia should now focus on well-targeted reforms and improving its communications infrastructure, particularly broadband roll-out. The ERP diagnoses the challenges in the areas of social protection and poverty reduction, education, employment and social policies, but the proposed measures lack clearly defined objectives.

5.2. ECONOMIC OUTLOOK AND RISKS

After a strong rebound in 2021, GDP growth was still solid in the first half of 2022 but decelerated strongly in the second half. Impacted by the economic fallout from Russia's war of aggression against Ukraine, in particular on inflation via soaring energy and food prices, overall real GDP growth slowed to 2.3% in 2022([81]). Growth was mostly driven by higher private consumption and inventories that was partially offset by a negative contribution to growth from net exports. On the supply side, growth was mostly driven by services while agriculture and construction contracted and industrial activity broadly stagnated. Following a slight increase in 2021, the annual unemployment rate fell sharply in 2022 driven by robust employment growth in the first half of the year.

The ERP's baseline scenario forecasts that the pace of output expansion will still be moderate in 2023 but will gradually accelerate thereafter. Following a projected expansion by 2.5% in 2023 (2.5 pps below the projection in the previous ERP), annual GDP growth is projected to gradually pick up to 3.5% in 2024 and 4.0% in 2025, thus broadly returning to the pre-2020 rates. This acceleration is expected to be mostly driven by a gradual pick-up in private consumption and gross fixed capital formation. From 2023, these main growth drivers are projected to be accompanied by a positive contribution of net exports as a result of export growth substantially exceeding import growth, by around 1 pp in 2023 and 2 pps annually as of 2024. As a result, net exports are expected to contribute positively to GDP growth by 0.1 pp, 0.5 pps and 0.3 pps in 2023, 2024 and 2025 respectively. The output gap remained positive in 2022 following the strong rebound in 2021, but the ERP expects it to turn slightly negative in 2023 and to remain broadly unchanged thereafter as the economy is projected to expand in line with its potential growth rate. Supported by steady economic expansion, the annual unemployment rate is projected to continue its downward trend resumed in 2022, albeit at a somewhat slower pace of around -0.5 pps annually, to 8.3% in 2025.

The baseline scenario seems plausible overall but is surrounded by high uncertainty. The growth outlook continues to be subject to a high degree of uncertainty about the further economic impact of Russia's war of aggression against Ukraine. The macroeconomic scenario appears plausible overall. In spite of the strong deceleration of growth in the second half of 2022, the projected 2.5% growth in 2023

([81]) Macroeconomic and fiscal estimates and forecasts covering the period 2022-25 have been taken from the ERPs themselves; if available, preliminary macroeconomic and fiscal outturn data for 2022 have been taken from the relevant national sources (national statistical office, ministry of finance, central bank).

appears achievable in particular as the partial recovery of domestic electricity production and a closer to average agricultural season could contribute substantially to overall GDP growth in 2023. Albeit subject to high uncertainty due to the geopolitical context, the expected moderate gradual pick-up in consumption, investment, exports and imports in 2024-2025 also appears reasonable, also in view of the inflationary environment and the related monetary tightening. However, the expected positive contribution of net exports to growth assumes a further substantial expansion of new export capacities. The projections for potential growth appear to be reasonable overall as the moderate expected growth of total factor productivity is supported by foreign direct investment (FDI) inflows, domestic innovative activity, digitalisation and structural reforms.

Table II.5.1:
Serbia - Comparison of macroeconomic developments and forecasts

	2021		2022		2023		2024		2025	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	7.5	**7.5**	2.7	**2.5**	2.4	**2.5**	3.0	**3.5**	n.a.	**4.0**
Contributions:										
- Final domestic demand	9.3	**9.6**	2.8	**2.8**	2.5	**2.0**	2.8	**3.4**	n.a.	**4.0**
- Change in inventories	-1.2	**-1.1**	0.6	**1.5**	0.0	**0.3**	0.0	**-0.3**	n.a.	**-0.2**
- External balance of goods and services	-0.6	**-1.0**	-0.8	**-1.7**	0.0	**0.1**	0.2	**0.5**	n.a.	**0.3**
Employment (% change)	2.6	**2.9**	2.5	**3.0**	0.3	**0.6**	0.5	**1.0**	n.a.	**1.2**
Unemployment rate (%)	11.0	**11.4**	9.7	**9.9**	9.5	**9.5**	9.2	**9.0**	n.a.	**8.3**
GDP deflator (% change)	5.9	**5.9**	9.7	**10.2**	11.3	**10.6**	6.0	**5.6**	n.a.	**4.3**
CPI inflation (%)	4.1	**4.0**	11.9	**12.0**	10.6	**12.5**	5.6	**5.3**	n.a.	**3.0**
Current account balance (% of GDP)	-4.2	**-4.3**	-8.6	**-9.0**	-7.8	**-8.5**	-6.5	**-6.7**	n.a.	**-6.0**
General government balance (% of GDP)	-4.1	**-4.1**	-3.9	**-3.8**	-3.4	**-3.3**	-2.8	**-2.2**	n.a.	**-1.4**
Government gross debt (% of GDP)	57.1	**57.1**	55.2	**56.9**	52.4	**56.1**	51.3	**55.1**	n.a.	**54.0**

Sources: Economic Reform Programme (ERP) 2023, Commission Autumn 2022 forecast.

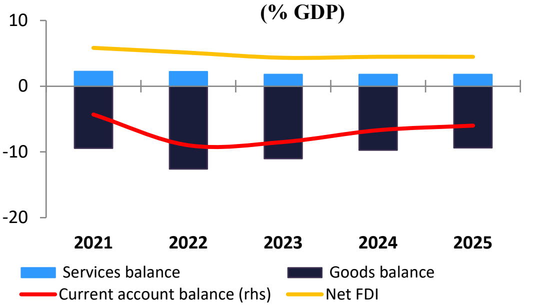
The ERP's economic risk analysis focuses on downside risks from external developments and includes a detailed alternative macroeconomic scenario. The programme identifies a series of risks to the baseline scenario related to uncertainty about the further economic impact of Russia's war of aggression against Ukraine and the ensuing changes in the geopolitical context. Fluctuations in energy prices, global trade restrictions and supply chain disruptions (particularly in the euro area gas market) could result in lower external demand and higher imported inflation than under the baseline scenario, thus dampening growth in disposable incomes and private consumption, and leading to tighter financial conditions and therefore lower investment growth. Unlike in previous years, no domestic risks have been included in the ERP's risk analysis section, which does not seem to provide a realistic assessment of the current domestic risk outlook. Under the alternative macroeconomic and fiscal scenario, which assumes that all external downside risks will materialise, economic growth in Serbia would be substantially lower (only 0.5% in 2023, 2.5% in 2024 and 3.0% in 2025) with a significant negative impact on the fiscal outlook. However, although the alternative scenario very pertinently points to the potential magnitude of risks related to a further deterioration of the geopolitical context, the ERP does not specify the scenario's underlying assumptions in sufficient detail to allow for a further assessment.

Consumer price inflation continued to rise steadily throughout 2022, but the ERP expects it to start declining in the first half of 2023 and to return to within the target range in the second half of 2024. Following an initial rise in the second half of 2021 to 7.9% year on year in December, consumer price inflation continued on a steadily increasing path throughout 2022 reaching a plateau of 15.1% in November and December followed by a further increase to 16.2% in March 2023. Average annual inflation rose from 4.0% in 2021 to 11.9% in 2022. The strong increase in headline inflation continued to be driven by food and energy prices in particular while core inflation (excluding energy, food, alcohol and tobacco) also picked up steadily throughout the year and reached 10.1% in December 2022. The

National Bank of Serbia (NBS) started to gradually raise its key policy rate in April 2022, bringing it up (in monthly steps of either 50 basis points (bps) or 25 bps) from 1% in March 2022 to 6.0% in April 2023. In line with its long-standing policy of exchange rate stabilisation, the central bank continued to intervene frequently in the foreign exchange market. Strong dinar depreciation pressures at the beginning of 2022 (due to a high level of energy imports and foreign currency cash demand by citizens following resulting from Russia's war of aggression against Ukraine) caused the NBS to sell EUR 2.3 billion on the foreign exchange market between January and April. Appreciation pressures in the remainder of the year led to cumulative purchases by the NBS of EUR 3.3 billion between May and December, resulting in net purchases of EUR 1.0 billion in 2022. The dinar remained stable against the euro in 2022 as a result. Gradual increases in electricity and gas tariffs for households (as included in the standby-arrangement (SBA) with the IMF) are still generating inflationary pressures in 2023 and the NBS expects inflation to peak in the first half of 2023 but gradually decline thereafter and to return below the upper limit of the target range (3% ±1.5 pps) in the second half of 2024. Disinflation is expected to be supported by decreasing global cost pressures, the negative output gap and an expected closer to average agricultural season. Average annual inflation is projected to rise further to 12.5% in 2023 but to fall back sharply to 5.3% in 2024 and 3% in 2025. Overall, the inflation projections appear plausible because the energy tariff increases in 2023 contribute to a backloaded disinflation profile.

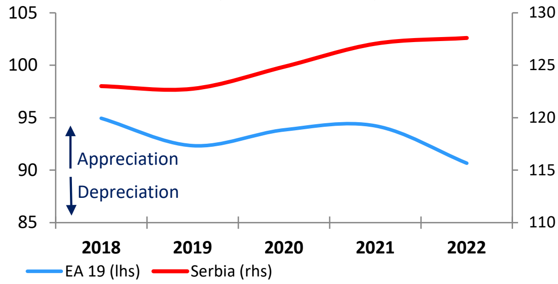
External competitiveness and current account

Graph II.5.1a: **Serbia - Current account balance (% GDP)**



Source: Economic Reform Programme (ERP) 2023.

Graph II.5.1b: **Serbia - Real effective exchange rate (CPI based, index)**



Source: Economic Reform Programme (ERP) 2023 and ECB.

The current account deficit increased sharply in 2022 and the ERP expects it to narrow only gradually and stay above 6% of GDP throughout the programme's duration. The ERP expected the current account deficit to increase from 4.4% of GDP in 2021 to 9.0% of GDP in 2022, but the actual outturn was much lower, at 6.9% of GDP. A substantially higher merchandise trade deficit (particularly due to energy imports) and a higher primary income deficit (mainly reflecting increases in reinvested earnings and dividends) were only partially offset by a higher surplus on the secondary income balance (reflecting in particular increased workers' remittances) and the services trade balance. According to the ERP's projections, the current account deficit is set to gradually narrow from 9% of GDP in 2022 to 6.0% of GDP in 2025. This is based mainly on forecasts of an improving goods trade balance (reflecting in particular lower energy imports and a foreign-direct-investment-driven increase in export capacities) and a lower primary income deficit. These balance-improving factors are expected to be partially offset by shrinking remittances as a percentage of GDP and a slightly deteriorating services trade balance.

Net inflows of FDI continue to make an important contribution to external sustainability and competitiveness. Net FDI inflows reached a record level of EUR 3.7 billion in 2021 (6.9% of GDP) and increased still further to EUR 4.3 billion (7.1% of GDP) in 2022. This was mainly driven by manufacturing and construction and continued to fully cover the current account deficit. The ERP projects that net FDI inflows will decrease to EUR 3.5 billion in 2023 before gradually rising to EUR 4.3 billion in 2025. They are thus expected to stabilise in GDP terms (at around 5.3%), but this would not fully cover the current account deficit. Provided macroeconomic stability is maintained and the business environment is further improved, the sustained inflow of foreign direct investment, which is crucial for the further structural transformation of the economy towards tradable sectors, appears plausible. The stock of net FDI continues to account for a very high share (92% in Q3-2022) of Serbia's net international investment position, which, even after declining by 9 pps from the end of 2021, still stood at a relatively high level of -74% of GDP in Q3-2022. The high share of FDI in net foreign liabilities, coupled with the relatively high level of foreign exchange reserves, reduces Serbia's vulnerability to external shocks. Foreign exchange reserves helped cushion the impact of the crisis in early 2022 and rose to a record level of EUR 19.4 billion in December 2022, also boosted by the first instalment of the SBA with the IMF (EUR 1 billion) and a bilateral loan from the United Arab Emirates (USD 1 billion). The ERP expects that foreign exchange reserves will continue to cover around 5 months' worth of imports throughout the programme's duration.

The financial sector has maintained sound macroprudential indicators, but credit growth slowed down considerably in the second half of 2022. Impacted by tightening monetary policy and stricter credit standards applied by banks to both corporates and households, lending growth moderated in 2022. Until the third quarter the rate of nominal credit growth was still close to double digits but slowed considerably in the fourth quarter to 6.1% year on year for households and 4.2% year on year for companies in December 2022([82]). A large share of the growth in business lending was for liquidity and working capital. The non-performing loan (NPL) ratio continued to decline steadily from 3.6% at the end of 2021 to 3.0% in November 2022. After a fall in 2020 due to the COVID-19 pandemic and broad stabilisation in 2021, profitability indicators improved in 2022 and broadly returned to their 2019 levels by November 2022. The share of deposits denominated in dinar decreased temporarily in early 2022 due to heightened uncertainty resulting from Russia's war of aggression against Ukraine but resumed its upward trend in June 2022 and broadly returned to the previous year's level by December (40.1% - 0.2 pps year on year). Dinarisation of banking sector claims had increased in 2020 and 2021 but decreased steadily throughout 2022 to 35.1% in December (-3.1 pps year on year). There appears to be scope to increase the financial sector's role in reaching climate and energy targets in line with European and international commitments by adopting policy measures in the area of sustainable finance (such as sustainability disclosures, sustainable finance taxonomies etc.).

Table II.5.2:
Serbia - Financial sector indicators

	2018	2019	2020	2021	2022
Total assets of the banking system (EUR million)	41 514	45 838	50 775	56 748	61 141
Foreign ownership of banking system (%)	75.4	75.7	86.0	87.0	83.4
Credit growth (aop)	4.3	9.7	12.3	9.1	10.9
Deposit growth (aop)	7.4	12.9	15.0	14.4	8.4
Loan-to-deposit ratio (eop)	1.00	0.96	0.91	0.88	0.88
Financial soundness indicators (%, eop)					
- non-performing loans to total loans	5.7	4.1	3.7	3.6	3.0
- regulatory capital to risk-weighted assets	22.3	23.4	22.4	20.8	20.2
- liquid assets to total assets	35.7	36.0	37.3	37.7	37.5
- return on equity	11.3	9.8	6.5	7.8	13.9
- forex loans to total loans*	68.5	67.1	64.7	63.2	65.5

* Includes both denominated and indexed positions.
Note: Data for December 2022 are preliminary.
Sources: ERP 2023, National Central Bank.

([82]) Given rising inflation rates, credit growth rates turned negative in real terms in 2022.

5.3. PUBLIC FINANCE

The general government deficit decreased in 2022 as a high level of fiscal support to state-owned energy utilities and a series of ad hoc expenditure measures were largely offset by the balance-improving effects of high inflation. Very good revenue performance due to high inflation, the delayed effect of the strong economic rebound in 2021 and overall containment of the main categories of current expenditure caused the general government deficit to decrease from 4.1% of GDP in 2021 to 3.1% of GDP in 2022. It thus came very close to the original 2022 budget deficit target of 3.0% and below the revised target of 3.8% of GDP despite some very substantial expenditure increases (mainly to support the state-owned energy utilities Elektroprivreda Srbije and Srbijagas to allow them to cover high energy import costs). Budget support for these two companies alone amounted to around 2.7% of GDP and drove the high outturn of budget loans to SOEs. At 2.9% of GDP, this exceeded the amount estimated in the November budget revision (2.2% of GDP). The November 2022 amending budget also included a series of ad hoc expenditure measures that the government had implemented throughout the year. This particularly concerned direct lump sum cash payments to young people aged between 16 and 30 (0.4% of GDP), increased family allowances and assistance for mothers to buy real estate (0.2% of GDP) and increased agricultural subsidies (0.2% of GDP). At the same time, the phasing-out in 2022 of the COVID-19-related 2021 fiscal support measures helped contain overall expenditure growth in 2022 at +11% year on year, which was lower than the 13.4% increase in revenue. Expressed as a share of GDP, total revenue increased by 0.1 pps, while total spending decreased by 0.9 pps due to very high nominal GDP growth. The most significant revenue increases were from VAT (+0.5 pps) and corporate income tax (+0.5 pps), while excise duties (-0.5 pps) and social contributions (-0.3 pps) recorded the most significant decreases. On the expenditure side, only net budget loans (+2.1 pps) and repayment of guarantees (+0.2 pps) increased faster than nominal GDP. The very high rise in nominal GDP caused the *ex post* share of public wages in GDP to fall from 10.0% in 2021 to 9.6% in 2022.

Table II.5.3:
Serbia - Composition of the budgetary adjustment (% of GDP)

	2021	2022	2023	2024	2025	Change: 2022-25
Revenues	43.3	43.0	40.9	40.4	39.6	-3.4
- Taxes and social security contributions	38.6	37.7	35.6	35.5	35.0	-2.8
- Other (residual)	4.7	5.3	5.3	4.9	4.7	-0.6
Expenditure	47.4	46.8	44.2	42.5	41.0	-5.9
- Primary expenditure	45.7	45.2	42.4	40.5	39.1	-6.1
of which:						
Gross fixed capital formation	7.4	7.3	6.8	6.4	6.1	-1.2
Consumption	17.9	17.5	16.7	16.5	16.2	-1.3
Transfers & subsidies	16.8	15.6	15.7	15.3	15.2	-0.5
Other (residual)	3.5	4.8	3.2	2.3	1.5	-3.2
- Interest payments	1.7	1.6	1.8	2.1	1.9	0.3
Budget balance	-4.1	-3.8	-3.3	-2.2	-1.4	2.5
- Cyclically adjusted	-4.6	-4.1	-3.2	-2.0	-1.3	2.9
Primary balance	-2.4	-2.2	-1.5	-0.1	0.6	2.8
- Cyclically adjusted	-2.9	-2.5	-1.4	0.1	0.7	3.2
Gross debt level	57.1	56.9	56.1	55.1	54.0	-3.0

Sources: Economic Reform Programme (ERP) 2023, Commission calculations.

The planned gradual return to a prudent fiscal position in line with the new deficit rule is a welcome objective of the ERP's fiscal strategy over the medium term. The very high level of support to the energy sector in 2022 that is projected to be only gradually phased out over 2023-2025 means that the fiscal consolidation planned in the previous ERP was again largely postponed by one year at slightly higher annual deficit levels. The deficit is projected to be reduced to 3.3% of GDP in 2023, 2.2% in 2024 and 1.4% in 2025 – so below the 1.5% limit set by the new fiscal rule if debt is lower than 55% of GDP. This is consistent with a gradual fall in the debt-to-GDP ratio to below 55% in 2025. The overall planned fiscal stance appears appropriate to ensure medium-term fiscal sustainability. The tightening of the cyclically-adjusted primary balance is expected to be frontloaded in 2023-2024.

The ERP expects the improving fiscal balance to be driven by a strong decrease in the expenditure-to-GDP ratio over 2023-2025([83]). The decreasing spending ratio (-5.9 pps between 2022 and 2025) results from the planned gradual reduction of support to the state-owned energy utilities; the non-renewal of one-off support measures adopted in 2022; the decreasing share of capital expenditure from a high base; and modest growth below nominal GDP for most spending categories in 2023-2025. Social transfers as a share of GDP are projected to remain broadly stable at around 13% throughout 2022-2025, reflecting an increase in the share of pensions by 0.9 pps to 9.9% of GDP and a 0.8 pps decrease in the share of other social assistance to 3.2% of GDP. The latter is mostly frontloaded in 2023, reflecting the non-recurrence of the one-off payments to pensioners implemented in 2022. On the revenue side, the ERP expects a 3.4 pps fall in the revenue ratio in 2023-2025. This decrease is set to be mostly frontloaded in 2023 (-2.1 pps compared with the ERP 2022 estimate) as a result of revenue-decreasing discretionary measures (such as the reduction of employers' social contributions by 1 pp) and the expiry of one-off factors that boosted revenue in 2022, including the deferred payment of 2020 social contributions. The share of excise duties as a proportion of GDP is also expected to decline by 0.7 pps in 2023 which reflects, among other factors, the extension of the temporary reduction of excise duties on certain petroleum products that was initially introduced in March 2022. Good collection performance in 2022 means that VAT projections for 2023 (a 0.2 pps decline in VAT receipts) are very conservative. As in previous years, the programme also estimates non-tax revenue prudently, based on the conservative exclusion of extraordinary non-tax revenues([84]) for future budget planning (this entails a -0.3 pps drop in 2023). The only revenue item that is projected to increase as a percentage of GDP in 2023 is donations, which are expected to increase by 0.4 pps (mostly due to the budget support received from the EU to address the energy crisis). VAT, corporate and personal income tax are projected to increase broadly in line with nominal GDP in 2024, but overall revenue as a share of GDP is still expected to decrease by 0.5 pps, mostly reflecting the non-recurrence of the EU's energy-crisis-related budget support. The further drop of revenue as a share in GDP by 0.8 pps in 2025 mostly reflects conservative assumptions regarding non-tax revenue and excises and prudently low revenue elasticities for VAT, corporate and personal income tax.

The 2023 budget targets a relatively minor reduction of the deficit. As a result of decreases in both the revenue and expenditure ratios by 2.1 pps and 2.6 pps respectively, the 2023 budget plans a moderate headline fiscal consolidation of 0.5 pps to 3.3% of GDP (which would even correspond to a slight 0.2 pps increase compared with the actual 2022 deficit of 3.1% of GDP). On the revenue side, the 2023 budget introduces some changes to tax legislation that mostly build on gradual adjustments initiated in previous years. These adjustments concern the planned further small increase in the tax-exempt part of gross salaries which will slightly reduce the tax wedge on labour (though only in nominal terms given the increase in inflation) and a 1 pp decrease in the rate of employers' pension contributions. The budget also extends the temporary reduction of excise rates on certain petroleum products (introduced in March 2022) and does not apply the usual indexation of excise duties to the previous year's inflation. On the expenditure side, the 2023 budget reduces the expected net budget loans to the state-owned energy sector by around 0.5% of GDP. The budget increases pensions by 12% as from January 2023, in line with the modified indexation rule. This comes on top of the 9% ad hoc increase granted in November 2022 and therefore brings the full year-on-year pension increase in 2023 to around 20.5%. The minimum wage has

[83] In this paragraph, all changes in the 2023-2025 revenue and spending ratios in comparison to 2022 refer to expected changes as compared to the 2022 ERP estimates.

[84] Ordinary non-tax revenues include various fees, charges, revenues of bodies, etc. that are generated at a broadly steady rate over the year but with some seasonal variations. Extraordinary non-tax revenues include profits of public companies and agencies, budget dividends, etc.

been increased by 14.3%. Public sector wages have been increased on an ad hoc basis by 25% for professional military personnel and by 12.5% for all other public sector employees, thus resulting in an overall average increase of around 13%. This is projected to bring overall general government wage expenditure to 9.6% of GDP (i.e. within the 10% limit stipulated in the new fiscal rule which entered into application in 2023). Capital expenditure is projected to decrease to 6.8% of GDP in 2023 (following an ERP estimate of 7.3% GDP in 2022 and an outturn of 7.2% of GDP).

Box II.5.1: **The budget for 2023**

The Serbian parliament adopted the 2023 budget on 9 December 2022.

The general government deficit target for 2023 was set at 3.3% of GDP. This indicates some policy tightening when compared with the ERP estimate of 3.8% of GDP for 2022 but a slight fiscal easing when compared with the actual 2022 result of 3.1% of GDP. On the revenue side, the main discretionary fiscal policy measures are the reduction in employers' contributions to pension insurance by 1 pp and an increase in the personal income tax allowance. The main new expenditure measures are the decrease of budget loans to energy utilities and a decrease in capital expenditure.

Main discretionary fiscal measures in the 2023 budget*

Revenue measures	****Expenditure measures**
• reduction by 1 pp of the pension insurance contribution paid by employers **(-0.4 % of GDP)** • increase in personal income tax allowance from RSD 19 300 to RSD 21 712 (**-0.1% of GDP**) • Instrument for Pre-Accession assistance (IPA) budget support grant **(+0.2% of GDP)**	• decrease in budget support to energy utilities **(-0.5% of GDP)** • decrease in capital expenditure **(-0.5% of GDP)** • energy subsidies financed by IPA grant **(+0.2% of GDP)**
Total revenue effect (-0.3% of GDP)	**Total expenditure effect (-0.8% of GDP)**

* Estimated impact on general government revenue and expenditure compared with the 2022 ERP estimate.

** This table does not include the main expenditure impact corresponding to the carry-over effect from the November 2022 additional pension increase because this had already been adopted in the November 2022 amending budget.

The ERP expects the public debt ratio to continue gradually declining due to high nominal GDP growth and an improving primary balance. The general government debt-to-GDP ratio continued to decrease to 55.6% in 2022 (1.3 pps lower than the ERP estimate of 56.9% due to the lower-than-projected deficit outturn and lower deficit-increasing stock-flow adjustments). The ERP projects the debt ratio to fall by 1.0 pp annually on average in 2023-2025 thanks to high nominal growth and a further gradual improvement in the primary balance. These debt-reducing effects are expected to be only partly offset by positive stock-flow adjustments, which are not further specified. Less favourable conditions on international and domestic financial markets meant that Serbia did not issue any Eurobonds in 2022 to cover the increased financing needs related to costly energy imports, but it did agree a two-year standby arrangement (SBA) with the IMF (worth approximately EUR 2.4 billion and replacing the non-disbursing Policy Coordination Instrument) with an immediate disbursement of EUR 1 billion in December 2022. Serbia also secured a bilateral loan from the United Arab Emirates of USD 1 billion, which was also disbursed in December 2022. On 19 January 2023, in view of some stabilisation of financing conditions on international markets, Serbia issued a USD 1 billion ten-year eurobond and a USD 750 million five-year eurobond at coupon rates of 6.25% and 6.5%, respectively85. The large proportion of foreign currency-denominated debt (74.6% in Q3-2022) continues to expose government debt to exchange rate risks (as demonstrated by the ERP's debt sensitivity analysis). This risk is nevertheless mitigated by the authorities' exchange rate stabilisation policy, which is underpinned by ample official foreign exchange reserves. The recently adopted reinforced rules-based framework designed to better anchor fiscal policy may also play an important role in reinforcing medium-term debt sustainability.

Box II.5.2: **Debt dynamics**

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

	2021	2022	2023	2024	2025
Gross debt ratio [1]	**57.1**	**56.9**	**56.1**	**55.1**	**54.0**
Change in the ratio	-0.7	-0.2	-0.8	-1.0	-1.1
Contributions [2]:					
1. Primary balance	**2.4**	**2.2**	**1.5**	**0.1**	**-0.6**
2. "Snowball" effect	**-5.1**	**-4.8**	**-4.7**	**-2.6**	**-2.3**
Of which:					
Interest expenditure	1.7	1.6	1.8	2.1	1.9
Growth effect	-3.8	-1.3	-1.2	-1.8	-2.0
Inflation effect	-3.0	-5.1	-5.3	-2.9	-2.2
3. Stock-flow adjustment	**2.0**	**2.4**	**2.4**	**1.5**	**1.7**

[1] End of period. In accordance with the Budget System Law. This includes all government-guaranteed debt and non-guaranteed local government debt. It differs from government debt according to the national methodology (Public Debt Law), which does not include non-guaranteed local government debt.
[2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).
The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other effects.
Source: Economic Reform Programme (ERP) 2023, Commission calculations.

The government debt-to-GDP ratio decreased by 1.5 pps in 2022 (more than the ERP projection of 0.2 pps). This decrease resulted from the effects of high inflation and moderate real growth, which more than offset the debt-increasing impact of the primary deficit, interest expenditure and positive stock-flow adjustments. The ERP expects that the primary balance will still have a substantial debt-increasing impact in 2023 and that this impact is set to turn broadly neutral in 2024. In 2025, stock-flow adjustments and interest expenditure are projected to remain the only debt-increasing factors. High inflation, reaccelerating real growth and the return to a primary surplus are expected to ensure a moderate downward trend for the debt ratio over 2023-2025. It is projected that the improvement in the debt-to-GDP ratio will continue to be slowed down by substantial debt-increasing stock-flow adjustments that reflect reserves for potential higher use of project loans, possibly higher local government debt and potential adverse shocks due to current global circumstances. Restitution-related debt could also contribute to an increase in the debt-to-GDP ratio by around 3 pps.

(85) The corresponding USD exposure has been hedged into EUR, which reduces exchange rate risk under the current policy of a de facto stabilised RSD exchange rate against the EUR.

There are some short-term upside fiscal risks related to conservative revenue estimates and easing energy price pressures, while structural downside fiscal risks persist in the medium term. In the short term, despite a high degree of uncertainty surrounding the economic outlook, there are some upside risks relating to the achievement of the 2023 fiscal targets because budget revenues have been forecast using conservative assumptions. Also on the revenue side of the budget, the new electronic fiscalisation model and transition to electronic invoicing have been successfully completed and constitute an upside risk because they may have a significant impact by shrinking the grey economy, increasing VAT collection and improving the tax control process. Moreover, the gradual retail price increases for gas and electricity agreed in the SBA might (in combination with lower than expected international energy prices and the earlier reestablishment of domestic electricity production capacity) reduce the need for the budget transfers to the state-owned electricity company Elektroprivreda Srbije and to Srbijagas as compared to budget plans. On the other hand, new unforeseen economic repercussions from the Russian war of aggression against Ukraine may call for further fiscal mitigation measures. In addition and as in previous years, new non-budgeted ad hoc expenditure measures could be announced. Looking ahead, revenue projections remain relatively conservative in terms of elasticities but keeping expenditure growth below the nominal growth of GDP might be challenging for some expenditure categories in view of their track record (particularly for spending on employees, subsidies and transfers to state-owned enterprises). Given the scale of fiscal risks stemming from inefficient state-owned enterprises (as highlighted by the ERP's sensitivity analysis), more transparency and effective implementation of structural reforms in this area (particularly as regards EPS and Srbijagas([86]) seem crucial in order to ensure the sustainability of the targeted 2.1 pps of GDP reduction in net budget loans (and even a reduction of 2.8 pps when compared with the 2022 outturn). The further implementation of the SOE ownership and management strategy could play an important role in this regard. As in previous years, the programme does not mention the restitution-related obligations of EUR 2 billion (around 3% of 2022 GDP) concerning properties confiscated by the communist government after the Second World War. The government confirmed the arrangements for monetary compensation in 2021 and the first government bonds specifically relating to this were issued in January 2022 and January 2023 (to a value of EUR 69 million (0.1% of GDP) and EUR 40 million (0.05% of GDP) respectively). The guarantee schemes set up during the COVID-19 crisis in 2020 and 2021 also constitute a contingent liability that may be triggered to some extent. The schemes had an initial loan volume of EUR 2 billion (around 4.3% of 2020 GDP) with a maximum state guarantee of 30% at portfolio level. The original 2020 scheme was topped up in 2021 with an additional EUR 500 million (1% of GDP) and complemented by a new guarantee scheme to the same amount to support the most affected sectors and enterprises. However, updated estimates for the two guarantee schemes point to relatively low default risks in the coming years([87]). Another non-negligible fiscal risk concerns decisions by domestic and foreign courts that result in fines and damages payable by government bodies. Such potential obligations may in particular arise from the legacy of the Socialist Federal Republic of Yugoslavia (e.g. from ongoing complaints by employees of former socially-owned enterprises).

Recent improvements in the quality of public finances are set to be consolidated. The projected breakdown of public expenditure confirms that progress has been made towards a stronger pro-growth orientation of the budget, especially as regards the share of capital expenditure. After a record level of public capital expenditure of 7.5% of GDP in 2021 and an ERP estimate of 7.3% of GDP in 2022 (the actual result was 7.2% of GDP), the ERP forecasts annual decreases of around 0.4 pps over 2023-2025, which will gradually bring the ratio down to 6.1% of GDP, which is still high. There is nevertheless room to strengthen the cost-effective implementation of infrastructure spending by applying the same rigorous selection and management framework to all projects, regardless of the source of financing. Health

([86]) As regards EPS and Srbijagas in particular, it appears essential to effectively address governance challenges and implement structural reforms despite the expected short-term improvements in financial outcomes resulting from the scheduled increases in electricity and gas prices,

([87]) The revised 2023-2025 fiscal strategy expects gross fiscal outflows related to the guarantee schemes to be limited to 0.12% of GDP in 2022, 0.07% in 2023 and 0.01% in 2024.

expenditure([88]) peaked at 7.1% of GDP in both 2020 and 2021 due to the COVID-19 pandemic and is estimated to have remained high at 6.6% of GDP in 2022. After a further fall to 6.1% of GDP in 2023, it is expected to stabilise at that level in 2024 and 2025 (i.e. still 0.8 pps of GDP above the pre-COVID-19 crisis level). Education spending as a proportion of GDP is projected to remain unchanged at the 2022 estimated level of 3.1% of GDP throughout the programme period. Interest expenditure is projected to gradually increase from an estimated 1.6% of GDP in 2022 to 1.8% in 2023 and 2.1% of GDP in 2024 (in line with less favourable financing conditions and the relatively slow projected decrease in the debt-to-GDP-ratio) before slightly decreasing to 1.9% of GDP in 2025 (in line with the decreasing debt level). On the revenue side, increasing the tax-free allowance for personal income tax and lowering employers' pension contributions by 1 pp should help to gradually reduce the tax wedge for low-income earners. To make informal labour less attractive, there may be grounds for raising the threshold further and above the inflation rate.

Structural fiscal reforms progressed well in 2022, particularly as regards the adoption of revised fiscal rules. Following a delay of several years (due in part to the COVID-19 crisis), a new system of fiscal rules was adopted through a corresponding revision of the budget system law in December 2022. The central rule consists of a general government deficit ceiling set by reference to the level of debt (3% of GDP if debt is below 45% of GDP; 1.5% of GDP if debt is below 55% of GDP; 0.5% if debt is below 60% of GDP and 0% if debt is above 60% of GDP). This deficit rule has already been adopted but will only enter into force in 2025 because specific deficit targets for 2023 and 2024 had already been agreed in the SBA with the IMF. The new rules also include a cap on the general government wage bill at 10% of GDP and a modified rule for pension indexation for which the calculation methodology will vary according to the ratio of pension expenditure to GDP([89]). The enforcement mechanism might need to be strengthened, but the new rules can be considered to be reasonably credible and binding due to their relative flexibility at lower debt levels / lower shares of pensions/salaries relative to GDP. It would seem appropriate to reinforce the medium-term perspective of the fiscal rules' implementation by strengthening medium-term budgeting. The public sector wage system reform has been postponed to 2025, but the new central electronic public wage and employment registry (Iskra) became operational for some sectors in 2022 and will be rolled out to most of the public sector (except military, security and higher education institutions) by the end of 2023 as an important preparation for the reform. The November 2022 amending budget was adopted using the urgent procedure, but the 2023 budget was adopted broadly in line with the normal legislative procedure (albeit with some delay). Neither the 2022 amending budget nor the 2023 budget provide an adequate level of transparency regarding the breakdown of capital transfers and guarantees to SOEs, in particular to EPS and Srbijagas. There was a meaningful parliamentary debate on the 2023 budget and the government also submitted the final annual budget execution report for 2021 to the parliament. The well-established Fiscal Council has continued to function properly and produce independent fiscal assessments and recommendations. Budgetary statistics have been delivered on time, but budget execution reports still lack information on large one-off measures.

5.4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

Serbia has been gradually restructuring its economy, mainly by investing in the tradable sector and further integrating it with the EU. Exports have been a major driver of growth. Manufacturing has modernised and diversified in recent years, but traditional industry, notably the energy sector, has not undergone sufficient opening or restructuring. Its underperformance continues to undermine Serbia's competitiveness and economic growth potential - this has been accentuated during the current energy crisis, as long-standing structural issues remain unaddressed. Moreover, Serbia will only be able to

(88) As defined using the functions of government (COFOG) classification.

(89) Pensions are indexed in line with average earnings if they represent less than 10% of GDP. If they represent between 10% and 10.5% of GDP, then the indexation rate is the total of half the growth rate for average earnings and half the inflation rate (the 'Swiss formula'). If they represent more than 10.5% of GDP, then they are indexed in line with inflation.

achieve higher growth rates in the longer term if it makes better use of the opportunities offered by the single market and the service sector, and ensures a level playing field for all companies. Further economic growth and improvements in living standards towards EU levels will therefore depend on the continuous implementation of structural reforms across many sectors.

The Commission has conducted an independent analysis of Serbia's economy and identified three key structural challenges to competitiveness and inclusive growth, drawing on Serbia's own ERP and other sources:

(i) increasing employment, in particular of young people, women and vulnerable groups, and social protection to combat poverty;

(ii) creating a more favourable business environment for investment, and

(iii) greening and diversifying Serbia's energy sector, reducing dependence on Russian energy supply and fully opening the energy market.

While the Serbian economy continues to experience several obstacles to inclusive growth and competitiveness the three key structural challenges through properly targeted reforms offers the biggest potential for economic resilience, and inclusive growth and competitiveness. The Commission welcomes that Serbia has broadly identified the same three key structural challenges in Chapter V of its ERP. However, there are some differences in substance, chiefly for key structural Challenge 3 on greening and diversifying Serbia's energy sector, reducing dependence on Russian energy supply and fully opening the energy market. The ERP still does not sufficiently focus on the greening aspects of this challenge, which the Commission considers to be key to reforming the sector. This year's ERP recognises that the energy market should be fully opened as well as the need to diversify the energy sector away from Russia, but the reform measures currently planned by Serbia are not sufficient to achieve these objectives.

Serbia needs to tackle corruption, improve the rule of law and strengthen institutions in order to promote competitiveness. Addressing these fundamental concerns is a prerequisite for a successful transformation of the economy. The Commission is closely monitoring the issues of strengthening the rule of law and fighting corruption in its annual Serbia report.

Furthermore, the country should proactively implement the Energy Community's Decarbonisation Roadmap to achieve the agreed climate and energy targets, and strive towards establishing a carbon pricing instrument compatible with the EU ETS.

Key challenge #1: Increasing employment, particularly of young people, women and vulnerable groups, and social protection to combat poverty

The labour market has rebounded since the peak of the COVID-19 pandemic. The employment rate (aged 20-64) rose from 64.3% in 2020 to 66.7% in 2021, whereas the activity rate (aged 15-64) rose from 66.4% to 70.3% in the same period. This is the highest level for both indicators in the last 10 years. Serbia is making steady progress towards the EU's average employment and activity levels, but there is still some way to go (the average employment rate of the EU-27 was 73.1% and the average activity rate was 73.6% in 2021). The unemployment rate for all age groups taken as a whole rose from 9.1% in 2020 to 11.1% in 2021 but declined again in 2022 (it was 8.9% in Q3-2022). The rate for the EU-27 in 2021 was 7%. Here too, Serbia is close to some EU Member States.

Despite an overall good performance in all area of employment, Serbia continues to face structural challenges that are hampering further improvement. Many of its young people are emigrating to the EU and other economies where they can enjoy better career prospects in all fields of employment. This outflow is compromising Serbia's economic growth potential. The average and median salaries were EUR 882 and EUR 490 respectively in Q3-2022. The 2022 housing and population census revealed that Serbia's population had fallen by 402 193 compared with the previous census in 2011 (Serbian Statistical Office 2022). The share of the working population aged 15-64 decreased from 68.3% in 2011 to 64.4% in 2021. Around 14% of people who were born in Serbia now live abroad (ETF, 2021). This labour outflow is particularly (but by no means exclusively) weakening the health and service sectors in the Serbian countryside and the Serbian economy's overall growth perspective. It also poses a challenge to the ongoing green and digital transition, which requires new skills to be available on the labour market. The Serbian ERP acknowledges the need to provide incentives to encourage the Serbian diaspora to return home and the need to attract foreign experts. The Serbian government has adopted the strategy on economic migration of the Republic of Serbia for the period 2021-2027 (Official Gazette of the RS, No. 21/20) and an action plan to implement this strategy. The strategy covers a range of topics related to the economic migration, its management, the correlation between migration and development, and the diaspora's potential role as a driver of (local) development. Serbia is proposing Reform Measure 4 ('improvement of the environment for encouraging, supporting and monitoring circular and economic migration') in this context. This measure has been rolled over from the two previous ERPs. It remains a valuable initiative, but it would also be worthwhile to examine how effective the reform measure is in practice and Serbia should therefore quantify how many highly qualified (and other) people have returned home to Serbia. Data are collected periodically and the next data set is due to be collected in April 2023.

School-to-work transitions have improved but remain structurally difficult. The low quality of available jobs is limiting young Serbians' chances of properly establishing themselves in the labour market, and they remain more likely to be in temporary and/or informal employment than other age groups. 52.4% of young people (aged 15-24) have only temporary jobs and the rate of young persons in informal employment is 4.8 pps higher than for the overall working-age population. The high NEET (not in employment, education or training) rate only began to decrease in the 15-29 age group in 2021 (from 20% in 2020 to 18.8% in 2021). However, insufficient investment in human capital, limited capacities of the public employment service and the unfinished reform of VET resulted in this age group having lower employment prospects than older age groups. Serbia is addressing this by upgrading VET.

Reform Measure 3 ('qualifications oriented to the needs of the labour market') will introduce a dual VET system. The measure has been rolled over from several years, but the share of dual VET has stagnated at 5% despite plans to reach 12% by 2025. It seems reasonable to increase the share of dual VET and to improve quality standards in the remaining school-based VET education in order to improve the overall situation. Serbia also needs to launch the Youth Guarantee, which is a flagship initiative for the Western Balkan economies under the economic and investment plan (EIP) and an EU-tested tool to get young people in to employment. To this end Serbia has launched the Reform Measure 1 ('establishment of a framework for the introduction of the Youth Guarantee in the Republic of Serbia'). The goal of this structural reform is to provide young people with an offer of high-quality employment, continuing education, an internship or training within a period of four months of becoming unemployed or leaving education. Serbia needs to implement this measure consistently and to adopt its Youth Guarantee implementation plan in line with the Western Balkans Declaration on ensuring sustainable labour market integration of young people (Brdo Declaration of 9 July 2021). The staffing and resources of the Serbian public employment service need to be significantly upgraded to make it effective and fit for purpose.

The female employment rate is still significantly lower than the male employment rate (the employment rate of women aged 15-74 in the third quarter of 2022 was 43.9%, while the employment rate of men was 58.3% – a gender employment gap of 14 pps). Female labour force participation is a key factor for the future development of the labour market and the economic growth. The picture is better for the gender pay gap, remaining stable at 8.8% and lower than the EU average (14.1%). The percentage of children aged under 3 years in formal childcare was 17.2% in 2019. Bringing this closer to the EU-27 average of 35.3% by upgrading childcare facilities would help to bring more women into paid work and would thus help narrow the gender employment gap. Serbia scores 58.0 points in the Gender Equality

Index, which is below the EU-27 average of 67.4 but nonetheless higher than some individual EU Member States. This score has improved by 2.2 points on 2016, but the European Institute for Gender Equality (EIGE) estimates that it will take another 59 years to reach full equality at the current rate of change. Serbia is addressing gender equality with a 2021-2030 gender equality strategy and an associated action plan, but the ERP does not outline the concrete measures of this action plan – even though this should be a matter of priority.

Active labour market policies remain underfunded at 0.1% of GDP in 2021. The 2021 national employment strategy includes an employment rate target of 66.1% for those aged 15-64 in 2026. This would be an increase of 5.9% compared with the base year of 2019. More offers for reskilling and upskilling with a view to the green and digital transformation of the society could help achieve the employment target. The 'my first salary programme' was a good example of an active labour market policy. Serbia is fostering social enterprises and adopted a Law on social entrepreneurship in February 2022. Social enterprises have great potential to provide inclusive employment to the more vulnerable sections of the national workforce. Helping such enterprises is therefore a worthwhile initiative and in line with policy developments in the EU.

Serbia has not tapped the full potential of social dialogue, which can advance economic development. Collective bargaining in the private sector remains limited and there are only a few sectoral agreements. Sectoral agreements in the private sector could promote a level playing field in various areas and provide benefits such as complementary pensions. The expertise of social partners in view of VET reskilling and upskilling of the workforce is not being put to use. In addition, social partners and government have not been able to agree on an adequate minimum wage in recent years, with the result that the government has had to set the level of the minimum wage by decree. The minimum wage has been approximately RSD 40 000 (around EUR 340) since January 2023. This is roughly the price of the minimum consumer basket for a three-person household This is just above the EUR 337 minimum consumer basket for a three-person household in 2021. But the fact that minimum wage recipients still need to pay taxes and social security contributions means that it hardly constitutes a living wage. Reducing the tax wedge for low incomes would help to curb poverty and labour migration. The social dialogue institution (the Economic and Social Council) has to issue opinions on government initiatives but is not always consulted in good time and is therefore unable to function properly.

Lower secondary school education results for 15-year-olds lag behind the EU average, although Serbia's PISA rating is the best in the Western Balkans and its average scores are close to those of some EU Member States (Bulgaria, Greece and Romania). The average score is 439.5 in reading (EU: 481.7; Western Balkans: 402), 448.3 in mathematics (EU: 488.6; Western Balkans: 414) and 439.9 in science (EU: 484; Western Balkans: 408). Entry into upper secondary programmes is not equitable because boys are twice as likely as girls to attend VET which is not conducive to increasing female labour market participation. The high proportion of early school leavers (young people aged 18-24 who at best completed primary education and did not pursue further education) continues to be a problem and amounted to 5.1% in the third quarter of 2022. Upskilling efforts to improve their employability remain necessary given current and future anticipated skills shortages. Serbia has introduced structural reform measure 2 ('the young talent fund reform'), which is intended to promote academic excellence in public administration and in the economy. This is a commendable measure but is limited in scope with 225 funded talents in the Serbian administration and economy targeted by 2025.

Serbia's ERP also recognises the challenges in the field of social protection but has not yet addressed them with suitable measures. The AROPE (at-risk-of-poverty or social exclusion) rate was 28.4% in 2021 (6.7 pps more than the EU average of 21.7%) The impact of social transfers (excluding pensions) on poverty reduction was 18.02% in 2019 (32.38% for the EU-27). As noted above, the average minimum consumer basket for a three-member household in Serbia was EUR 337 in 2021, while the poverty risk threshold for a three-member household (two adults and one child under the age of 14) was EUR 368. At the same time, the amount of social assistance received by a three-member family amounted to EUR 147, which was less than half of the average minimum consumer basket and less than half of the poverty risk threshold. There is therefore an urgent need to properly fund and resource social policy. Serbia has committed itself to the European Pillar of Social Rights which includes adequate social protection. The policy guidance of past ERPs has unfortunately not been taken into consideration because Serbia has increased the financial social assistance (FSA) benefit only slightly nominally and below the inflation rate, which has led in turn to a de facto fall in the level of benefits. The Commission therefore reiterates its policy recommendations from the 2021 and 2022 ERP cycles and calls on Serbia to substantially increase its FSA social benefits to an adequate level close to or at the cost of living. The Law on the Social Card, which was presented in previous ERPs, came into force in 2022. It established the Social Card Register to better coordinate and follow up social benefits, but it does not affect the adequacy of benefits. Serbia is also working on amendments to the Law on Social Protection, whose exact scope and impact is not yet known. It is intended to improve the procedure for activating working-age beneficiaries of financial social assistance. This seems to be a rationalisation and activation effort, rather than an increase in the level of benefits for the vulnerable part of the population. Finally, Serbia has been working for several years on its new social protection strategy. Its ambition and impact will need to be checked once it has been issued.

Key challenge 2: Creating a more favourable business environment for investment

Serbia's business environment is improving, but significant structural challenges still have to be addressed if Serbia is to achieve its economic growth and competitiveness potential. Serbia has made notable progress in reducing the regulatory and administrative burden on businesses and in particular through digitalisation efforts, which were accelerated by the pandemic, such as expanding e-commerce. However, the impact on SMEs was limited. Key structural challenges nonetheless remain largely unaddressed, relating primarily to the continued strong footprint of state-owned enterprises (SOEs) in the economy and their market dominance in key sectors that remain unreformed, threatening the level-laying field. Unaddressed issues also include insufficient transparency, reliability and predictability of the regulatory framework.

Serbia has recorded strong inflows of foreign direct investment in recent years but private domestic investment is still lagging behind. Addressing the remaining issues would encourage both private and public, domestic and foreign investment, including in industries that play a key role in sectors crucial to making progress in digitalising and greening the economy in line with the Green and the Digital Agendas for the Western Balkans, and the need to move with some urgency towards renewable and more diversified energy sources away from Russian sources and in line with the REPowerEU strategy, as well as to avoid Serbian goods becoming subject the upcoming EU Carbon Border Adjustment Mechanism. Addressing the remaining issues would also boost competitiveness, medium-term growth potential and job creation. The economic and investment plan for the Western Balkans and the further development of the common regional market will help increase the competitiveness of the economy backed by a digital and green transition, but to achieve the economy's full potential, a conducive business and investment climate is crucial. The government's ERP therefore rightly continues to recognise the importance of improving the business environment and attracting investment to further boost Serbia's economic growth and competitiveness as one of the three structural challenges also in this year's ERP.

The role of the state in the economy is shrinking but remains large and hampers competition, while the continuing poor management and financial performance of many state-owned enterprises (SOEs) constitutes a fiscal problem. Outside the financial sector, privatisation and restructuring efforts have largely stalled and SOEs continue to dominate many sectors, including energy, transport, utilities, telecommunications, infrastructure, mining, and extraction of natural resources. This outsized presence deters private investment and innovation, and impedes overall competitiveness. Furthermore, many of Serbia's state-owned enterprises do not apply corporate governance rules and operate with low efficiency and high costs. Most public companies continue to rely on state support, in the form of direct or indirect subsidies. The poor management and subsequent financial performance of these companies poses substantial fiscal risks, as recently confirmed by Elektroprivreda Srbije's (EPS) losses of nearly EUR 630 million in 2022. This is of particular concern in the current context of rising inflation and other disturbances accentuated by Russia's war of aggression on Ukraine, and potential new external shocks to the economy.

Governance of SOEs also continues to pose problems and a large share of the directors are in acting capacity, many having expired mandates as the law on public enterprises limits the tenure of acting directors to 12 months. This stands in the way of a root-and-branch reform of these companies, including more professional management. Improving the efficiency of public enterprises would reduce the strain on public finances and improve the quality of services, level the playing field, and limit the scope for preferential treatment and politically influenced decisions. The new Law on SOEs, which is currently in the drafting stage is expected to make it possible to address these issues.

The legal framework in competition and State aid is largely in line with the EU *acquis*, but implementation still needs to be improved. The commission for protection of competition and the commission for state aid control have both had their administrative capacity increased and are operating as legally independent bodies. However, the track record of the commission for protection of competition is not sufficiently consistent and transparent, and the independence of the commission for state aid control has yet to be demonstrated through a consistent and transparent track record. In the area of State aid, well defined rules are not always implemented due to strong political pressure for financial assistance, channelled to SOEs and large foreign investors. These resources are often substantial and may have a significant impact on competition. State support is not sufficiently transparent, including in the 2023 budget.

A robust process for transparent appraisal and selection of public investment projects is a priority, given Serbia's significant infrastructure needs and long pipeline of future projects, including projects for the green and digital transition, and for the diversification of the energy sector. The legislative framework for public investment management remains unsatisfactory as regards transparency, assessment and prioritisation of investment. The new legislative framework for public investment management from 2019 still allows too many exceptions to the rule. In addition, the Law on special procedures for linear infrastructure projects adopted in 2020, which is expected to be revoked in the course of the first half of 2023, still allows certain linear infrastructure projects to be exempted from public procurement rules, without providing clear guidelines for strategic prioritisation. This increases opportunities to extract benefits by inflating prices in the absence of competition and various subcontracting contracts and creates opportunities for corruption. Serbia has committed to revoke the Law on special procedures for linear infrastructure projects in the course of the first half of 2023. As a result of these legal arrangements, and, in some cases, a lack of enforcement of rules, a significant share of public funds for capital investment is still spent without proper checks to ensure compliance with public procurement, State aid and technical standards. This is particularly true for big infrastructure projects financed by loans granted mostly by non-EU countries. Investment decisions are still often taken without the appropriate feasibility studies, cost-benefit analysis and environmental impact assessments necessary to ensure the sound use of public funds.

Serbia has in recent years reduced the regulatory and administrative burden on businesses, but more effort is needed. Some burdensome business procedures have been significantly simplified and their cost reduced, but many burdensome administrative procedures still remain, especially for small and medium-sized enterprises (SMEs). Local firms have to make 33 tax payments per year, twice as many as in the regional peers. The many parafiscal charges remain high and non-transparent, lacking rationalisation, thus undermining the predictability and stability of Serbia's tax system and hampering economic development. The business community generally considers the Law on foreign exchange transactions to be too restrictive in its design and unpredictable in its application.

The legal framework is prone to unexpected and significant changes, which can be detrimental to business. Business predictability is negatively affected by the lack of full transparency in the adoption of legislation. Government decisions in a number of business-relevant areas are still often taken without proper consultation with businesses and social partners and under too short time constraints. This includes numerous trade restrictions introduced by Serbia with little or no notice, thus negatively impacting the stability of supply-chains, and further hampering the predictability for businesses and investors.

Further efforts are needed to improve the quality, independence and efficiency of the justice system. An efficient and independent judicial system is a prerequisite for a predictable investment- and business-friendly environment, and is necessary in order to encourage innovation, attract additional foreign direct investment and secure tax revenues. Businesses also raise the issue of the lack of reliability in contract enforcement, as well as lack of expertise among judges, particularly in complex areas of law such as competition, intellectual property, or taxation, which leads to inconsistency in rulings.

Serbia's legal framework for fighting corruption and dealing with economic crime and abuse of office is largely in place, but, its implementation should be strengthened. A particularly critical area is public procurement. The level of competition in the public procurement process remains limited: the average number of bids per tender remains very low (2.5 in 2021). The supervisory institutions (the Public Procurement Office, the Commission for the Protection of Rights in Public Procurement Procedures, the State Audit Institution, the Anti-corruption Agency, the state prosecutor, etc.) lack staff and do not always coordinate their anti-corruption work effectively and systematically.

The widespread informal economy remains a major impediment to the development of a strong corporate sector and the consolidation of a functioning market economy. Driving forces behind the informal economy include high taxes and contributions on the lowest salaries, a lack of financial resources and favourable loans, parafiscal charges, hidden tax fees and red tape. The consequences are tax evasion, market distortion, unfair competition and inefficient resource allocation. Notable investment has been made to reduce the size of the informal sector, but the pace of reform is slow.

The ERP reform measures in the area of the business environment target as last year the high administrative and regulatory burden, the management of state-owned enterprises and the functioning of the capital markets, but they still do not sufficiently address the main underlying structural weaknesses. *Reform measure 5, 'Improvement of the quality of public services through optimisation and digitalisation of administrative procedures – e-paper')* has been rolled over from past ERPs. It has the potential to significantly reduce administrative costs for businesses, reduce opportunities for corruption and increase Serbia's general attractiveness as an investment destination. However, the measure has only yielded rather limited results so far: out of nearly 3 000 procedures, 380 have been fully optimised, 64 digitalised, and 21 abolished. Significant efforts are needed to speed up and eventually conclude the reform. *Reform measure 6 ('Sustainable and efficient management of business entities owned by the Republic of Serbia')* has been rolled over from last year's ERP and remains very relevant given that it aims to improve the management of SOEs. The ERP rightly recognises the need to speed up the implementation of the related 2021-2027 strategy. Finally, *Reform measure 7 ('Development of the domestic capital market providing a greater level of investor protection')* has also been carried over from last year's ERP. While the measure might have a positive impact on the capital market and help attract further investment, it does not directly aim to address any of the most significant underlying structural challenges and the planned activities lack ambition and detail.

The ERP once again does not contain any reform measures specifically addressing the issue of the informal economy. However, *Reform measure 11 ('tax administration transformation')* has been carried over from last year's ERP and may, if properly implemented, lead to improvements in tax inspections and management, with a positive impact on reducing the informal economy. This reform measure is further analysed in Section 6 under public financial management.

Key challenge 3: Greening Serbia's energy sector and fully opening the energy market

There was good progress in 2021, particularly on renewables and energy efficiency. However, the energy sector remains inefficient and polluting, and is not fully compliant with the Energy Community Treaty or the EU *acquis*, and continues to hamper competitiveness. Energy infrastructure is largely outdated: the energy supply continues to rely mostly on lignite, energy production from coal is still heavily subsidised and many individual heating systems use wood and coal as fuel. The energy sector is the main source of air pollution in Serbia and imposes health costs on the economy. Licensing rules are rarely applied. In addition, the underperformance of the energy sector and the slow progress on the green energy transition constrain Serbia's economic growth potential, especially in the long term. The lack of efficiency in the energy sector also undermines the country's overall economic competitiveness. As EU Member States move towards greener economies, it is important that Serbia moves in the same direction in order to be competitive both in the immediate future and after its accession to the EU. Furthermore, Serbia's dependence on Russia in the energy sector is the highest in the Western Balkans. Russia's war of aggression on Ukraine, its impact on the global energy market and Russia's control of critical infrastructure makes Serbia particularly and further underlines the need to diversify and thus secure supply.

Addressing the remaining issues in this area will stimulate both domestic and foreign investment. This will benefit sectors that are crucial to digitalising and greening the economy in line with the Green agenda for the Western Balkans and backed by the economic and investment plan. It would also boost economic competitiveness, the medium-term growth potential and the creation of new jobs. The government's ERP therefore rightly recognises the importance of greening Serbia's energy sector and fully opening the energy market. The need to reduce dependence on specifically Russian energy sources is only partially recognised.

Serbia's energy sector as a high energy and carbon intensity. This is due to losses in distribution, outdated infrastructure, intensive use of coal and low energy efficiency at the end-user level. Most energy companies are state-owned and have down the years relied to a varying degree on support from the budget. Serbia paid direct subsidies worth about EUR 35 million to support coal-fired power generation in 2020, thus sustaining unprofitable, inefficient and highly polluting thermal power plants and coal mines. The retail electricity market, though fully liberalised, remains highly concentrated. For example, despite the liberalisation, the state-owned utility Elektroprivreda Srbije (EPS) remains the single most dominant supplier, with around 97% of participation in the electricity market in 2021. Direct or indirect regulation of energy prices is keeping entry barriers to the sector high.

Serbia remains highly dependent on coal. Work on a joined-up long-term strategy that combines energy and climate targets is ongoing but progress is too slow. Serbia relies on domestic coal-fired electricity production provided by outdated power plants. In 2021, about 60% of domestic electricity production came from coal (lignite), 33% from hydropower, 2% from gas, but only 3% from wind and solar combined, and around 1% from other renewable energy sources (SORS, 2023). Serbia continues to invest in new coal power plants and is currently building a new lignite power plant (Kostolac B3) with a capacity of 350 MW, although it did suspend the new Kolubara B 350 MW power plant project in early 2021. The new climate law adopted in March 2021 is a step in the right direction. The long-standing national energy and climate plan is due to be adopted by the end of June 2023 and must be sufficiently ambitious to take forward Serbia's green transition.

Coal power generation adds to already alarming air quality levels in Serbia. According to the European Environment Agency's latest estimates, air pollution from PM2.5 particles caused a total of nearly 14 400 premature deaths in Serbia in 2020 (EEA, 2020). The energy sector is the main source of pollution in Serbia, responsible for 80% of the country's greenhouse gas emissions. Several of the most polluting coal power plants in Europe are located in Serbia, with Kostolac B being the continent's most notorious sulphur dioxide polluter. Sulfur dioxide emissions were six times higher than the national ceiling in 2020. Serbia adopted a national emission reduction plan in February 2020, but it has still not been implemented in practice for sulfur dioxide and dust.

Inefficient energy use in Serbia is a major concern. Lack of efficiency in the energy sector is critically undermining the country's overall economic competitiveness. Serbia did nevertheless make major progress in aligning its legislation with the EU *acquis* on energy efficiency in 2021. It has created a new Directorate for Energy Efficiency and launched a housing renovation programme. An additional step was taken in February 2022 through the adoption of a long-term building renovation strategy until 2050. Priorities include continuing to improve financial, institutional and human resource capacities and better coordinating energy efficiency actions with all relevant stakeholders, including at the local level. Boosting investment in energy efficiency requires large-scale consumption-based metering and billing in district heating and the setting up of a sustainable financing mechanism. Serbia has not yet fully aligned its legislation with the EU's Energy Performance of Buildings Directive. Serbia should also allocate all income from the new energy efficiency fee, in full, to financing energy efficiency measures, and should develop energy efficiency programmes to support vulnerable households.

Major investment is needed to modernise Serbia's energy infrastructure and lower carbon emissions. Serbia's energy infrastructure is generally old and outdated, resulting in high energy losses (particularly in distribution). Serbia's reliance on coal-based energy supply means that major investment is needed to implement the necessary transition from fossil fuels, especially coal, to renewable sources of energy, while planning for the re-training of affected workers' and upgrading of their skills. Investment in renewable energy is increasing but only slowly. In 2020, Serbia achieved a 26.3% share of renewables in gross final energy consumption, which was just below the 27% objective and just above the renewable energy share of 21% in the 2009 baseline year. Domestic demand for electric power is expected to outgrow production capacity significantly in the next 5-10 years, and therefore require investment in new capacity.

Greening Serbia's energy sector is of paramount importance if Serbia is to meet its obligations under the Energy Community Treaty and its EU membership ambitions, and ensure the sector's sustainability and profitability. The EU Green Deal and the Green agenda for the Western Balkans have put in place a new policy framework for the coming period, which is also being incorporated into the Energy Community Treaty. Decreasing global prices for renewable energy and increasing efforts to address carbon leakage in Europe mean that Serbia needs to avoid locking itself into an increasingly unprofitable carbon-intensive energy system and to tackle this challenge head-on. Recent energy legislation introduced a competitive auction system instead of feed-in tariffs for renewable energy sources. This is an important measure to attract much-needed private investment in the renewables sector and it should be implemented swiftly. However, implementing legislation that will enable the launch of renewable energy sources auctions and simplify procedures for prosumers remains outstanding.

Electricity prices in Serbia are slowly increasing but have been too low for too long and do not incentivise investment in energy efficiency and energy savings – while the management and financial performance of the electricity provider EPS constitutes a fiscal risk. Current electricity tariffs do not cover the real cost of the investment needed to guarantee security of supply, an issue which has been accentuated with the increasing energy costs due to the situation on the global market and lower domestic production, accompanied by higher electricity imports. Moreover, they are unable to cover the investment needs for Serbia's energy and climate reforms. The planned continued increase in electricity prices should be accompanied by appropriate social programmes to mitigate potential adverse effects, bearing in mind that a considerable and increasing proportion of the population suffers from absolute poverty and energy poverty. The Commission's 2022 energy support package and the IMF's stand-by arrangement should create fiscal space for action. In December 2022, Serbia adopted the new Decree on Protection of Vulnerable Customers that should allow for increased number of beneficiaries (around 190,000) to receive support for paying energy bills. The energy bills of all Serbian citizens include the

EU logo and a description of the EU's support in helping to reduce energy costs, as well as information on how citizens can take individual action in order to lower their energy consumption.

Increased efforts are necessary to diversify Serbia's energy supply and overall energy mix and reduce its dependence on Russian energy sources. Ensuring security of supply for the domestic natural gas market remains a challenge, despite the diversification of gas supply routes. Serbia depends on imported natural gas for 88% of its total needs, which it receives from a single supplier, thus creating a supply security risks. Work started on the Serbian side of the Serbia-Bulgaria gas interconnector in February 2022 and on the Bulgarian side at the end of 2022. Locally produced electricity comes primarily from lignite. This supply mix is characterised by high direct and indirect costs, is converted inefficiently and is transported to sectors and industry at a price that does not allow full cost recovery. Serbia should in this regard make the best use of the economic and investment plan for the Western Balkans (European Commission, 2020) as well as the Commission's 2022 energy support package in order to begin phasing out coal and start building a climate-neutral economy by replacing fossil fuels with renewable energy, and gas as a transitional fuel, avoiding stranded assets, and reduce its dependence on Russian energy sources in line with the REPowerEU strategy.

Proper regulation of the electricity and gas markets is key to improving the sector's efficiency. Serbia's primary legislation is compliant with the EU's third energy package, but implementation is lagging behind, particularly in the gas sector. The government has mostly completed the liberalisation of the electricity market and created an operational electricity wholesale market. However, plans to reform the gas sector are yet to be implemented. There is still no third-party access to the gas network and none of the three transmission system operators have been unbundled. Serbia adopted an action plan on gas unbundling in May 2021 but key elements have been significantly delayed, including the certification of Transportgas Srbija. The implementation of Serbia's action plan on gas unbundling also depends on further amendments to the Energy Law.

Serbia's ERP for 2023-2025 is not sufficiently ambitious regarding the clean energy transition and energy efficiency. The reform measures proposed in the ERP once again fall short of providing decisive plans for making clean energy transition a core component of economic reform. In addition, major outstanding reforms, such as the unbundling of the gas sector and properly addressing energy poverty, are missing. *Reform measure 8* ('*Improvement of conditions for enhancing energy efficiency through creating conditions for application of energy labelling and eco-design, as well as through the incentives for enhancing energy efficiency*) has been partly carried over from last year's ERP. Novelties regard the introduction of eco-labelling as a contributor to higher energy efficiency in the housing sector. It correctly identifies the need to improve the legal framework in line with the EU *acquis* However, the measure still falls short of effectively incentivising energy efficiency investments, including in both the manufacturing and housing sectors. Steps to implement consumption-based metering and billing in district heating or a large-scale renovation wave in Serbia are still missing.

Reform measure 9 ('Integration of renewable sources of electricity through the "Beogrid 2025" project') is a new reform, aimed at enabling integration of electricity stemming from renewable sources into the transmission system primarily in parts of Belgrade and Zemun. Construction is planned to start mid-2024. The reform is relevant as it will prepare the electricity transmission system for electricity produced through renewable sources. However, its geographical coverage is rather limited. The planned activities are not sufficiently detailed, and do not, for example, cover what will be done to reduce the Corona effect which can cause significant losses of electricity in certain weather conditions. Such measures would reduce inefficiencies in the electricity system and help reduce energy inefficiency.

Reform Measure 10 (‘*Energy market development coupled with energy infrastructure construction’*) has been rolled over from previous ERPs. This represents a continuation of Serbia’s efforts to develop its electricity market coupled with new infrastructure investment through the Western Balkans Investment Framework, most notably the completion of all sections of the Trans-Balkan corridor. The reform focuses on the last two sections of this project, which are facing delays. As in the past, the reform does not go far enough in the gas sector, where no progress has been made in unbundling and providing third-party access to existing gas infrastructure.

Box II.5.3: Monitoring performance in light of the European Pillar of Social Rights([90])

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights on equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion for the benefit of citizens in the EU. The European Pillar of Social Rights Action Plan, adopted on 4 March 2021, aims at rallying all relevant forces to turn the principles into actions. Since the 20 principles provide a compass for upward convergence towards better working and living conditions in the EU, they are equally relevant for candidate countries and potential candidates. The new reinforced social dimension for the Western Balkans includes an increased focus on employment and social reforms through greater monitoring of relevant policies (EC, 2018). The Western Balkans Ministers' Declaration on improving social policy in the Western Balkans (6 November 2018) confirms that they will use the Pillar to guide the alignment of their labour markets and welfare systems with those of the EU.

Relative to the EU-27 average, there is scope for improvement in most available indicators of the Social Scoreboard supporting the European Pillar of Social Rights.

SERBIA		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Better than EU avg., worsening
	Individuals' level of digital skills	Worse than EU avg., improving
	Youth NEET (% of total population aged 15-29)	Worse than EU avg., improving
	Gender employment gap	Worse than EU avg., worsening
	Income quintile ratio (S80/S20)	Worse than EU avg., improving
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-74)	Worse than EU avg., improving
	Unemployment rate (% of population aged 15-64)	Worse than EU avg., improving
	Long term unemployment rate (% of population 15-74)	Worse than EU avg., improving
	GDHI per capita growth	N/A
Social protection and inclusion	At risk of poverty or social exclusion (in %)	Worse than EU avg., improving
	At risk of poverty or social exclusion rate for children (in %)	Worse than EU avg., improving
	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU avg., improving
	Disability employment gap	Worse than EU avg., worsening
	Housing cost overburden	Worse than EU avg., improving
	Children aged less than 3 years in formal childcare	Worse than EU avg., improving
	Self-reported unmet need for medical care	Worse than EU avg., improving

Serbia has steadily improved employment and has reduced unemployment and its labour market has grown . The employment rate exceeds pre-COVID-19 levels, as does the activity rate (70.3% in 2021, compared with 66.4% in 2020). The employment rate for women in Serbia is significantly lower than the employment rate for men. The gender employment gap is wider than the EU-27 average (14 pps in Serbia in 2021; 10.8 pps in the EU) due to the lower statutory retirement age for women and the low level of part-time work available combined with care responsibilities. Spending on active labour market policies remains insufficient at only around 0.08% of GDP in 2019 (the EU-27 average in 2019 was 0.39%).

Many young people in Serbia are not in employment, education or training (NEET) and the education system does not always meet the needs of the labour market. The NEET rate was 18.8% in 2021 significantly above the EU-27 average of 13.1%) but the lowest among all candidate countries.

Vocational education and training is not sufficiently oriented to labour market needs and, together with the lack of opportunities for reskilling and upskilling, is a key obstacle to higher youth and adult employment and activity rates in Serbia.

Serbia's performance on social inclusion, social protection, income equality and poverty alleviation is improving but could still be ssignificantly improved even further. The AROPE rate is 23.2% and is aamong the highest in Europe. Children and those aged under 18 face an at-risk-of-poverty rate of 27.5%. The at-risk-of-poverty-or-social-exclusion rate was very high in 2020 (28.4%) and significantly above the EU-27 average (21.7%) . The disposable income of individuals in the top income quintile is on average almost six times higher than the disposable income of those in the lowest quintile. Serbia's tax-benefit system is not as effective in reducing market inequality as other European countries' systems. Furthermore, high government expenditure does not greatly reduce income inequality.

Serbia has a well-developed statistical system. The Statistical Office of the Republic of Serbia is the main producer of primary data from the labour force survey and the survey on income and living conditions (SILC). The Institute of Public Health produces detailed statistics on public health and demographic trends. The quasi-governmental Social Inclusion and Poverty Reduction Unit processes and interprets data on poverty and inequality, and develops indicators to monitor social policy. The monitoring of social policy in Serbia (including methodology and results) is critically discussed in academic and civil society circles.

([90]) The table includes 16 headline indicators of the Social Scoreboard, used to compare performance of EU Member States (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators). The indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally, 2020 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). For data see Annex B. NEET: neither in employment nor in education and training; GDHI: gross disposable household income.

5.5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2022

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye has adopted targeted policy guidance for all partners in the region. The guidance represents the participants' common view on the policy measures that should be implemented to address macrofiscal vulnerabilities and structural obstacles to growth. The underlying rationale for the policy guidance is similar to that of the country-specific recommendations usually adopted under the European Semester for the EU Member States. The Commission evaluates the work carried out to implement the policy guidance in the following year's ERP assessments. The table below presents the Commission's assessment of the implementation of the 2022 policy guidance jointly adopted by the EU and the Western Balkans and Türkiye at their Economic and Financial Dialogue at Ministerial level on 24 May 2022.

Overall: Partial implementation (51.4%) ([91])	
2022 policy guidance (PG)	**Summary assessment**
PG 1:	There was **substantial implementation** of PG 1:
If needed, use the available fiscal space in the 2022 budget to cushion the potential impact of adverse shocks through targeted support to vulnerable households and firms; provided the economic recovery is well entrenched, plan a further gradual return to a deficit close to balance in the 2023 budget and medium-term fiscal framework.	1) **Partial implementation**: The authorities have provided very substantial fiscal support to cushion the impact of the energy crisis on households and firms via budget support to state-owned energy utilities, lower excise duties on fuel and specific support to farmers. However, energy support was not specifically targeted to vulnerable households and businesses and lump sum payments to all young people between 16-30 were not targeted to specific needs. Lower energy support needs helped to allow the 2023 budget and medium-term fiscal strategy to effectively include a plan for gradual fiscal consolidation, and the deficit is expected to meet the applicable fiscal rule in 2025.
Contain overall spending on wages as a percentage of GDP by adopting an adequate wage indexation mechanism and taking preparatory steps towards an appropriately designed public sector wage system reform.	2) **Substantial implementation**: Following a further 0.3 pps decline in 2022 due to very high nominal GDP growth, overall spending on wages as a percentage of GDP is projected to remain stable at 9.6% in 2023-2025. The planned containment continues to rely on ad hoc decisions, but the revised fiscal rules (adopted by amendment of the budget system law in December 2022) stipulate that the yearly budget law must stipulate the percentage of public sector wage increases and that the resulting share of wages as a proportion of GDP must not exceed 10% from 2023 onward. The public sector wage system reform has been postponed to 2025, but the new central electronic public wage and employment registry (Iskra) became operational for some sectors in 2022 and will be rolled out to most of the public sector (except military, security and higher education institutions) by the end of 2023 as an important step in preparing the delayed wage system reform.

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

Adopt a credible and binding system of fiscal rules for entry into force in 2023 as envisaged in the ERP.	3) **Full implementation**: A new system of fiscal rules has been adopted via a corresponding revision of the budget system law in December 2022. It sets a general government deficit ceiling based on the general government debt level (3% of GDP for debt below 45% of GDP; 1.5% of GDP for debt below 55% of GDP; 0.5% for debt below 60% of GDP; and 0% for debt above 60% of GDP). The deficit rule will not apply before 2025 because budget targets for 2023 and 2024 had already been agreed in the SBA with the IMF. The new rules also include ceilings (already applicable in 2023) on two large expenditure items: a 10% maximum share of GDP for the general government wage bill and a modified rule for pension indexation based on the ratio of pension expenditure to GDP. The enforcement mechanism may need to be strengthened, but the new rules appear reasonably credible and binding due to their relative flexibility at lower debt levels / lower shares of pensions/salaries as a proportion of GDP.
PG 2: To reduce the grey economy, strengthen VAT collection and improve the tax control process, finalise the introduction of the new model of electronic fiscalisation and the transition to electronic invoicing and implement the tax administration reform according to the ERP 2022 timeline.	There was **partial implementation** of PG 2: 1) **Substantial implementation**: The new electronic fiscalisation model and the transition to electronic invoicing have been implemented broadly within the set deadlines. Turnover has been exclusively recorded according to the new system of e-fiscalisation since 1 May 2022. As regards electronic invoicing, all three introduction phases (business-to-government as from 1 May 2022, government-to-business as from 1 July 2022 and business-to-business as from 1 January 2023) have been completed as planned. Training programmes for users of the new fiscalisation model and electronic invoicing were held as planned up to the end of 2022. The implementation of tax administration reform measures has been progressing broadly in line with the ERP 2022 timeline.
Reinforce fiscal risk analysis capacity, in particular on SOEs, and make resulting reporting publicly available in the fiscal strategy updates in spring and autumn.	2) **Limited implementation**: Work appears to be ongoing to establish and adjust models of fiscal risk analysis in line with the unified monitoring methodology adopted in 2021, and to improve capacities in the Fiscal Risks Monitoring Department via reinforced training. However, the expansion of the reporting on the results of the department's work in the fiscal strategy has been postponed until the upcoming fiscal strategy update in autumn 2023.
Implement the time-bound action plan for the deployment of the new SOE ownership and management strategy according to the ERP 2022 timeline to improve the governance of SOEs and reduce related fiscal risks.	3) **Substantial implementation**: A centralised database of economic entities which the Republic of Serbia fully or partly owns has been established and made publicly available on the website of the Business Registry Agency. An internal act of the baseline for setting mechanisms and criteria for reviewing and approving SOEs' key decisions has been adopted in the Ministry of the Economy. A draft

	law on ownership management for state-owned enterprises was prepared in 2022 and adoption was planned for early 2023 but may be delayed due to ongoing discussions and revisions.
PG 3: Carefully assess and analyse price developments and stand ready to tighten monetary policy further, if needed, to preserve price stability in the medium term.	There was **substantial implementation** of PG3: 1) **Full implementation**: During 2022, the central bank reacted swiftly to mounting price pressures and progressively tightened its monetary policy stance. Until April the central bank increased its average repo rate by tightening liquidity conditions. It then engaged in a series of consecutive hikes of the policy rate, which are helping to contain inflation and keep inflation expectations anchored.
Maintain a transparent and accurate reporting of asset quality and adequate provisioning, further upgrade NPL resolution, including by facilitating out-of-court settlement, and continue to reduce data gaps in particular as regards the real estate sector.	2) **Substantial implementation**: The COVID-19-related measures have been fully unwound, and provisioning remained high. There was no progress on reducing the remaining obstacles to NPL resolution, such as enabling the sale of retail NPLs and improving judiciary processes, but asset quality continued to improve. The Republic Geodetic Authority recently started to regularly publish real estate sector data, which helps to fill data gaps in this area.
Continue efforts to promote the use of the national currency, including by enhancing long-term financing in national currency, further encouraging forex hedging and raising awareness of risks related to forex lending.	3) **Substantial implementation**: The authorities have kept supporting the development and use of local government and corporate bond markets and encouraged dinar-denominated deposit and loan growth in the banking sector. However, the positive trend in dinarisation of recent years came to a halt in the first part of 2022, mainly because Russia's war on Ukraine triggered a confidence shock that led to domestic and foreign residents increasing their demand for foreign currency in terms of both deposits and loans.

PG 4:	There was **limited implementation** of PG 4:
Further improve transparency in the adoption and implementation of legislation, particularly by ensuring a timely consultation of businesses and social partners on new legislation affecting their operations.	1) **Limited implementation.** The legal framework for conducting transparent and inclusive public consultations is in place. Although the establishment of the e-consultation portal in 2021 should help ensuring its implementation, further improvements are needed, as the share of legislation undergoing consultative procedures remain low, and as businesses continue to experience shortcomings in the procedures. These shortcomings make it harder for businesses to obtain information about legislative changes, and to prepare for and provide comprehensive input.
Continue with the process to ensure a harmonised approach for prioritising and monitoring all investments and basing investment decisions on feasibility studies, cost-benefit analysis and environmental impact assessments.	2) **Limited implementation.** Although a decree on capital project management was adopted in 2019, it is not being applied to all investments. Furthermore, several gaps remain in the decree which are yet to be addressed.
Apply the principles of competition, equal treatment, non-discrimination and transparency in public procurement and state aid procedures in line with the EU acquis for all public investment projects regardless of the financing source and ensure a consistent and transparent track record demonstrating the operational independence of the Commission for State Aid Control.	3) **Limited implementation.** The special law on linear infrastructure projects remains in force, allowing for the circumvention of the domestic law on public procurement. Serbia has committed to revoke the law in the course of the first half of 2023.Although a number of bylaws related to the law on State aid have been adopted, others have still to be adopted. In addition, issues persist regarding competition and State aid provided through fiscal State-aid schemes, special laws and intergovernmental agreements. The Commission for State aid Control still needs to continue building up a track record of demonstrable operational independence.
PG 5:	There was **limited implementation** of PG 5.
Continue to develop and adopt a long-term energy and climate strategy in line with the Green Agenda for the Western Balkans and international commitments, and further increase investments in modernising energy infrastructure and lowering carbon emissions with a view to accelerating the green transition.	1) **Partial implementation.** Work on developing a long-term energy and climate strategy started in 2021and although draft was finalised in 2022, it remains to be adopted and must ensure an ambitious approach in line with EU goals. Investment in modernising energy infrastructure and in lowering carbon emissions is limited, there is still no prioritisation mechanism for investments, and ongoing investments are facing delays in implementation.
Implement outstanding financial and institutional measures for higher take-up of renewables and energy efficiency, including launching first auctions for renewable energy sources (RES) and further develop the administrative entity for energy efficiency which has been fully operational since early 2022, and further improve the sustainability of the financing mechanism.	2) **Limited implementation.** The completion of secondary legislation on RESs and energy efficiency related to the set of laws adopted in April 2021 is still pending. This is holding up the launch of the first RES actions. The Energy Efficiency Administration has been fully operational since early 2022.
With a view to further liberalising the energy market, address outstanding reforms including price and tariff reform for both gas and electricity, accelerate the unbundling of all energy utilities in line with the EU acquis, and as regards the gas sector in line with Serbia's	3) **Limited implementation.** The electricity sector has been unbundled, and the generation of electricity has been split off from transmission, but the government is still supervising both companies. In the gas sector, third-party access to the gas infrastructure including Horgos

Action plan which is also an obligation vis-à-vis the Energy Community, as regards Gastrans, Serbia should ensure that its regulatory regime is in full compliance with EU legislation all in line with the Action plan developed following the recently opened Cluster 4 for energy, Climate and Transport in the EU accession process. .	interconnection point is still not granted. The price and tariff reform has been started in line with the stand-by arrangement agreed with the IMF; further reform is expected. The founding acts of Srbijagas and Transportgas Srbija have been amended, but the gas sector has not yet been fully unbundled. Work on the certification of Transportgas Srbija as a transmissions system operator has been delayed.
PG 6:	There was **limited implementation** of PG 6.
Reduce poverty by increasing the adequacy of benefits of the Financial Social Assistance (FSA) scheme for individuals and families with children and by increasing substantially the untaxable wage base close or equal to the level of the minimum salary for workers.	1) **No implementation:** T The FSA benefits are very low. As an example: FSA support for a family of three amounts to less than half the cost of the average consumer basket and less than half the poverty threshold. There has been no announcement that this would be addressed by the draft social protection law in the pipeline or other initiatives. The tax-free allowance increased by RSD 1 000 a month in 2022 and is adjusted annually with the consumer price index but remains far below the minimum salary.
Continue facilitating school-to-work transitions by stepping up further VET, including dual VET, through revised curricula and the provision of infrastructure, which enables the acquisition of practical skills	2) **Partial implementation:** The Office for Dual Education and NQF was recently established as a new institution in the VET system, however it is still to be clarified what the added value of establishing a new institution is and how its competencies will contribute to improving the VET system, and not overlap with other institutions. No major developments have taken place since the previous ERP. There is a slow increase in the number of developed qualification standards in secondary VET, while higher education is yet to see the development of qualification standards and how this will link with quality assurance procedures in higher education. However, in order to make a meaningful impact on students' skills development, this is yet to be followed by the development of modernized curricula, teacher training and delivery in classrooms. VET curriculum in general remains outdated, however there has been some increased focus on the set up of regional VET training centres. A dual education monitoring framework was piloted and should be integrated in quality assurance mechanisms. The outreach of the dual VET is too limited with 5% share of all VET.
Finalise, in co-operation with all relevant ministries, their agencies and stakeholders, a Youth Guarantee Implementation Plan, adopt it and initiate its implementation.	3) **Partial implementation:** Serbia set up an expert group and a coordination body for drafting and monitoring implementation of the Youth Guarantee implementation plan. Work is ongoing with support from EU-ILO Technical Assistance Facility. Due to the change of government delays in the implementation occurred. The Ministry of Labour, Employment, Veteran and Social Affairs confirmed its target of delivering a draft Youth Guarantee implementation plan by March 2023 with a view to its adoption at the latest by Q2 2023.

5.6. THE POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TÜRKIYE

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

Brussels, 16 May 2023

[…]

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

1. Keep an appropriately tight fiscal stance in 2023 to help disinflation, including by reducing budget support to energy SOEs, while providing targeted and temporary support to vulnerable households and companies if needed to cushion the impact of high energy prices; and plan a further gradual reduction in the deficit in the 2024 budget and in the medium-term fiscal framework in line with the SBA commitments and the new fiscal rules. Contain overall spending on wages as a percentage of GDP in line with the new fiscal rule and continue the preparatory steps towards an appropriately designed public sector wage system reform. Strengthen medium-term budgeting via the development of a corresponding time-bound action plan and the implementation of its first steps.

2. Implement the tax administration reform according to the ERP 2023 timeline. Reinforce fiscal risk analysis capacity, in particular on SOEs, and make the resulting reporting publicly available in the fiscal strategy updates in spring and autumn. Continue the deployment of the SOE ownership and management strategy 2021-2027 by implementing the remaining steps of the time-bound action plan 2021-2023 and preparing the new time-bound action plan for 2024-2027 to improve the governance of SOEs and reduce related fiscal risks.

3. Continue to carefully assess and analyse price developments and ensure a sufficiently tight monetary policy stance to preserve price stability in the medium term, including by further tightening monetary policy, if needed. Strengthen further the reporting and risk management frameworks across the banking system as well as an accurate reporting of asset quality, further upgrade NPL resolution by reducing obstacles in the judiciary, improving bankruptcy procedures and facilitating out-of-court settlement, and building on recent progress further reduce remaining data gaps in particular as regards the real estate sector. Continue efforts to promote the use of the domestic currency, including by enhancing long-term financing in domestic currency, further encouraging forex hedging and raising awareness of risks related to forex lending.

4. Further improve transparency in the adoption and implementation of legislation, particularly by ensuring a timely consultation of businesses and social partners on new legislation affecting their operations, including on temporary legislative acts impacting established supply-chains of importing or exporting companies. Continue to ensure a harmonised approach for prioritising and monitoring all investments and basing investment decisions on feasibility studies, cost-benefit analysis and environmental impact assessments. Apply competition, equal treatment, non-discrimination and transparency principles in public procurement and state aid procedures in line with the EU acquis for all public investment projects regardless of the financing source and to ensure a consistent and transparent track record demonstrating the operational independence of the Commission for State Aid Control.

5. Adopt the national energy and climate plan in line with the Green Agenda for the Western Balkans and international commitments. Further modernise energy infrastructure and lower carbon emissions to accelerate the green transition also in the light of the upcoming EU Carbon Border Adjustment Mechanism (CBAM). Reduce over dependence from individual countries, accelerate renewables and energy efficiency, including launching first auctions for renewable energy sources (RES), further developing the administrative entity for energy efficiency, and the sustainability of the financing mechanism. Continue to implement the price and tariff reform, as well as other reforms related to energy SOEs, in line with Serbia's commitments under the stand-by arrangement agreed with the IMF in December 2022. To further liberalise the energy market, accelerate the unbundling of all energy utilities in line with the EU acquis and, for the gas sector in line with Serbia's Action Plan; as regards Gastrans, ensure that the regulatory regime is in compliance with EU acquis and the Action plan developed for the opening in December 2021 of Cluster 4 for Energy, Climate and Transport in the EU accession negotiations.

6. Reduce poverty by substantially increasing the adequacy of benefits of the Financial Social Assistance (FSA) scheme for individuals and families with children and by increasing the untaxable wage base close or equal to the level of the minimum salary for workers. Continue facilitating school-to-work transitions by stepping up further VET, including dual VET, through revised curricula and the provision of infrastructure, which enables the acquisition of practical skills. Finalise, in co-operation with all relevant ministries, their agencies and stakeholders, a Youth Guarantee Implementation Plan, adopt it and initiate its implementation.

ANNEX A: ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP 2023-2025

Public financial management

Despite generally strong diagnostics, more emphasis on the remaining obstacles could help identify well-targeted reform measures and clarify the link to the proposed reform measure that focuses exclusively on tax collection. The proposed reform measure does not address any of the Commission's recommendations in its 2022 report on Serbia in this area and the related part of the 2022 policy guidance. Although the new 2021-2030 Public Administration Reform Strategy and the new 2021-2025 Public Financial Management Reform Programme have both been adopted, weaknesses in managerial accountability persist. The capacity to monitor the functioning of the internal control systems, including risk management and internal audit, needs to be further expanded and monitoring needs to be better accepted in the administrative culture of the public sector. The Ministry of Finance's centralised budget inspection function, parliamentary oversight of public finances, and budget transparency require further strengthening. Action is still needed to put in place and implement a unified, comprehensive and transparent system for capital investment planning and management. Analytical units in all ministries and line bodies are still to be established to foster the effective consolidation of strategic, operational and financial management functions, in line with national strategic documents. Furthermore, the monitoring of fiscal risks has still to be improved in practice and the development of medium-term plans has not yet been completed in line with the Law on the Planning System. Finally, the quality of the State Audit Institution's audit work continues to improve, but its institutional capacity also needs to be improved and its continuing independence ensured.

Measure 11: 'Transformation of tax administration'

This reform measure has been carried over from previous ERPs, where it was dealt with in the section on improving the business environment. Although the transformation has been ongoing since 2015, and some targets have been met, the overall improvement remains limited and some activities are facing delays. Increases in tax revenues have been registered over the past year but the direct link to the reform is not statistically confirmed. The predictability and fairness in the implementation of tax rules are yet to fully materialise. A first step aimed at improving the management of human resources has now been incorporated among the planned activities. The measure does not include concrete activities to address the issue of insufficient human resources., but a gap analysis to feed into a new human resources strategy is ongoing. The description of the measure recognises its link to the business environment and the grey economy in particular.

Green transition

Following Serbia's endorsement of the Green agenda in November 2020, the adoption of a climate law in March 2021 and a package of important energy laws in April 2021, Serbia started making progress with its green transition, as recognised by the opening of Cluster 4 in the accession negotiations in December 2021. However, further progress with the adoption of important legislation and strategic documents, as well as significant implementation and enforcement efforts, is crucial to effectively address persisting environmental concerns. Although the ERP identifies and tackles a number of relevant issues that Serbia needs to address, it once again fails to integrate the green transition into all parts of the ERP, across the economy as a whole rather than just transport, energy, waste management and air quality. Furthermore, despite the recognition that environmental changes are a challenge for the Serbian economy, the ERP contains only one reform measure in this cross-policy area.

Measure 12: 'Implementation of the circular economy in creating favourable environment for the green transition'

The measure to promote the circular economy has been carried over from previous ERPs and remains relevant as it aims at supporting businesses and local self-governments in the green transition. This year's ERP introduces support for the application of green public procurement within this reform measure. Although the details of this activity are unclear, especially as this concept does not currently exist in Serbia and is pending the adoption of amendments to the Law on public procurement and therefore might be premature, it has potential. However, the measure still lacks ambition and still does not include any immediate practical steps towards a circular economy, which would need to be underpinned by a sufficient budget and robust performance indicators. The description of activities remains vague and it is unclear what type of support is planned.

Digital transformation

Serbia has made notable progress on digital transformation across the economy. Digitalisation remains a key priority for the government, but the diagnostics do not sufficiently focus on remaining obstacles to identifying well-targeted reforms. Serbia's communications infrastructure still requires systematic improvement of both regulation and investment. Broadband roll-out is too slow and this prevents the uptake of e-government and business services, and slows down the digital transformation of the economy. The 2025 Serbia programme, which was adopted in December 2019, announced much-needed investment in infrastructure to the amount of EUR 14 billion by 2025. The Law on broadband coverage is aligned with the 2025 European Gigabit Society Goals (100 MB/s networks) and is planned for adoption in 2023, but staff capacity in the ICT sector remains an issue. The challenge remains to ensure links between the ICT sector and traditional industries so as to speed up modernisation in traditional sectors. Unfortunately, the ERP still does not link this area to the green transition.

Measure 13: 'Improvement of the national information and communication infrastructure'

This measure has been rolled over from previous ERPs. It remains relevant as the lack of fast broadband connectivity in under-served regions in Serbia is a major obstacle to the digital transition, and as work to rectify this has been delayed. Most of the identified risks to the reform measure remain high, thus indicating that its implementation will probably be delayed still further. The measure is expected to have a favourable impact on competition, development and better connection of innovation/industry/services (a benefit to businesses and online work) as well as provide further education possibilities (access to schools) and better household access to the internet in general. However, the measure only addresses the infrastructure aspect and should also help to lay the ground for implementing the digital aspects of the common regional market.

Measure 14: 'Setting the infrastructure and environment for the creation and application of innovative IT solutions'

This measure has been rolled over from last year's ERP but with certain aspects extracted to form a separate individual measure (measure 15). However, the potential link between reform measures 14 and 15 is unclear. Measure 14 remains relevant as it provides for further infrastructure to expand the digital transformation, but its objective is still not sufficiently clear and detailed measures are still lacking. Furthermore, the measure only addresses the infrastructure aspect and neglects other aspects such as digital skills and support to the private sector for digital transformation, etc.

Measure 15: "Support for the development of talents and creative industries by establishing a multi-functional innovative and creative centre Ložionica"

This measure appears as a stand-alone reform measure for the first time but was part of Reform Measure 14 last year and can therefore be considered as carried over from last year's ERP. It focuses on establishing a hub to support the development of creative industries in Serbia. It does not seem to address any of the issues identified in the diagnostics. It is also not clear if the measure is intended or has the potential to address other structural challenges to Serbia's inclusive economic growth and job creation. Furthermore, the target value seems low and the potential link to reform measure 14 is unclear.

Business environment and reduction of the informal economy

The business environment and the relevant reform measures 5, 6 and 7 are analysed above in Section 4 under key challenge 2.

The informal economy has been slowly shrinking over the years, but remains extensive in terms of both its share of total output and in the number of people employed, as reforms are only slowly being implemented. Undeclared labour remains a persistent issue, despite some improvements in the labour market. Agriculture, construction and household services have a particularly high share of undeclared work. The driving forces are corruption, high taxes and contributions on the lowest salaries, lack of financial resources and favourable loans, parafiscal charges, hidden tax fees and red tape. The government should develop a mechanism to incentivise companies and workers to move to the formal sector.

The ERP once again does not contain any reform measures specifically addressing the issue of the informal economy. However, reform measure 11 ('tax administration transformation'), which has been carried over from last year's ERP, may, if properly implemented, lead to improvements in tax inspections and have a positive impact on the informal economy. The reform measure is ambitious in scope but concrete results have been limited so far.

Research, development and innovation

As the ERP recognises, Serbia has a relatively good scientific base, but investment in research and development in 2021 has remained low at around 0.9% of GDP and with less than one third of this coming from the private sector. The diagnostics also recognise the lack of human resources for research and development and the continued weak cooperation between businesses and academia. However, the underlying reasons for these major structural issues have still not been sufficiently identified. Infrastructure for science and technology parks is being expanded, but further support services for these institutions are still needed. The Innovation Fund, which provides grants for industrial research, similarly needs to play a more prominent role in facilitating academia-business cooperation. The smart specialisation strategy, the industrial policy strategy, and the strategy for the development of artificial intelligence adopted by Serbia in 2020 are being implemented. The ERP still does not include the link to the green and digital transition in this area.

Measure 16: 'Development of the start-up ecosystem'

This measure has been carried over from last year's ERP. It remains relevant because it is aimed at stimulating public and private investment and developing an ecosystem for start-up firms – one of the main structural issues in the area. It could, if successfully implemented, also help stimulate Serbia's economic growth and competitiveness. Work to establish a register on the National Innovation System is under way but facing delays. The measure focuses on smart specialisation in artificial intelligence and, although it has been extended to also cover biotechnology, its scope still remains relatively narrow. The planned activities are still not sufficiently concrete.

Measure 17: 'Creation of conditions for the development of bio science and bioeconomy through the construction of Bio4 campus'

This measure has been carried over from last years' ERP. It could help to create an attractive new sector in Serbia but is very narrow given its pure focus on Bio4 (biotechnology, biomedicine, bioinformatics and biodiversity). The planned activities are still not detailed enough to give a clear picture of the measure's potential. The measure still does not seem to address any of the obstacles set out in the diagnostics.

Economic integration reforms

The ERP does still not sufficiently identify unaddressed issues, including underlying issues related to the long awaited adoption of the Law on genetically modified organisms (GMOs). This is an obstacle to finalising Serbia's accession to the World Trade Organization (WTO). Economic integration with the EU, which is Serbia's biggest trade and investment partner, remains high despite increasing integration with non-EU countries. The EU accounted for around 60.% of Serbia's total trade in goods (ESTAT 2023) and around one third of net foreign direct investment inflows in 2022. Serbia is still to complete accession to the WTO, which is not moving forward. Trade with the region remains significant and Serbia actively participates in regional cooperation such as the common regional market and the Central European Free Trade Agreement (CEFTA). The implementation of the CEFTA Additional Protocols 5 and 6 continues, as stipulated also by reform measure 18. Further integration within the region could boost Serbia's economic growth and competitiveness, and maximise the benefits of the economic and investment plan. The customs administration development plan for customs e-systems, which aims to ensure integration with the EU system adopted in February 2020, is being implemented. Despite the role that digitalisation plays in improving administrative trade and customs procedures and in further integrating systems, as well as the recognition in the diagnostics of the upcoming EU Carbon Border Adjustment Mechanism, no link has been made to the green or digital transition.

Measure 18: 'Improving conditions for product safety and removing barriers to trade'

This measure has been rolled over from several previous ERPs. Reducing barriers to trade is important to strengthen the competitiveness of the economy and boost economic growth, in both the short and the long term. However, planned activities to accede to the WTO continues to lack concrete progress, delaying the ultimate accession and the benefits it could bring to Serbia as an export-oriented country. Appropriate steps are needed rapidly and resolutely, including the adoption of the new GMO-law through cooperation across relevant ministries. The activities planned under CEFTA are appropriate and credible, but it is not clear what results have been achieved so far and what remains to be implemented because the description of the planned activities lacks details. Serbia's constructive role within CEFTA remains crucial and Serbia's coming role as chair of CEFTA in 2024 could provide an opportunity to move the regional agenda forward. The planned activities do not address more recently appeared barriers to trade in the form of export restrictions introduced by Serbia.

Energy market reforms

This sector and reform measures 8, 9 and 10 are analysed above in Section 4 under key challenge 3.

Transport market reforms

The ERP identifies remaining challenges across the transport sector and sets out steps taken, particularly on rail transport, where progress is continuing. An updated transport strategy leading to an EU *acquis*-compliant transport sector has been pending for years. Critical improvements are still needed on traffic management, maintenance, road safety and the transparency of transport investment. Priorities need to be aligned with the goals of economic development and EU integration, and with the EU's sustainable and smart mobility strategy. Improvements regarding inland waterways are underway; the potential of river ports as important trade channels needs to be further examined and measures are needed to ensure their full interoperability with roads and railways. The ERP recognises the role of the railway sector and the construction of a metro in contributing to the green transition, but it does not reflect on this relevant link in other areas of the transport sector.

Structural Reform 19: 'Improvement of efficiency and safety in railway traffic'

This reform has largely been carried over from previous ERPs to advance Serbia's railway reform process. Although the diagnostics set out issues across the transport sector, the one reform measure targets only the railway sector. The focus on rail transport safety and access charges is appropriate and in line with recommendations in the Commission's Serbia 2022 Report. However, it remains too narrow considering other important aspects of the rail reform, such as strengthening institutional capacities, facilitating border crossing procedures, improving the management of railway network capacity, improving the management of railway assets, improving the process of issuing train driving licences and safety certificates to railway undertakings and mutual recognition of rolling stock. Serbia needs to put more focus on railway infrastructure maintenance, in particular given the ongoing cycle of investment in Serbian railway lines. Using rail to export and import goods should be more systematically encouraged to reduce pressure on the environment and on roads, and to speed up the green transition.

Agriculture

The ERP rightly recognises the importance of agriculture for the economy which remains significant when coupled with the more dynamic food processing sector. The ERP also recognises the structural challenges that remain. The number of people employed in the sector still accounts for around 15% of the total labour force but is diminishing in favour of the industrial and services sectors. However, its contribution to Serbia's GDP is stable. Exports of agricultural products accounted for nearly 5 % total exports at % in 2021. The sector nonetheless remains hampered by inefficiency, most notably concerning land (fragmentation, low productivity due to outdated technologies, small economic size and low utilisation of agricultural land per farm), and a lack of investment in new technologies. The strong influence of weather conditions and climate changes on the sector's performance remains unaddressed. Moreover, the sector faces the challenge of meeting EU obligations on food safety, veterinary and phytosanitary regulation, strengthening responsible authorities in those areas, and better risk analysis and risk-based performance in relation to border inspections. EU support allocated to Serbia for IPARD is substantial and increasing. Bottlenecks in the implementation of IPARD hinder that support to the sector is maximised. Successful implementation IPARD prevent support to the sector from being maximised. Successful implementation of IPARD would help increase the sector's competitiveness, increase the attractiveness of rural livelihoods, reduce outmigration from rural areas, and contribute to increasing the environmental and climate performance of agricultural producers and primary processors. There is a need to further strengthen the capacity of the IPARD Agency to facilitate access to finance. The ERP insufficiently notes the link to the green transition. There is no mention of the connection to the digital transition - an important element in helping to increase the efficiency in this sector too – even though it is part of reform measure 20.

Measure 20: 'Improvements in the competitiveness of agriculture'

This measure has been carried over from previous ERPs and remains relevant, but it does not aim to address the most significant issues set out in the ERP. It also continues to being exposed to further postponements of legislative initiatives, in particular the Law on quality schemes for agricultural and food products, and the Law on organic production (originally planned for 4 years ago and repeatedly postponed). The delays in the adoption of legislation are delaying both further legislative alignment and moving forward projects and developing structures as required by the EU *acquis.*

Industry

The competitiveness of industry is key to growing the economy, but the ERP still does not identify any remaining structural issues in this area. The ERP rightly recognises that the performance of industry has been stable despite the impact of COVID-19 (industry grew by 6.3% year on year and manufacturing industry by 5.5% in 2021). The ERP also recognises that access to finance for SMEs has improved. However, SMEs still face a number of structural challenges and their borrowing costs higher than those for large companies despite several programmes to support SME development, and despite their potential to create new, high-quality jobs. A strategy for the development of micro companies, SMEs and entrepreneurship is pending adoption. Support for incoming foreign direct investment continues to be principally geared towards attracting manufacturers. Support for investment is well developed, but this is less the case for other services. Clusters, technology parks, internationalisation, and industrial research do exist, and new standards or digitalisation in traditional industries have been introduced but have not yet had a systemic impact. Measures of this kind should fully comply with State aid rules. The ERP still lacks a measure for industrial green growth and does not refer to the green or digital transitions in this area.

Services

The ERP recognises the importance of the services sector, which has recovered well from the COVID-19 pandemic with the support of incentives for the tourism sector and a continued inflow of investments. About half the value added by services comes from retail, real estate and healthcare. Services have the potential to expand and represent an even greater share of total exports. Service exports are dominated by tourism, transport and ICT services. Investment in infrastructure and skills needs to be tailored for these fast growing and competitive services so that they can expand further. Targeted efforts are also needed to slow down the ongoing brain drain in most skilled labour areas across the services sector. The CEFTA agreement and the three agreements on mobility reached within the common regional market at the Berlin process summit in Tirana on 3 November 2021 highlight further sectors in which services could expand regionally. The ERP recognises the need to improve capacities in tourism to make it sustainable and meet environmental objectives in line with the Green agenda for the Western Balkans, but the ERP still does not make any clear reference to the green or digital transitions and does not include any reform measure directly targeting the services sector.

Education and skills

This sector and the relevant reform measures 1 and 2 are analysed above in Section 4, under key challenge #1.

Employment and the labour market

This sector and the relevant reform measure 3 are analysed above in Section 4, under key challenge #1.

Social dialogue

Social dialogue remains weak and needs further development, in particular in the private sector. Collective agreements are mostly concluded in the public sector. Only few agreements at branch level exist in the private sector. The social partners have limited capacity to address labour and employment challenges. Foreign investors represent a significant share of employers but do not directly participate in social dialogue. The tripartite Economic and Social Council of Serbia is not always consulted in a timely manner on policy initiatives and draft laws prior to their adoption. The Economic and Social Council lacks appropriate resources for its work.

Social protection and inclusion

This sector is analysed above in Section 4, under key challenge #1.

Healthcare

Serbia's healthcare system covers 99% (2021) of the population. The compulsory health insurance scheme is managed by the Health Insurance Fund. The system is partially financed by the contributions of employed and self-employed persons, persons with nonstandard work-contracts and pensioners. Unemployed persons who are not insured otherwise are insured free of charge. The contribution rate is 10.3%, equally shared between employer and employee. Public expenditure on healthcare accounted for 7.1% of GDP in 2021, up 1 pp. compared to the previous year (EU-27 average in 2021 was 8.0% of GDP). Only 0.13% of the population have private insurance. In 2020, 3.8% of the Serbian population reported unmet needs due to costs, travel distances or waiting lists. This is 2 pps. lower than in 2018 but still above the EU-27 average of 1.8% (2020). According to the World Health Organization, 37.04% of the payments to healthcare providers are out-of-pocket payments made by individuals (2019), significantly higher than the EU-27 average (15.57% in 2018). There are no official records on over-the-counter payments for pharmaceuticals.

Measure 21: 'Improvement of the Efficiency of the Healthcare System through the Process of Digitalization'

This reform has been rolled over from last year. The single electronic health card will create a digital health file with patient information accessible to health sector workers and patients. It aims at contributing to better diagnosis and treatment through centralised and instantaneously available patient and treatment information. The initiative is a step forward towards digital transformation of the health sector and contributes to sustainable development goal 3: good health and well-being. The reform aims at greater transparency and efficiency in healthcare. However, the measure does not alleviate the shortage of medical staff and their tendency to emigrate.

ANNEX B: OVERVIEW OF THE MAIN INDICATORS PER AREA/SECTOR OF THE ECONOMY

Area/Sector	2017	2018	2019	2020	2021	EU-27 Average (2021 or most recent year)
Energy						
Energy imports dependency (%)	33.8%	34.6%	35.6%	29.8%	N/A	55.6%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	418.01	394.50	375.78	391.18	N/A	110.35
Share of renewable energy sources (RES) in final energy consumption (%)	20.29%	20.32%	21.44%	26.29%	25.28%	21.7%
Transport						
Railway Network Density (meters of line per km^2 of land area)	42.53 w	42.53 w	42.52 w	43.2w	43.4w	N/A
Motorization rate (Passenger cars per 1000 inhabitants)	278.2	284.1	297.6	315	325.4	N/A
Agriculture						
Share of gross value added (Agriculture, Forestry and Fishing)	7.2%	7.7%	7.2%	7.6%	7.6%	1.8%
Share of employment (Agriculture, Forestry and Fishing)	17.2%	15.9%	15.6%	14.6%	15.0%	4.3% (2020)
Utilised agricultural area (% of total land area)	38.8% w	39.4% w	39.3% w	N/A	N/A	40.6% (2020)
Industry						
Share of gross value added (except construction)	26.5%	25.4%	24.0%	23.4%	23.0%	19.9%
Contribution to employment (% of total employment)	21.2%	22.5%	22.6%	22.6%	N/A	16.1%
Services						
Share of gross value added	61.3%	61.5%	61.9%	62.5%	N/A	79.2%
Contribution to employment (% of total employment)	57.5%	57.2%	57.0%	57.5%	N/A	70.9%

Research, Development and Innovation						
R&D intensity of GDP (R&D expenditure as % of GDP)	0.87%	0.92%	0.89%	0.91%	0.99%	2.26%
R&D expenditure – EUR per inhabitant	48.6€	56.3€	N/A	61.2€	77.2€	734.5
Digital Economy						
Percentage of households who have internet access at home	68%	73%	80%	81%	82	92.5%(2022)
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	70%	73%	77.4%	79%	84	90%(2022)
Trade						
Export of goods and services (as % of GDP)	50.5%	50.4%	51.0%	48.2%	54.5%	50.4%
Import of goods and services (as % of GDP)	57.1%	59.1%	61.0%	56.5%	62.3%	46.7%
Trade balance (as % of GDP)	-8.1%	-10.3%	-11.7%	10.6%	-11.6%	N/A
Education and Skills						
Early leavers from education and training (% of population aged 1824)	6.2%	6.8%	6.6%	5.6%	6.3%	9.7%
Young people neither in employment nor in education and training (NEET) (% of population aged 15-29)	21.7%	20.1%	19.0%	20.0%	16.4%	10.8%
Children aged less than 3 years in formal child care (% of under 3-yearsolds)	14.5%	13.3%	17.2%	18.1%	18.0%	36.2%
Individuals who have basic or above basic overall digital skills (% of population 1674)	39%	N/A	46%	N/A	41%	54%

Employment						
Employment Rate (% of population aged 20-64)	60.0%	61.6%	63.6%	64.3%	66.7%	73.1%
Unemployment rate (% of labour force aged 15-74)	14.6%	13.8%	11.3%	9.8%	11.1%	7.0%
Long term unemployment rate (% of labour force aged 15-74)	7.4%	6.7%	5.5%	4.5%	N/A	N/A
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	14.7 pps.	15.4 pps.	14.6 pps.	14.6 pps.	14 pps.	11.5 pps.
Disability employment gap (Percentage points difference in employment rates between people with and without a disability)	25.4 pps.	27.2 pps.	36.0 pps.	34.8 pps.	N/A	N/A
Real gross disposable income of households (Per capita increase, Index = 2008)	N/A	N/A	N/A	N/A	N/A	N/A
Social Protection System						
At-risk-of-poverty or social exclusion rate (AROPE) (% of population)	39.5%	34.0%	31.1%	29.8%	28.4%	21.7%
At-risk-of-poverty or social exclusion rate of children (% of population 0-17)	41.7%	36.0%	34.5%	30.6%	N/A	N/A
Impact of social transfers (Other than pensions) on poverty reduction	18.67%	17.91%	18.02%	18.73%	28.14%	37.08%

Income inequality - quintile share ratio (S80/S20) (Comparison ratio of total income received by the 20% of the population with the highest income to that received by the 20% with the lowest income)	9.40	8.60	6.50	6.06	5.95	5.97
Housing cost overburden (% of population)	33.6%	31.3%	21.6%	17.8%	N/A	N/A
Healthcare						
Self-reported unmet need for medical care (of people over 16)	4.8%	5.8%	4.8%	3.8%	5.3%	2.0%
Out-of-pocket expenditure on healthcare (% of total health expenditure)	40.64% [z]	38.31% [z]	37.04% [z]	N/A	N/A	N/A

w: *data supplied by and under the responsibility of the national statistical authority and published on an "as is" basis and without any assurance as regards their quality and adherence to EU statistical methodology'*

z: Data from World Health Organisation

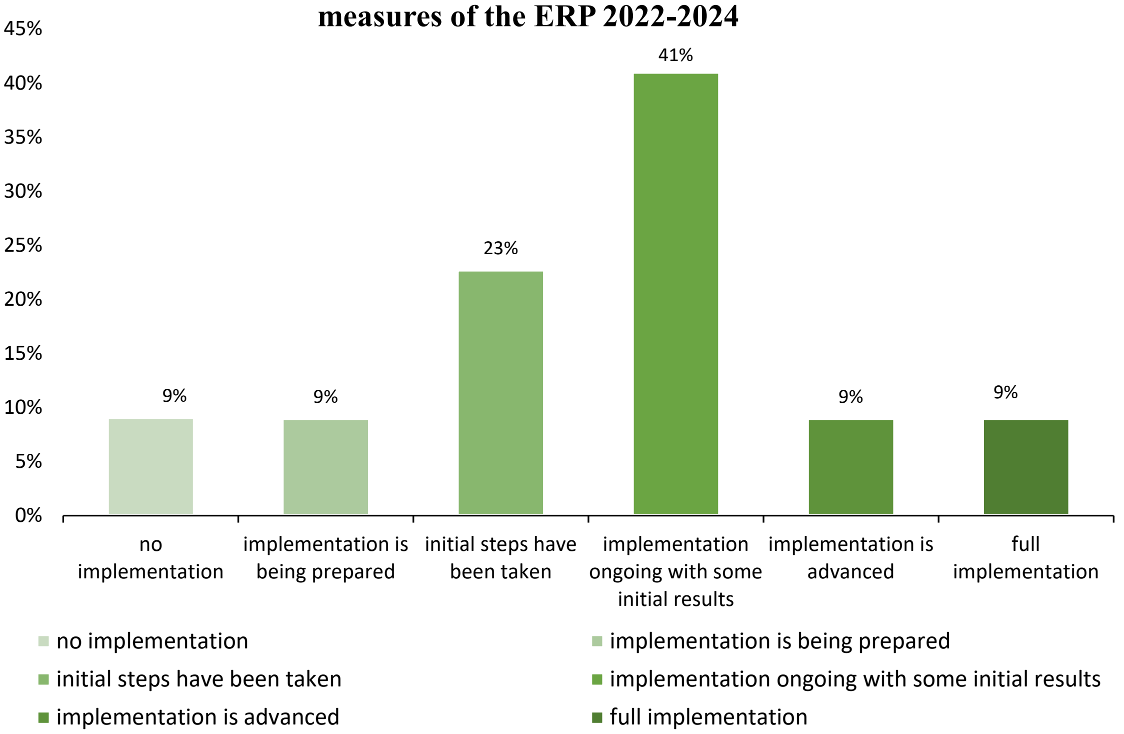
Source of data in Annex B: EUROSTAT unless otherwise indicated

ANNEX C: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM ERP 2022-2024

There was continued progress in implementing the measures in 2022, with an average score of 3.1 out of 5 (down from 3.3 in 2022). Overall, reporting on the implemented activities is fair but would benefit from being more concrete.

The highest level of implementation involves measures that have been carried over for several years, in particular measures relating to the reduction in administrative and regulatory burden for businesses, but also the energy sector. The reform measure on the introduction of a new fiscalisation model and electronic invoicing, and the reform measure on developing infrastructure related to the energy market both reached full implementation. By contrast, the pace of implementation is particularly slow for reforms regarding land consolidation, digitalisation of the agricultural sector and railway reform. The start of implementation of the reform measure on the digitalisation of the education system was not initiated.

Graph II.5.2: **Serbia - Implementation of the structural reform measures of the ERP 2022-2024**



ANNEX D: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government adopted and formally submitted the Economic Reform Programme on 31 January 2023. The programme is in line with the medium-term fiscal strategy and the 2023 budget and covers 2023-2025.

Inter-ministerial coordination

Preparation of the 2023-2025 ERP was coordinated by the Ministry of Finance (the Minister of Finance was appointed as a national coordinator) and the Secretariat for Public Policies. A number of other institutions also contributed through a working group set up specifically for this task, including the National Bank of Serbia (for the macrofiscal part) and some line ministries (for the structural reform measures part). This ERP, which is the ninth, has benefited from the accumulated know-how and lessons learned from previous rounds, which further improved the overall process. Several training courses for those involved in preparing the document were organised by the Centre of Excellence in Finance, the German Academy for International Cooperation (GIZ) and other bodies.

Stakeholder consultation

The national authorities involved stakeholders in the preparation of the document and held a consultation on the draft ERP. Stakeholders were invited to provide comments through the new online e-consultation portal for the second consecutive year. The final step in the consultation procedure was a meeting with the National Convention, which brought together some 700 social partners, non-governmental organisations, business associations and other stakeholders in Serbia. The National Convention set up an inter-sectoral working group, which examined the proposed reform measures and then submitted comments and suggestions. Some participants voiced their strong interest in having more time to comment on the ERP and to be involved earlier in the process. Comments received from stakeholders were included in the annex to the economic reform programme document.

Macro framework

The programme presents a clear and concise picture of past developments. It also covers all relevant data at the time of drafting. The macroeconomic framework is sufficiently comprehensive and coherent. The baseline macroeconomic scenario is broadly plausible and major uncertainties and risks are clearly outlined and recognised. The programme presents an alternative macrofiscal scenario that results in lower economic growth and higher budget deficit and debt levels. The alternative scenario appears very relevant in view of the identified risks in a context of inflationary pressures and high uncertainty, but the underlying assumptions do not appear to be sufficiently detailed and quantified to allow further assessment.

Fiscal framework

The fiscal framework, which is based on the baseline medium-term macroeconomic scenario, is sufficiently comprehensive and integrated with the overall policy objectives. Most revenue and expenditure measures are sufficiently explained, although the medium-term impact of some of them is not covered in sufficient detail. The programme does not contain any long-term projections of population trends or of the implications of an ageing population for the labour market and public finances, notably as regards health and pension systems. Significant further efforts would be needed to ensure that the fiscal data are compatible with ESA 2010.

Structural reforms

Reporting on implementation of the 2022-2024 structural reform measures is detailed and up to date. The ERP presents 21 reforms, one more than the maximum suggested by the guidance. The quality of measures varies. Some measures are narrow in scope, well-targeted and planned in detail, but others are overambitious and too wide-ranging. The annexed tables have been filled in correctly.

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6. TÜRKIYE

The economic reform programme (ERP) was submitted on 31 January 2023, before the two devastating earthquakes that hit Türkiye on 6 February 2023. The earthquakes constitute, first and foremost, a humanitarian crisis. As a consequence of this tragedy, more than 50 000 people died and more than 100 000 were wounded; around 3 million have been displaced and more than 1.5 million lost their homes. However, from an economic standpoint, the full impact of the earthquakes is yet to be assessed. The earthquakes affected 11 provinces accounting for 16% of the country's total population, 9.8% of its GDP and 5.2% of tax revenues. The GDP per capita of the affected provinces is around 60% of national average. While the extent of capital destruction is still being evaluated, it is clear that most of it was residential housing. The losses are in the range of tens of billions of euro. This year's economic reform programme assessment, based on a set of assumptions from before the earthquakes, must therefore be read in conjunction with Türkiye's revisited priorities following these events. Fully aware of the implications of the disastrous events on the Turkish society and economy, the European Commission believes it is worthwhile going ahead with this year's analysis in the spirit of a constructive technical dialogue.

6.1. EXECUTIVE SUMMARY

Although slowing down, Türkiye's economic growth remained strong in 2022. Real GDP grew by 5.6% in the year as a whole, but after a strong first half of the year, the rate decelerated in the second half. The economic reform programme (ERP) predicts a relatively robust growth performance but, in view of the built-up imbalances, this scenario appears optimistic. Moreover, despite the tragic loss of life and significant destruction of capital assets, the 6 February earthquakes are likely to dampen economic growth only slightly in 2023. In the current circumstances, priorities in the country are fully focused on recovery and offering help to all people in need. From an economic point of view, the reconstruction activities could have a positive impact on economic growth in the following years. The current policy mix favours economic growth over macroeconomic stability, sustained by increasingly disruptive policy measures. Following a series of interest rate cuts since the autumn of 2021, the central bank has maintained deeply negative real interest rates despite soaring inflation and tightening global financial conditions. Despite the outstanding export performance in recent years, the trade deficit remained significant and even expanded last year as gold imports tripled and high energy prices doubled the value of energy imports. The banking sector has remained resilient so far, navigating multiple shocks since 2018 and, after repeated capital injections in state-owned banks, entering 2023 with sound capital adequacy and liquidity ratios.

Following a strong fiscal boost expected in 2023, an election year, the ERP aims for a mild fiscal consolidation over the medium term. The government was already planning to increase the overall deficit in 2023, even before any support for the earthquake-hit regions was considered. In view of the significant reconstruction needs, the initial plan to tighten fiscal policy in the next 2 years would need to be reconfirmed and supported by new measures. The quality and credibility of the medium-term consolidation plan suffer from the lack of detailed measures in the ERP to back it up and from the continued withholding of productive capital expenditure. Earthquake-related reconstruction will likely add to public spending pressures, even though the authorities' initial response was to try to accommodate such costs within the 2023 budget. The ERP projects that the government debt-to-GDP ratio will decline steadily, to 32% in 2025. Heavy-handed regulatory measures affected the government securities market, lowering reliance on external debt and lengthening maturity, but did not fundamentally address debt vulnerabilities. Most debt stock remains denominated in foreign currencies and the country risk premium is very high. The relatively good budget performance in recent years masks an underlying trend of rising fiscal pressures and risks. Reflecting these risks, Türkiye's long-term sovereign rating was lowered further to non-investment-grade by all major rating agencies in 2022. Successive crises and shocks also triggered the adoption of numerous ad-hoc measures with budgetary effects that have strained public finance management. Fiscal governance would benefit from the introduction of fiscal rules and the setting up of an independent oversight body.

The main challenges facing Türkiye are the following:

- **The key challenge is to find a better balance between pursuing high economic growth, bringing down the very high inflation, reducing external imbalances, keeping exchange rate risks in check and maintaining buffers.** Overly loose monetary policy has led to very high inflation. Highly disruptive regulatory and macro-prudential measures hamper medium-term growth prospects and increase vulnerabilities. Addressing these challenges will require a tighter monetary policy stance, compatible with achieving price stability, a careful and gradual unwinding of the web of regulatory measures under a transparent monetary policy framework, and consistent communication.

- **Pre-election fiscal largesse is challenging the authorities' commitment to fiscal discipline and undermines efforts to reduce imbalances.** The fiscal stance is set to loosen and the composition of public expenditure to worsen in 2023 amidst rising spending pressures linked to the electoral cycle. Ad hoc policy measures have become more frequent. A credible medium-term fiscal consolidation plan and a return to primary surpluses, supported by improvements in public finance management, could help curtail fiscal risks.

- **Türkiye needs to upgrade the skills level of its working-age population in order to strengthen human capital and increase employment, in particular for women and young people.** Türkiye also needs to further increase the enrolment of children aged 5 and below in early childhood education and care in order to improve educational outcomes and allow women's participation in the labour market. The Turkish labour market has recovered from the COVID-19 pandemic and the employment rate (for those aged 15+) increased to 45.2% in 2021, from 42.7% in 2020. However, despite this recovery and the overall economic rebound, the gap between male and female employment remains significant, with activity and employment rates for women less than half the rates of men. In 2021, the employment rate for men was 62.8% against only 28% for women. Similarly, the transition of young people into the labour market remains a challenge. The youth unemployment rate (15-24) decreased from 24.9% in 2020 to 22.6% in 2021. The rate of young people not in employment, education or training improved but is still high. Finally, there is a need to address the persistent mismatch between the requirements of the labour market and the skills acquired in the education system and prepare the labour force for jobs of tomorrow such as in the green transition sectors.

- **Türkiye should speed up efforts on connectivity, green transition and adaptation to climate change which would also help the country to become more energy-independent.** A credible and concrete roadmap is needed to upgrade the country's energy infrastructure, notably to lower greenhouse gas emissions (including methane), with a view to peaking emissions as close to 2030 as possible and drastically accelerating the green transition. Türkiye should update its Nationally Determined Contribution under the Paris Agreement with a 2030 objective that is compatible with the ambition to reach net-zero in 2053. Cost-effective decarbonisation implies concrete steps to implement and roll out in 2024 an EU-compatible emission trading system. Additionally, with a view of meeting the national decarbonisation objective, Türkiye should promote more actively energy efficiency, the steady growth of renewables (both traditional and hydrogen-based), a phase-down of coal use in its energy mix to avoid the risk of stranded assets, and a phase-out of fossil fuel subsidies. Steps towards the green transition would also help to reduce Türkiye's dependency on external energy supplies, in particular natural gas imports from Russia, that is still very significant. Finally, in order to adapt to climate change – and taking into consideration the reconstruction efforts that will follow the devastating 6 February earthquakes – Türkiye should prioritise the highest standards in terms of green and resilient building and infrastructure.

- **Further efforts are needed to nurture competitiveness, and address informality and the digital transition.** Structural challenges remain for State aid, competition and the efficiency of the judiciary, where specialised courts for business and IP law do exist, but their number needs to increase and their efficiency needs to improve. Businesses continue to be affected by a lack of transparency and predictability in the way business-related legislation is adopted, which is only slowly improving. Türkiye's policy mix with regard to the country's 3.5 million SMEs would also need to be rationalised and streamlined. With the aim of improving the business environment, Türkiye should strengthen the rule of law and, in order to increase policy predictability, improve the regulatory environment and consultation mechanisms with business organisations and social partners on relevant new legislation. Additionally, Türkiye should implement legislation and enhance transparency regarding State aid to achieve a meaningful level-playing field in the spirit of the Customs Union.

The implementation of the policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2022 has been limited. The policy mix remained unbalanced, with an overly loose monetary policy and a tight fiscal policy in 2022. The government increased its support for households and firms via multiple channels (such as minimum wage hikes, support for energy bills, support for students, government-backed loans, etc.). Contrary to the commitments expressed in policy documents, tax restructuring and capital repatriation became established practice. Parliamentary approval of the public-private partnership (PPP) framework legislation is still pending, and public procurement procedures and exemptions have not been simplified. The implementation period of the foreign exchange (FX) value guarantees on lira time deposits and the incentives applied to the scheme have been extended. The central bank further reduced its key policy rate and the authorities are increasingly relying on macro-prudential measures to achieve their monetary policy goals. The recommendations on carbon pricing and resource efficiency have not materialised into concrete legislative changes to date, although some preparations are ongoing. Some reform measures have been announced on the business regulatory environment and the green transition, but these fall short of addressing core problems in these areas. Concrete steps have been undertaken to streamline business disputes and to set up an ETS system, but a realistic timeline and concrete milestones are needed to progress on both fronts. Some measures have been adopted for young people and those not in education, employment or training (NEET), for example to improve quality and access to vocational education and training (VET). As regards the rate of participation in early childhood education and care the offer is not developed enough to allow for more female employment. This and active labour market policies aimed at getting women into the labour market have had little structural impact.

The key structural challenges identified in the ERP largely correspond to those identified by the Commission, but the analysis is incomplete. The analysis of structural obstacles does not examine key sectors of the economy, notably industry and services (except tourism). While the analysis of the green transition does examine some of Türkiye's challenges, on which a specific measure is included, the shared European growth model involving green and digital transition needs to be further strengthened, especially in the current geopolitical context. In line with the EU strategy for the digital agenda, reform of the development of broadband infrastructure is expected to positively affect the economy. The reform measures largely address the identified key challenges. However, the ERP includes no measures to improve the quality of higher education.

6.2. ECONOMIC OUTLOOK AND RISKS

Although decelerating, Türkiye's economic growth remained strong in 2022. Real GDP grew by 5.6% ([92]), above the authorities' expectations, but after a strong first half of the year it decelerated in the

([92]) Macroeconomic and fiscal estimates and forecasts covering the period 2022-25 have been taken from the ERPs themselves; if available, preliminary macroeconomic and fiscal outturn data for 2022 have been taken from the relevant national sources (national statistical office, ministry of finance, central bank).

second half. Net exports made a positive contribution to growth, despite a rapid loss in export momentum and a pick-up in imports by the end of the year. A notable increase in technology-intensive and export-oriented sectors drove industrial production up to record-high levels on average in 2022. The growth in household consumption was particularly strong, sustained by robust job creation, large increases in the minimum wage, and deeply negative real interest rates. Inventories continued to fall and very weak construction investment pulled down total investment, while investment in machinery and equipment maintained a robust rate of expansion.

The ERP forecasts steady annual economic growth of around 5% over the medium term. While headline growth projections remained largely unchanged from last year's programme, the growth composition shifted slightly away from domestic demand towards net exports. Nevertheless, domestic demand is expected to remain the main driver of growth with a strong contribution from private consumption and investment. Despite the tragic loss of life and significant destruction of capital assets, the 6 February earthquakes are likely to dampen economic growth only slightly in 2023, while reconstruction activity could have a positive impact on growth in the following years. According to ERP projections, good export and industrial performance will continue, in line with the authorities' plan (the 'Turkish Economic Model') implemented since the autumn of 2021. This plan aims to achieve a positive current account balance, reduce dependency on (short-term) external financing, and increase the role of the lira in the economy, while keeping interest rates low and directing credit to tradable and high-value-added sectors. The plan also assumes the prolongation of complex and sometimes disruptive macroprudential and other regulatory measures and the possible introduction of new ones. The reliability of estimates on the cyclical position of the economy has been affected by the high economic volatility in recent years and major structural changes, triggered first by the COVID-19 crisis and later by the spillover from Russia's war of aggression in Ukraine. Nevertheless, the ERP estimates the output gap to have been positive in 2022 and forecasts it to continue to widen throughout the duration of the programme. By factors of production, economic growth in 2023-2025 is expected to be driven mainly by capital (2.1 percentage points (pps) per year on average), with sizeable contributions from employment (1.7 pps), and total factor productivity (1.5 pps).

Table II.6.1:
Türkiye - Comparison of macroeconomic developments and forecasts

	2021		2022		2023		2024		2025	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	11.4	**11.4**	5.0	**5.0**	3.5	**5.0**	3.0	**5.5**	n.a.	**5.5**
Contributions:										
- Final domestic demand	11.1	**11.4**	8.2	**8.3**	3.1	**3.9**	2.6	**4.9**	n.a.	**4.7**
- Change in inventories	-6.3	**-4.9**	-5.0	**-5.7**	0.0	**0.1**	0.0	**-0.1**	n.a.	**-0.1**
- External balance of goods and services	6.4	**4.8**	1.9	**2.4**	0.4	**0.8**	0.5	**0.6**	n.a.	**0.9**
Employment (% change)	7.9	**7.9**	6.5	**6.5**	2.6	**2.8**	1.8	**2.9**	n.a.	**2.8**
Unemployment rate (%)	11.8	**12.0**	10.5	**10.8**	10.5	**10.4**	10.5	**9.9**	n.a.	**9.6**
GDP deflator (% change)	29.0	**29.0**	74.4	**76.5**	69.4	**32.3**	54.7	**19.1**	n.a.	**11.0**
CPI inflation (%)	19.4	**19.6**	71.7	**72.3**	54.1	**31.6**	40.4	**19.7**	n.a.	**11.9**
Current account balance (% of GDP)	-1.7	**-0.9**	-5.9	**-5.9**	-3.3	**-2.5**	-2.6	**-1.4**	n.a.	**-0.9**
General government balance (% of GDP)	-1.1	**-2.6**	-3.5	**-3.2**	-4.0	**-3.5**	-3.5	**-2.4**	n.a.	**-1.4**
Government gross debt (% of GDP)	41.8	**41.8**	39.4	**36.7**	38.3	**35.2**	37.2	**33.6**	n.a.	**32.1**

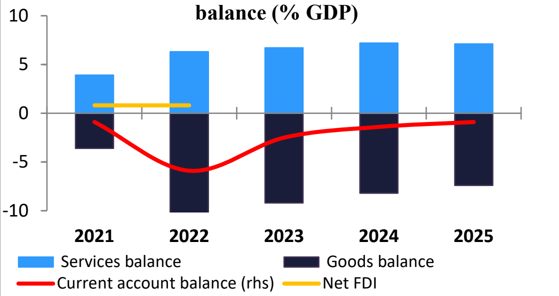
Sources: Economic Reform Programme (ERP) 2023, Commission Autumn 2022 forecast.

The macroeconomic scenario appears rather optimistic in view of the built-up imbalances and the complex and disruptive policy measures. The key challenge is to find a balance between pursuing high economic growth and bringing down the very high inflation, reducing external imbalances, keeping exchange rate risks in check and maintaining buffers. The planned growth path is likely to be increasingly difficult to follow as intrusive regulatory actions skew incentives and strain resources in the economy, undermining medium-term growth potential. Growth volatility is likely to remain a feature of the economy, closely linked to policies that stimulate domestic demand, which are in turn connected to the 2023 elections and the earthquake recovery. While the export profile seems plausible, it will largely depend on the growth performance of major trading partners in the EU, in a highly uncertain geopolitical environment, and the ability to hold on to competitiveness gains. On the positive side, Türkiye stands to gain from the shortening of global supply chains and nearshoring (transferring business operations to nearby countries) but it has yet to realise its full potential in attracting foreign direct investment. The macroeconomic and fiscal outlook continue to be affected by high degree of uncertainty related to the further economic fallout from Russia's war of aggression against Ukraine, in particular on energy supply and inflation. However, Türkiye has also benefited from expanding its trade with Russia and from preferential conditions on some of its energy imports. With the balance of risks tilted to the downside, the failure to present an alternative scenario is a drawback of the programme.

Bringing down the very high inflation in a sustainable manner is an uphill battle. The inflation targeting regime and the free-floating exchange rate nominally pursued by the central bank are effectively no longer the guiding framework for monetary policy. The monetary policy transmission mechanism is broken, with limited responsiveness of key market interest rates to the central bank policy rate. After depreciating by 40% against the US dollar in the first three quarters of 2022, the lira remained broadly stable up to early March 2023. Inflation peaked at 85.5% in October 2022 and declined steeply in the following months on the back of sizeable base effects. The ERP forecasts that inflation will fall steadily to 24.5% by the end of 2023 and enter single digits in 2025, which appears optimistic unless the policy stance tightens substantially. The earthquakes may also have a certain inflationary impact via the disruption of supply chains, increased domestic demand, and looser policies. The central bank has maintained deeply negative real interest rates since the fall in 2021 and has cut its key policy rate by another 550 basis points (bps) to 8.5% in February 2023 (the last 50 bps were delivered after the earthquakes), despite very high inflation and tightening global financial conditions. To sustain this policy and alleviate its many contradictions, the authorities have introduced an increasingly complex web of regulatory and macroprudential measures to reduce dollarisation, support the lira, lower inflationary pressures, ration and direct credit, and limit interest rates. While this set of measures achieved some short-term results, it failed to address the fundamental drivers of high inflation, namely deeply negative real interest rates, the lack of an effective policy anchor, and the weakened institutional independence of the central bank and key agencies. As relative prices adjust, inflation is thus likely to remain high at above 40% in 2023, driven by unanchored expectations, inertia, and bouts of exchange rate volatility.

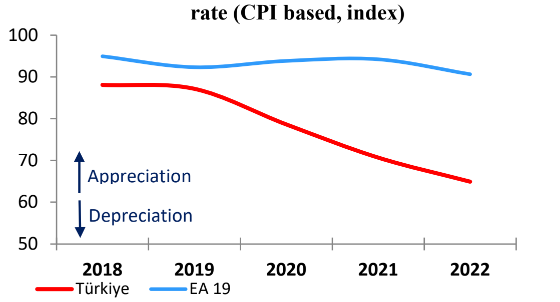
External competitiveness and current account

Graph II.6.1a: **Türkiye - Current account balance (% GDP)**



Source: Economic Reform Programme (ERP) 2023.

Graph II.6.1b: **Türkiye - Real effective exchange rate (CPI based, index)**



Source: Economic Reform Programme (ERP) 2023, Central Bank, ECB.

Türkiye's trade openness increased further to a record high level, but imbalances widened mainly due to increased global energy prices. Exports rose further, reaching new highs in 2022, benefiting from a sizeable depreciation of the lira – the average real effective exchange rate has depreciated by around 30% since 2018. Despite outstanding export performance in recent years, the trade deficit remained significant and even expanded in 2022 as non-monetary gold imports tripled (reflecting increasing demand for gold as a financial asset) and high energy prices doubled the value of energy imports. As a result, the current account deficit grew from less than 1% of GDP in 2021 to above 5% of GDP in 2022, while the non-energy, non-gold current account recorded a surplus. The ERP forecasts a steep reduction in the current account deficit, expecting energy prices, and with it the energy import bill, to decline in 2023, and the export of tourism services to continue growing after their best-ever performance in 2022. However, after the earthquakes this scenario is largely outdated and in addition is subject to non-negligible risks from global commodity prices, the tourism sector's vulnerability to geopolitical tensions, and more frequent extreme weather events. Historically, external imbalances have also been very sensitive to policy-induced volatility from overly expansionary domestic policies, while the appreciation of real exchange rate since last summer has somewhat reversed price competitiveness gains.

The ERP outlines an intention to move towards more stable, long-term foreign financing, but results have been paltry so far. In view of Türkiye's recent past and future development ambitions, the goal of becoming less reliant on volatile foreign inflows seems well warranted. However, the new economic model has been only partially successful so far in repelling some of the so-called 'hot money,' while, despite an uptick in 2022, foreign direct investment remains below its historic highs. In addition, around half of the current account deficit financing in 2022 came from unexplained sources. The larger-than-usual errors and omissions may have been partially driven by a return to the banking system of deposits withdrawn during the depreciation of the lira in December 2022, unrecorded repatriation of foreign assets by Turkish residents, and cash inflows linked to Russian immigrants. Türkiye also secured a large deposit from Russia's Rosatom and a swap (in non-SDR basket currencies) from the central bank of the United Arab Emirates in 2022, and a USD 5 billion deposit from Saudi Arabia in March 2023. These non-market and politically-driven inflows have boosted foreign exchange reserves, though they are still dwarfed by the large foreign financing needs (the current account deficit and short-term debt on remaining maturity basis totalled nearly USD 240 billion or around 25% of GDP at the end of 2022). External debt remained broadly unchanged in nominal terms and declined slightly as a percentage of GDP, to around 53% in 2022. However, the unorthodox domestic policy setting has increased perceived risks and has generally shifted external borrowing from long-term to short-term maturities, in particular for non-financial companies. These companies have remained largely resilient and managed to reduce their open net foreign exchange position, while further building up their positive short-term position (above USD 70 billion). Despite higher costs, banks have managed to roll over their external obligations, but their increased exposure to foreign currency swaps with the central bank raises economy-wide foreign currency liquidity concerns.

The banking sector has remained resilient so far. Türkiye's commercial banks have been the authorities' preferred channel for demand management and are of vital importance for the rest of the economy. The sector has navigated multiple shocks since 2018 and entered 2023 with sound capital adequacy (19.5%) and liquidity ratios. In 2022, supported by large net interest revenues, return on assets reached 3.7% and return on equity 49.9%, but due to the very high inflation real return was deeply negative. The non-performing loan ratio fell to its lowest level in years (2.1%) and loan-loss provisioning increased further. However, headline asset quality indicators remain blurred by expansive forbearance measures, although the biggest of these, the use of the end-2021 exchange rates, was tightened substantially in early 2023 with the move to end-2022 exchange rates. The banking system's duality (diverging behaviour of public and private-sector banks) intensified as state-owned banks expanded further in 2022, reflecting their role as the main conduit for delivering credit at below-market rates at the expense of generally weaker capital and profitability positions. Türkiye remains on the Financial Action Task Force grey list and is working on implementation of an action plan to ensure effective regimes for anti-money laundering and countering the financing of terrorism, in line with the Task Force's recommendations.

Far-reaching prudential and regulatory measures have disrupted the functioning of financial markets and increased risks. Reducing interest rates and keeping them down is the revealed policy 'anchor', which necessitated follow-up actions to mitigate its fundamental contradictions in a high-inflation environment. A succession of measures providing incentives or imposing restrictions have been introduced since late 2021 covering: deposits (Turkish-lira-denominated deposits protected against depreciation losses; required shares of Turkish-lira-denominated deposits); reserve and security requirements; collaterals in swap and interbank money markets; tax exemptions; FX surrender requirements for exporters; capital adequacy ratios; risk weights; and commercial loans (see the text box for further details). Many of these measures negated and replaced price signals with quantitative targets or directly socialised risk with a view to providing incentives to market players that offset the impact of the monetary policy stance. Such a complex financial repression system distorts price signals and incentives, creates inefficiencies, is difficult to manage, increases financial sector risks, leads to sizeable public liabilities, and has major, often overlooked, distributional consequences. Moreover, exiting such measures will not be simple in view of the many interlinkages and vulnerabilities, and future monetary policy normalisation carries certain (interest rate) risks for the banking sector.

Box II.6.1: **Main policy measures taken since December 2021**

Date	Field	Measure
December 2021	Interest rate	Policy rate (one-week repurchase agreement (repo)) cut by 100 bps to 14%.
December 2021	Deposits	Introduction of FX-protected return for converting foreign exchange (FX) and gold deposits into lira deposits (applied to domestic real persons).
December 2021	Loans	Maturity restriction on consumer loans for mobile phones
January 2022	Deposits	FX-protected return scheme extended to legal persons' deposits.
January 2022	Taxation	Tax exemption of gains from the FX-protected deposits.
January 2022	FX	Exporters required to sell 25% of their FX earnings to the central bank.
January 2022	Swaps	A swap agreement with the Central Bank of the United Arab Emirates (AED 18 billion and TRY 64 billion; USD 4.9 billion).
January 2022	Minimum wage	Monthly net minimum wage increased by 50.6% from TRY 2,825.00 to TRY 4,253.40.
February 2022	Deposits	FX-protected return scheme extended to non-resident Turkish citizens.
February 2022	Budget	Central bank decided to pay advance dividends from its 2021 profit.

Continues...

Main policy measures taken since December 2021 (continued)

Date	Field	Measure
February 2022	Loans	Loan-to-value and maturity restrictions on vehicle loans.
March 2022	State-owned banks	The Turkey Wealth Fund injected TRY 51.5 billion of additional capital into several state-owned banks, including the biggest – Ziraat, Vakıfbank and Halkbank.
April 2022	Reserve requirements	Reserve requirements (10%) imposed on banks and financing companies' lira-denominated commercial cash loans, except for some loans (SMEs, export, investment, tradesmen, agricultural, state-owned enterprises (SOEs), financial institutions, commercial credit cards); banks with a loan growth rate above 20% by 31 May 2022 compared to 31 December 2021 are subject to a higher reserve requirement.
April 2022	Reserve requirement	Additional reserve requirement of 500 bps for banks with a conversion rate of real person's FX accounts to TRY accounts below 5%, and 300 bps for banks with a conversion rate between 5% and 10%.
April 2022	Deposits	Commission fee of 1.5% if banks cannot reach the FX deposits conversion targets.
April 2022	FX	Exporters required to sell 40% of their earnings to the central bank.
April 2022	Reserve requirement	Lira-denominated required reserves lowered to 0%.
May 2022	Loans	The risk weight for commercial Turkish lira-denominated cash loans increased to 200% (except for agricultural loans, SME loans, export and investment loans, loans to public institutions organizations and SOEs, corporate credit cards and loans to banks or financial institutions)
June 2022	Budget	Revised budget adopted with unchanged deficit target of 3.5% of GDP.
June 2022	Government securities requirement	Commercial banks required to maintain additional Turkish lira long-term fixed-rate government securities for foreign currency deposits/participation funds (minimum of 45% of collateral in swap/interbank money market transactions to be in domestic government bonds).
June 2022	Reserve requirement	Loans reserve requirement increased from 10% to 20%.
June 2022	Government securities requirement	Commercial banks required to hold fixed-rate government bonds with a maturity of at least 5 years, and with at least 4 years left to maturity, against their foreign currency deposits (3% or 10%, depending on the conversion rate of FX into lira deposits).
June 2022	Loans	New lira loans restricted to companies with FX cash over TRY 15 million (USD 0.8 million), and more than 10% of total assets or annual revenues.
June 2022	Loans	Minimum payment limit on credit cards with a card purchasing limit over TRY 25 000 raised from 20% to 40%. The risk weight of commercial cash loans extended to domestic residents (except for banks and financial institutions) who carry out derivative transactions with non-residents increased to 500%. Loan-to-value restrictions on housing loans.
July 2022	Government securities requirement	45% swap collateral raised to 50%.

Continues...

Main policy measures taken since December 2021 (continued)

Date	**Field**	**Measure**
July 2022	Minimum wage	Monthly net minimum wage raised by 29.3% from TRY 4 253.40 to TRY 5 500.35.
August 2022	Interest rate	Policy rate (one-week repo) cut by 100 bps to 13%.
August 2022	Government securities requirement	20% loans reserve requirement replaced by securities maintenance requirement (30%).
August 2022	Government securities requirement	Securities requirement holding set at 20% of the loan amount if at an annual compound interest rate 1.4 times higher than the CBRT-released annual compound reference rate; 90% if the interest is 1.8 times higher.
August 2022	Required reserves	Additional reserve requirement of 500 bps for banks with a conversion rate of FX deposits lower than 10% and 300 bps for conversion rate between 10% and 20%.
September 2022	Interest rate	Policy rate (one-week repo) cut by 100bps to 12%.
September 2022	Deposits	Commission fee if banks cannot meet FX deposits conversion targets (share of lira deposits less than 50% of total deposits) raised from 1.5% to 3%.
October 2022	Interest rate	Policy rate (one-week repo) cut by 150bps to 10.5%.
October 2022	Government securities requirement	Securities maintenance ratio revised to 5%. From 2023 securities to be maintained based on targets for lira deposits share, instead of conversion rate.
November 2022	Interest rate	Policy rate (one-week repo) cut by 150bps to 9.0%.
December 2022	Government securities requirement	Securities maintenance regulation extended to other financial institutions and the scope of assets and liabilities subject to it expanded.
January 2023	Loans	Maturity restrictions on mobile phone loans unchanged, but the threshold for consumer purchases raised from TRY 5 000 to TRY 12 000.
January 2023	Government securities requirement	Securities maintenance ratio raised to 10%. Banks with lira deposits between 60% and 70% of total to get a 5-point discount, and those above 70% a 7-point discount on the securities maintenance ratio.
January 2023	Required reserves	Required reserves for lira deposits longer than 3 months and for the increase in FX liabilities with maturities longer than 6 months provided directly from abroad set at 0%.
January 2023	FX	Companies selling FX obtained from abroad to the central bank and depositing funds (after selling at least 40% of their FX) in FX-protected conversion accounts to receive 2% conversion support.
January 2023	Minimum wage	Monthly net minimum wage raised by 54.6% from TRY 5 500.35 to TRY 8 506.00.

Table II.6.2:
Türkiye - Financial sector indicators

	2018	2019	2020	2021	2022
Total assets of the banking system (EUR million)	641	676	678	628	724
Foreign ownership of banking system (%)	26.8	26.0	25.0	25.9	24.9
Credit growth (aop)	21.3	6.5	28.4	22.7	56.0
Deposit growth (aop)	22.9	18.8	36.4	28.0	78.3
Loan-to-deposit ratio (eop)	1.18	1.03	1.04	0.85	0.79
Financial soundness indicators (%, eop)					
- non-performing loans to total loans*	3.9	5.4	4.1	3.2	2.1
- regulatory capital to risk-weighted assets	17.3	18.4	18.8	18.4	19.5
- liquid assets to total assets	10.7	10.0	9.4	13.3	11.6
- return on equity	14.7	11.5	11.4	15.5	49.9
- forex loans to total loans	39.9	38.0	34.0	42.2	32.6

* including the impact of write-offs.
Sources: National Central Bank, IHS Markit.

6.3. PUBLIC FINANCE

The fiscal stance tightened as budget outturn continued to outperform expectations in 2022. The central government ended the year with a budget deficit of TRY 139.1 billion (0.9% of GDP), significantly below the original budget target, the revised budget target of 3.4% (of September 2022), and the previous year's deficit of 2.8% of GDP. Preliminary estimates also point to a marked fall of the general government deficit to around 1.0% of GDP, instead of the expected 3.2% of GDP. The better-than-planned budget outturn is not fully reflected in the ERP analysis due to the late availability of the data, but it materially changes some of its conclusions. Very high inflation and good corporate profits boosted the revenue side and total budget revenue increased to an estimated 20.7% of GDP, or 2 pps above the initial budget. Despite a significant increase in transfers and lending to contain the pressures from high energy prices and support the liraisation strategy, overall government spending growth was restrained, and total spending even declined to 21.7% of GDP mainly due to lower personnel expenditure and social transfers. The stable exchange rate since the summer of 2022 also brought tangible savings as expenditure on the FX-protected deposits scheme turned out lower than planned. The financial repression measures that forced domestic banks to increase their holdings of government bonds helped to lower interest payments as a share of GDP, more than offsetting the effects of the weaker lira. With an estimated positive and growing output gap, the actual fiscal stance had become strongly counter-cyclical, and the structural balance turned to surplus.

Following a widening of the budget deficit in 2023, even before the recent earthquakes, the ERP targets a mild consolidation over the medium term. The fiscal stance is expected to become pro-cyclical as government expenditure, both structural and one-off, is set to increase strongly in 2023, influenced by the election cycle. Earthquake-related public reconstruction spending will add to the expenditure pressure. However, the authorities' initial response was to try to accommodate reconstruction costs within the 2023 budget, by redirecting and prioritising appropriations. They have also raised donations from the central bank, state-owned banks, and state-owned enterprises, and declared that they stand ready to raise additional revenue if needed. Foreign donors also pledged substantial amounts for reconstruction efforts at the donors' conference organised by the European Commission and the Swedish Presidency of the Council in March. After deteriorating in 2023, the primary balance is planned to improve by 1.9 pps in 2024-2025 to a surplus of 1.5% of GDP, which is close to the level achieved in 2022. The medium-term consolidation plan is expenditure-driven, while the revenue-to-GDP ratio is set to decline marginally. The expiry of one-off and other temporary measures and lower public consumption is expected to contribute to a total fall in spending by 2.5 pps. Government investment is set to remain at a very low level (2.5% of GDP), while interest payments are set to increase to around 3% of GDP. The quality and credibility of the medium-term consolidation plan are affected by a lack of detailed measures in the ERP to back the plan up and from the continued suppression of productive capital expenditure.

Table II.6.3:
Türkiye - Composition of the budgetary adjustment (% of GDP)

	2021	2022	2023	2024	2025	Change: 2022-25
Revenues	30.9	29.5	30.8	30.5	30.4	0.9
- Taxes and social security contributions	24.5	23.9	25.1	25.0	25.0	1.1
- Other (residual)	6.4	5.6	5.6	5.5	5.4	-0.2
Expenditure	33.5	32.8	34.3	32.9	31.8	-1.0
- Primary expenditure	30.9	30.3	31.2	29.8	28.9	-1.4
of which:						
Gross fixed capital formation	2.6	3.0	2.5	2.5	2.5	-0.5
Consumption	14.4	13.4	13.8	13.4	13.3	-0.1
Transfers & subsidies	6.8	5.8	7.2	6.2	6.1	0.3
Other (residual)	7.1	8.1	7.7	7.7	7.0	-1.1
- Interest payments	2.6	2.5	3.1	3.1	2.9	0.4
Budget balance	-2.6	-3.2	-3.5	-2.4	-1.4	1.8
- Cyclically adjusted	-2.3	-3.7	-3.9	-2.7	-1.7	2.0
Primary balance	0.0	-0.7	-0.4	0.7	1.5	2.2
- Cyclically adjusted	0.3	-1.1	-0.7	0.4	1.3	2.4
Gross debt level	41.8	36.7	35.2	33.6	32.1	-4.6

Sources: Economic Reform Programme (ERP) 2023, Commission calculations.

Pre-election fiscal largesse is challenging the authorities' commitment to fiscal discipline and is undermining efforts to reduce imbalances. The parliament approved the 2023 central government budget on 16 December, planning a deficit of TRY 659.4 billion (3.5% of GDP). The budget is based on the rather optimistic macroeconomic assumption of 5% real GDP growth and 24.9% average consumer price inflation. Total revenue is planned to increase by 36.0% and expenditure by 52.0% in comparison to the 2022 budget outturn. The large increase in expenditure in an election year would support domestic demand at a moment when the economy is already overheating and inflation is significantly above the central bank target. It would also make it harder to lower inflationary pressures and external imbalances, while exacerbating an environment of continued macro-financial volatility, and most likely triggering additional distortionary regulatory measures.

The 2023 budget introduced some new measures but failed to fully exit the 'crisis mode' of ad hoc decisions. On the revenue side, the 2% accommodation tax adopted 2 years ago started to be applied at the beginning of the year. The corporate income tax rate has been lowered as planned to its standard rate of 20%. The ERP, however, did not clarify the status of the numerous tax reductions and exemptions introduced to fight inflation and support the lira, and other temporary measures, which had significant impact on budget revenues in 2022. On the expenditure side, the budget continues to underwrite costly and poorly targeted measures to support the lira and cushion the impact of high energy prices, although lower-than-expected international gas prices are likely to provide some relief and lead to sizeable savings. The budget will also finance subsidised loan programmes and a new social housing construction project that were announced last year. Some measures with large budgetary impact, increasing non-discretionary expenditure, were finalised after budget adoption and are not fully reflected in the budget. These include a 54.7% increase in the net monthly minimum wage, a hike in civil servant salaries and pensions by 30% (above the level prescribed by existing rules), and the removal of the age requirement for early retirement (affecting more than 2 million people and likely adding up to 1% of GDP to budget expenditure in 2023).

The budget also did not take into consideration new tax amnesty legislation (revenue-restructuring and outright forgiveness for small obligations to the state) that was adopted at the beginning of 2023.

Box II.6.2: **Debt dynamics**

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

	2021	2022	2023	2024	2025
Gross debt ratio [1]	**41.8**	**36.7**	**35.2**	**33.6**	**32.1**
Change in the ratio	2.1	-5.1	-1.5	-1.6	-1.5
Contributions [2]:					
1. Primary balance	**0.0**	**0.7**	**0.4**	**-0.7**	**-1.5**
2. "Snowball" effect	**-8.5**	**-15.8**	**-6.7**	**-3.8**	**-1.8**
Of which:					
Interest expenditure	2.6	2.5	3.1	3.1	2.9
Growth effect	-3.2	-1.1	-1.3	-1.5	-1.6
Inflation effect	-8.0	-17.2	-8.5	-5.3	-3.1
3. Stock-flow adjustment	**10.6**	**10.1**	**4.9**	**2.9**	**1.8**

[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) 2023, Commission calculations.

The ERP projects that government debt will decline steadily, to 32% of GDP in 2025. The debt ratio peaked at 42.3% of GDP in early 2022 but came down strongly by the end of the year, to 31.7% of GDP, below even the ERP estimate of 36.7%. Net debt also declined. The strong denominator effect from the very high inflation was the main reason for the steep fall in the debt-to-GDP ratio in 2022. Although deteriorating in 2023, the primary balance is expected to return to surplus in 2024 and to be a stabilising factor for the government debt ratio. High inflation is projected to remain the main driver of debt reduction, but its contribution is set to decrease substantially, in line with the ERP's sanguine assumptions about the pace of disinflation. Forecast real GDP growth is expected to cover around half of the debt-increasing effects from interest payments. The debt-increasing contribution from stock-flow adjustments, stemming mainly from the depreciation of the lira, is projected to subside rapidly in 2023 due to the expected relative stability of the exchange rate.

Heavy-handed regulatory measures affected the government securities market but did not fundamentally address debt vulnerabilities. The authorities introduced requirements for commercial banks to increase their holdings of government debt denominated in lira. As a result, yields on government bonds fell across the board to levels close to those on foreign exchange-denominated securities, despite the much higher domestic inflation rate. The banking sector's share in domestic debt reached 76.9%, up nearly 30 pps over the last 5 years, as corporate investors reduced their exposure and non-residents left the market entirely (their share was below 1%), further shrinking the investor base. Concerted 'liraisation' efforts increased the share of new domestic borrowing in lira to 90% in 2022. Nonetheless, because of its depreciation, the lira's share in government debt stock went up only marginally from 34.0% to 34.5% in 2022, while close to two thirds of the debt stock was still denominated in foreign currencies. The weighted average maturity of domestic borrowing increased further from 53.5 to 70 months, raising the average time to maturity for domestic debt to 3.6 years. However, the average time to maturity for the total debt stock remained unchanged at 5.4 years, as external debt maturity decreased for a fifth year in a row to 7.1 years. After peaking at historically high levels (above 900 bps) in the summer, affected by changing domestic and global financial and geopolitical conditions, Türkiye's 5-year credit default swap spread declined by around 400 bps but remained very high at above 500 bps. Reflecting increased macro-financial risks, Türkiye's long-term sovereign rating was lowered by all major rating agencies in 2022.

Although fiscal policy has been tight, risks are growing. The relatively good budget performance in recent years masks an underlying trend of rising fiscal pressures, which escalated further in the run-up to the election. Some crisis-related measures, like FX-guaranteed lira deposits and energy-crisis-related transfers and lending, had a direct and sizeable impact on the budget. The FX-guaranteed deposits also remain a potentially significant source of budget liabilities, above the amounts envisaged in the 2023 budget. Some policy decisions, like subsidised and directed lending via state-owned banks, ultimately also have a bearing on the budget via lost tax revenue and the need for frequent recapitalisations. Systematic public information on expenditure arrears is lacking. The government's liquidity preference remained high, with public sector deposits and other financial assets persistently above 5% of GDP since mid-2020. In addition, the 2023 budget also contains large reserve appropriations (0.5% of GDP) and other buffers, the latter partly stemming from interest payments, which are likely overestimated in the current financial repression context.

After some improvements in recent years, the quality of public finance deteriorated. Successive crises and shocks triggered the adoption of numerous ad-hoc measures with budgetary effects that have strained public finance management. Economic volatility and additional demands on the budget have also led to recurring budget revisions, derailing the regular budget process. Despite a limited increase in capital spending in 2022, investment in human and physical capital is low and is expected to remain so over the duration of the programme. The multiple tax exemptions and reductions undermine tax bases and complicate planning (tax expenditures are sizeable), while successive tax amnesties have now become the rule rather than the exception, despite official policy declarations. The planned new single, consolidated framework for all public-private partnerships has yet to be adopted. The framework is to be fully integrated in the budget process and should be designed to improve management and monitoring. The government continued to use the negotiated procedure in its procurement deals, which allows contracting authorities to limit competition and transparency by referring to discretional criteria that cannot be objectively measured.

The fiscal framework lacks strong anchors. Even though the fiscal performance has been consistently robust in recent years, there are still no national fiscal rules or independent fiscal institutions to monitor fiscal performance, review forecasts and advise the government on fiscal policy matters. The medium-term budget framework is subject to frequent changes and is not sufficiently credible and binding. Macroeconomic forecasts underpinning budgetary planning remain biased, repeatedly underestimating domestic and external imbalances. Some steps have been taken to strengthen the system of public internal financial control by updating the relevant legislation and improving administrative capacity.

6.4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

Türkiye benefits from a strategic geographical position, a strong and entrepreneurial business sector, a large domestic market and a young population. It also has privileged access to the EU market for goods through the customs union with the EU. Since the early 2000s, the Turkish economy has relied on credit growth and foreign financing to provide jobs for the many new entrants to the labour market. As a consequence, structural imbalances worsened, amplifying the economy's vulnerability. As Türkiye mitigated the COVID-19 crisis in 2021, it continued to expand domestic credit and relax monetary policy. While this policy was effective in providing some short-term relief, it has fuelled record-high inflation and strained economic fundamentals.

The Commission has conducted an independent analysis of the Turkish economy to identify the key structural challenges to boosting competitiveness and inclusive growth. This analysis drew on the Turkish ERP itself, discussions with the authorities, as well as other sources. It shows that Türkiye is experiencing a number of structural weaknesses across many sectors. Besides the need to secure long-lasting macroeconomic stability, which ultimately underpins prospects for inclusive and durable growth, the Commission considers that the main challenges in terms of boosting competitiveness and long-term and inclusive growth are:

(i) raising the level of skills in order to increase employment, in particular among women and young people;

(ii) improving transparency and predictability in the regulatory and institutional environment affecting businesses; and

(iii) improving energy security, primarily by supporting the economy's green transition and increased energy efficiency.

Overall, Türkiye needs to improve the rule of law and the independence of the judiciary, and strengthen institutions to promote competitiveness and attract foreign investments. On the green transition, Türkiye needs to swiftly and decisively step up implementation of climate, clean energy and environmental policies. Addressing these fundamental concerns is a prerequisite for successfully transforming the economy.

Furthermore, the country should proactively implement the Energy Community's Decarbonisation Roadmap to achieve the agreed climate and energy targets, and strive towards establishing a carbon pricing instrument compatible with the EU ETS.

Impact of the earthquakes of 6 February 2023 on the analysis of structural challenges and overall priorities

The earthquakes of 6 February 2023 constitute, first and foremost, a humanitarian crisis. However, from an economic standpoint, the full impact of the earthquake is yet to be assessed. The 11 provinces affected by the recent events account for around 16.5% of Türkiye's overall population, and around 10% of Turkish GDP. In the World Bank's Post-Disaster Damage Estimation Report ([93]), direct damages from the earthquakes are estimated at approximately USD 34.2 billion (equivalent to 4% of Türkiye's 2021 GDP).

More than 105 000 low-rise houses and multi-story apartment buildings have been reported as severely damaged, including 9 432 buildings reported as collapsed. In line with these staggering figures, damages to residential buildings, put at USD 18 billion, account for the greatest share – 53% – of the total direct damages. Damages to non-residential buildings, (USD 9.7 billion) account for 28%, and damages to infrastructure (USD 6.4 billion) for the remaining 19%.

The World Bank estimates the cost of readying Türkiye's existing buildings to earthquakes at around USD 465 billion, or 55% of GDP. With the increased awareness towards earthquakes, households, firms and government should be expected to allocate a significant amount of their investment budgets to renew

([93]) The World Bank Group, Global Rapid Post-Disaster Damage Estimation (GRADE) Report, 6 February 2023 Kahramanmaraş Earthquakes, Türkiye Report, 20 February 2023.

and fortify the existing real estates and infrastructure. While such expenditures must be made at all costs to save lives and economic assets, compared to a counterfactual scenario where all those investments would go to creating additional productive capacity, the short to medium term growth potential of the country would be lower.

It is clear, therefore, that this year's ERP assessment of structural challenges, which is based on a set of assumptions preceding the earthquakes, needs to be read in conjunction with Türkiye's priorities following these disastrous events. While the European Commission believes it is worthwhile going ahead with this year's analysis, it is obviously aware of the implications of the recent events for Turkish society and for the economy. The analysis outlined in this section should therefore be read in the spirit of constructive cooperation with Türkiye that underlies the ERP, despite the obvious shift in the Turkish government's priorities.

Key structural challenge 1: Raising the level of skills in order to increase employment, in particular of women and young people

Türkiye's labour market has rebounded strongly from the COVID-19 crisis. Labour market indicators show a positive trend and an increased employment rate (among those aged 15+) from 42.7% in 2020 to 45.2% in 2021, improving further to 47.5% in 2022. The unemployment rate (15+) decreased from 13.1% to 12% in 2021 and stood at 10.4% in 2022. The unemployment rate for women decreased to 13.4% (14.7% in 2021). However, despite this recovery and the overall economic upturn, the gap between male and female employment remains significant, with female activity and employment rates less than half the male rates. In 2022 the employment rate for men was 65% against only 30.4% for women, leading to a gender employment gap of 34.6 pps. Female labour force participation rate recorded a slight increase but remained low at 35.1%. Barriers in certain occupations, patriarchal views and traditions, and lack of skills all restrict female labour force participation. The lack of adequate childcare facilities and the fact that state schools are often only open on a half-day basis makes working especially difficult for women with children. Policies aimed at the activation of women in the labour market have so far yielded limited results.

Active labour market policies aimed at getting women into the labour market have had little structural impact. The most important policy initiative to increase employment and labour force participation among women has been a subsidy system to incentivise employers to hire female employees. In 2019, two further programmes started which support childcare provision, but they only involve 14 000 working mothers. These measures are commendable but, given the size of the Turkish labour market, they remain limited in scope and impact. Part-time work – often appropriate for working mothers – is less common in Türkiye than in the EU (10% versus 19%). The low rate of women's labour market participation limits Türkiye's economic growth outlook. According to a McKinsey study conducted in cooperation with the Turkish Industry and Business Association (TÜSİAD) ([94]) in 2016, Türkiye's GDP would increase by 20% if it were to reach the OECD average activity rate for women (53.1% in 2019) within 10 years. This still holds true. A higher labour force participation of women is a cornerstone for improving Türkiye's economic growth potential.

Due to natural population growth and immigration, the workforce will further increase in the coming years. Hundreds of thousands of people will join the labour market every year. According to estimates, the population could reach 100 million by 2040. To reap the benefits of the growing workforce and to avoid informal employment, under-employment and unemployment, Türkiye needs to address its structural weaknesses such as low female labour participation, school-to work transitions and human capital development.

([94]) https://tusiad.org/en/reports/item/9642-women-matter-turkey-2016-report-turkey-s-potential-for-the-future-women-in-business.

Young people continue to have difficulties entering the labour market. The youth unemployment rate (aged 15-24) decreased from 22.6% in 2021 to 19.4% in 2022. But the rate of young people not in employment, education or training (NEETs) is still structurally high at 24.7% in 2021. With the adoption of the national youth employment strategy and action plan, Türkiye is aiming to reduce the NEET rate to 20% by end of 2023. Türkiye needs to upgrade its school, tertiary, and vocational training system to be able to bring the NEET rate closer to the EU average of 13.1% (2021). Most of the NEETs in Türkiye are again young women, which entrenches women's disadvantaged position on the labour market as they have even less chance than men to upgrade their professional skills with on-the-job-learning. According to some estimates, 82% of Turks between the ages of 17 and 30 would move abroad if they could. This is a clear mandate for stepping up efforts to provide more economic opportunities for young people in Türkiye. Türkiye's Public Employment Service of organises *virtual fairs* (reform measure 2) to bring job-seekers and employers together. This is a commendable measure and has the potential to facilitate school-to-work transitions to some extent. In order to bring Turkish NEET rates closer to the EU average, active labour market measures and activation schemes inspired by the EU Youth Guarantee, targeting young people not in education, employment or training would be needed.

The informal economy continues to compromise the state's tax and social security revenues. As the country has industrialised and the economic significance of agriculture has shrunk, the number of informally employed people has been decreasing over the years. However, around 28% of all workers still have no social security protection against illness, accident and old age. Undeclared work among refugees and Syrian nationals under temporary protection is even more common. They often work for less than the minimum wage and faced considerable hardship in 2022 as soaring inflation made basic goods and services unaffordable. Türkiye cannot afford to leave them behind and should pursue its formalisation policies with enhanced labour and tax inspection. Ensuring occupational health and safety at work also remains a priority for Türkiye, even more so in sectors where more accidents are recorded such as the construction sector, metallurgy and mining. In the context of the debris removal and reconstruction process after the dramatic earthquakes of February 6th, it will be paramount to ensure Occupational Safety and Health in particular regarding the risk of exposure to hazardous materials and the need for workers to be properly equipped and protected. This is also in the interests of Turkish businesses paying taxes and social security contributions, which want a level playing field for their business activities.

Introducing greater flexibility in the labour market with more part-time work would help, as would replacing the current rigid severance pay system with upgraded unemployment benefits. In particular, this would help SMEs to create more formal jobs without outsourcing parts of the work to informal workers. The minimum wage should enable a decent standard of living without disincentivising the creation of formal labour. The net minimum wage is currently TRY 8 560 (EUR 428). According to the Turkish trades union confederation, TÜRK-İŞ, a single household needs currently TRY 10 612 (EUR 530) to be above the poverty line. The number of working poor has grown in Türkiye. In view of the high inflation, several adjustments to the minimum wage were essential in 2022 to prevent widespread impoverishment.

The government with its social partners should foster social dialogue at sectoral or branch level in the private sector, to enable the social partners to settle on an appropriate wage level for the individual sector or branch. Unfortunately, the rarity of collective bargaining and the under-developed social dialogue in the private sector constitute a missed opportunity for a sound approach to wage setting and tapping into the social partners' knowledge on vocational training, reskilling and upskilling.

The quality of school education has improved over the years in Türkiye, as demonstrated by the results of the OECD programme for international student assessment (PISA). Yet the results for 15-year-olds in reading, mathematics and science are still below the OECD and EU averages. There is notably no universal enrolment of 5-year-olds, of whom around 91% are currently enrolled at school. Early childhood education and care lays the basis for good performance later in school and should be prioritised, including before the age of 5. ERP reform measure 3 '*Access to preschool education will be provided based on equal opportunity principle*' aims among other things, at universal enrolment of

5-year-olds and granting an education to children in disadvantaged areas. This is a commendable initiative. Further efforts are required to increase the availability of child care below the age of 5 to improve learning outcomes, increase the participation of women in the labour market thus strengthening the economy and reducing poverty. In addition, Türkiye has introduced ERP reform measure 4 '*Specialised institutional guidance and inspection branches will be established depending on school and program types*', which aims to ensure quality in the delivery of education. Moreover, Türkiye is initiating ERP reform measure 14 '*Improving special education services, guidance and psychological counselling services.'* The latter targets students with special needs. The measures point in the right direction.

The quality of tertiary education must be upgraded, too. According to the OECD survey on adult education (under the programme for the international assessment of adult competencies – PIAAC), Türkiye has the biggest skills gap of any OECD country for workers with tertiary education. In addition, unemployment rates for graduates from tertiary education are higher than the rates for those with vocational training. Most unemployed graduates are women, whose studies are often not geared towards the needs of the labour market. Other factors that hamper the integration of educated women into the labour market – particularly in rural Türkiye – are traditional stereotypes linked to the role of women in the family and a lack of job opportunities. The Türkiye's national youth employment strategy (2021-2023) aims to provide a closer link between education and the labour market through career information and outreach activities. This is commendable but its impact remains to be seen.

Vocational education and training (VET) has the potential for getting people into jobs more quickly and for reducing the skills gap and the skills mismatch on the labour market as the economy develops, notably in the green and digital sectors. The labour market uptake is better for VET-trained students than for students with tertiary-level education in Türkiye. This is particularly relevant as the country has still a great deal of informal employment, high youth unemployment and a high NEET rate. The Turkish Ministry of National Education (MoNE) is in charge of VET education in Türkiye. The Vocational Education Board, composed of ministries, representatives from trades unions and employers' associations and public institutions, ensures that VET education is aligned with economic needs. MoNE has a strategic framework (2019-2023 strategic VET plan (in Turkish)) with seven objectives and 33 sub-objectives. They have become a part of the 2023 education vision. As regards the delivery of VET, upper secondary VET education is delivered through public and private vocational and technical Anatolian high schools. Türkiye has also introduced dual education for some VET students enrolled in vocational training centres. These students work in a company 4 days a week and go to school for 1 day. However, a large majority of students still attend classical VET schools. More work-based learning and focus on practical skills would help make VET education in Türkiye more practically relevant and would smooth school-to-work transitions. By progressively applying EU quality frameworks for traineeships ([95]) and apprenticeships ([96]) and Türkiye could improve the quality and relevance of work based learning opportunities and thus make VET more attractive to students. With a view to opening access to higher education, VET students have the right to sit exams for tertiary education if they cover the necessary preparatory courses.

In this context, Türkiye introduced ERP reform measure 13 'digital skills in VET curricula'. This is a very welcome reform step on the path towards digitalising the economy. Yet the outreach should go beyond the 5 updated programmes every year.

As regards adult education, Türkiye, just like EU countries, needs to embrace a culture of lifelong learning. The country endorses the Osnabrück Declaration objective of establishing a new lifelong learning culture. Lifelong learning is also referenced in the MoNE's strategic framework. For the 25-64 age group, participation in adult learning in Türkiye has increased but, at 5.8% (2020), it is still far below the EU average of 10.8% (2021). The need for more adult learning is also demonstrated by the OECD

([95]) Council recommendation of 10 March 2014 on a European Quality Framework for Traineeships.
([96]) Council recommendation of 15 March 2018 on a European Framework for Quality and Effective Apprenticeships.

PIAAC survey on adult education, which reveals that Türkiye's performance is well below the OECD average for literacy, numeracy and problem-solving skills in technology-rich environments. Unsurprisingly, this leads to a skills gap. According to a MANPOWER survey, around 80% of Turkish employers have difficulties filling vacancies. The resultant labour shortages hamper growth prospects for the whole economy. Structural reform measure 1 '*Future professions',* rolled over from last year's ERP, aims to upskill young people by on-the-job-training. However, the modest outreach of 1 000 training courses per year will not have a significant impact on Türkiye's economy. Bolder measures should follow.

To promote faster technological development, automatisation of industry, decarbonisation of the economy and continuous integration in global value chains, the Turkish economy needs comprehensive and ongoing skills upgrading of its workforce. According to World Bank, 13-18% of all Turkish workers may be at risk of dismissal. The Ministry of Labour and Social Security is starting to work on job transition strategies. Currently, Türkiye's labour force does not have the skills to enable the green and digital transition of Türkiye's economy. Particular attention needs to be paid to workers depending on fossil fuel industries, notably domestic coal and lignite, who are exposed to economic and social risks as the global and national economy speed up decarbonisation processes in line with the Paris Agreement objectives; an ambitious just transition plan is urgently needed for these categories of workers.

Box.II.6.3: Monitoring performance on the European Pillar of Social Rights ([97])

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights on equal opportunities and access to the labour market, fair working conditions and social protection and inclusion for the benefit of people in the EU. The associated action plan, adopted on 4 March 2021, aims to rally all relevant parties to turn the principles into action. Since the 20 principles provide a compass for levelling up working and living conditions in the EU, they are also relevant for candidate countries and potential candidates.

Relative to the EU-27 average, there is scope for improvement in most available indicators from the Social Scoreboard supporting the European Pillar of Social Rights.

Türkiye's labour market indicators have improved but structural problems persist, especially for young people and women. The employment rate has been improving – from 42.7% in 2020 to 45.2%, and improving further to 47.5% in2022. according to TurkStat. The unemployment rate decreased from 13.1% to 12% in 2021 and to 10.4% in 2022. It was still above the EU average of 6.1% in 2022. While long-term unemployment has slightly deteriorated in recent years to 3.3% in 2020, it is not significantly worse than the EU rates of 2.8% in 2021 and 2.4 in 2022. The youth NEET rate (aged 15-24) decreased to 22.6% in 2021. The gender employment gap is the highest in the region at 34.6 pps, compared with the EU average of 11 pps. A significant proportion of the female population never enters the formal labour market.

TÜRKIYE		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Worse than EU avg, improving
	Individuals' level of digital skills (basic or above basic)	Worse than EU avg., improving
	Youth NEET (% of total population aged 15-29)	Worse than EU avg., improving
	Gender employment gap	Worse than EU avg., improving
	Income quintile ratio (S80/S20)	Worse than EU avg., deteriorating
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-64)	Worse than EU avg., improving
	Unemployment rate (% of population aged 15-74)	Worse than EU avg., improving
	Long-term unemployment rate (% of population aged 15-74)	Worse than EU avg., improving
	GDHI per capita growth	N/A
Social protection and inclusion	At risk of poverty or social exclusion (in %)	Worse than EU avg., deteriorating
	At risk of poverty or social exclusion rate for children (in %)	Worse than EU avg., stable
	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU avg., improving
	Disability employment gap	Better than EU avg., improving
	Housing cost overburden	Around EU avg., no change
	Children aged less than 3 years in formal childcare	Worse than EU avg., trend N/A
	Self-reported unmet need for medical care	Around EU avg., improving

Skills mismatches and limited reskilling opportunities continue to limit labour market improvements. Overall, education outcomes remain low. Individuals' level of digital skills is improving, but it remains significantly below the EU average at 34%, compared to 55%. Primary education is not yet universal and there are low enrolment and high dropout rates in secondary education. Enrolment figures for pre-primary and primary education slowly improved, but the quality of education remains a challenge, as indicated in the PISA results.

The impact of social transfers on poverty reduction remains very low. It accounts for only 8.94% (EU average 32.38%), although the figures are slowly improving. The rate of people at risk of poverty or social exclusion (AROPE) continues to increase. In Türkiye, 34.1% of the population and 43.4% of children are AROPE, compared to the EU averages of 21.7% and 24.4% respectively. Income distribution remains the most uneven in the region with the income quintile ratio at 9.20 compared to the EU average of 4.97.

Türkiye has a well-developed system for labour market and social statistics. The Turkish Statistical Institute (TurkStat) is the main producer and coordinator of Türkiye statistical system. TurkStat publishes the labour force survey monthly, quarterly and annually and the survey on income and living conditions annually.

([97]) The table in this box includes 16 of the Social Scoreboard's headline indicators , which are used to compare the performance of EU Member States (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators), and also of the Western Balkan countries and Türkiye. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; 2020 data are generally used for this comparison) and a review of the trend for the indicator based on the latest available 3-year period for the country (improving/deteriorating/no change). For data, see Annex B. NEET: not in employment, education or training; GDHI: gross disposable household income.

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

The institutional and regulatory framework remains fragile, particularly as regards predictability, transparency and efficiency, although some action has been taken to improve dispute settlement. The serious backsliding in recent years with regard to the judicial system continued to undermine business trust in its efficiency and independence. Effective measures to strengthen the rule of law, ensure adequate and timely contract enforcement and improve the availability and functioning of dispute settlement mechanisms are key factors for improving the business environment. Intellectual property rights enforcement remains very weak. Increased state interference in the economy and the lack of State aid checks hinder market-based consolidation of a level playing field for business.

Türkiye recognises the importance of a transparent, high quality and effective **judiciary** for economic activity. Measures under the 2019 judicial reform strategy have aimed to improve the functioning of businesses and have included facilitating the setting-up of specialised courts and providing online access to court decisions. These steps may have improved procedures technically but there is no evidence-based assessment of the results of strategy implementation. Most importantly, the measures do not address structural deficiencies in the judicial system, in particular with regard to its independence and professionalism, and thus do not lead to significant improvements in its overall functioning.

Effective measures to ensure appropriate and timely **contract enforcement and to improve the availability and functioning of dispute settlement mechanisms** remain crucial for improving the country’s business environment. Türkiye has introduced some important measures to improve the resolution of commercial disputes. In particular, it ratified the Singapore Convention for international commercial disputes in April 2022 and has further promoted mediation in a number of fields. However, commercial judicial processes remain slow, and a large backlog of commercial court cases persists. The reform of the bankruptcy system has yet to bring results while procedures are still costly and slow, with a low recovery rate. Since 2017, the average duration of bankruptcy and insolvency proceedings has been growing. With a view of streamlining bankruptcy case law, fast-track procedures could be introduced for SMEs, which represent the backbone of Turkish economy. Moreover, a distinction could be drawn in the law between regular and fraudulent proceedings.

The regulatory environment remains unstable and unpredictable and in some cases is an obstacle to fair competition. The independence of key regulatory authorities continued to be compromised by the increasing direct influence of the Presidency in their functioning. Preparations are underway for the 12th Development Plan for 2024-2028, with wide participation of stakeholders and social partners. In 2022, the Coordination Council for Improvement of the Investment Environment continued to hold meetings with private sector representatives. Despite these preparatory steps, the results of these meetings and related action plans are not reported. Besides this, no improvement can be reported in the use of consultation mechanisms to develop relevant legislation. There are still no systematic mechanisms in place for consultations with businesses and social partners on legislative initiatives. Consultations are held through consultative boards, councils, working groups and technical committees set up by a few ministries; yet neither a clear calendar for these meetings nor their conclusions are publicly available. Though a legal framework is already in place for regulatory impact assessments, such studies are still rarely carried out. As underlined in the OECD SME Policy Index 2022, ([98]) in practice, regulatory impact assessments are not being conducted for primary legislation – they are only conducted for subordinate legislation on an *ad hoc* basis, at the discretion of the Presidency.

Additionally, legislation on easing private investment has not been finalised despite the fact that comprehensive draft legislation had been drafted and was being revised in light of feedback from stakeholders.

([98]) OECD, 'SME Policy Index: Western Balkans and Turkey 2022’, 8 July 2022.

Market interventions by the state hinder competition and the businesses' ability to implement long-term business plans. Strengthening the legal framework for state intervention by making it more transparent, accountable and predictable is a key requirement for a more favourable business environment. Legislation to implement State aid rules is long overdue in Türkiye, and its absence hinders enforcement and transparency. The current structure for monitoring State aid is not complete, independent or operational. Türkiye has not formally set up a comprehensive and transparent state inventory of all aid schemes. The Ministry of Industry and Technology, the Scientific and Technological Research Council (TÜBİTAK) and the Small and Medium Enterprises Development Organisation (KOSGEB) provide medium-high and high-technology sectors with support and incentives to increase value-added production; Türkiye is now implementing a special programme, the technology-focused industrial movement programme, to intensify the support and incentives.).

State intervention in price-setting mechanisms expanded in key sectors, which hampers the free functioning of product markets. More than a quarter of the consumer basket is composed of goods whose prices are set or heavily influenced by the public authorities. The authorities have continued to use a sliding scale system to curb the inflationary pressures coming from oil prices. Furthermore, from the beginning of 2022, Türkiye has implemented an electricity tariff system based on the level of consumption (block tariffs). The regulator has been also authorised to set up a tariff for vulnerable consumers before the gradual lifting of some subsidies.

The Türkiye Wealth Fund (TWF) and the Savings Deposits Insurance Fund (SDIF) are largely exempt from transparency requirements and competition. The TWF further expanded its presence in the economy. Created under a special law in 2016, the TWF is fully owned by the government. It holds shares in major companies in the financial, telecommunications, petrochemicals, real estate, mining, agriculture, and transport sectors. The TWF continues to enjoy a number of exemptions which are problematic from the competition point of view, such as exemptions from various taxes, charges and rules on (publicly held) corporations' transactions. In 2022 significant amendments were introduced to the TWF's legislative framework, further extending the exemptions and exceptions to cover companies, funds and their subsidiaries in which the TWF has become the controlling shareholder. TWF total assets increased to TRY 3.2 trillion at the end of 2021, up from TRY 2.2 trillion (44% of GDP) in 2020. The TWF is audited by an independent audit firm and by auditors appointed by the President. The acquisition and management of companies under the trusteeship of the SDIF remains non-transparent and the number of companies managed under its trusteeship is still high at 683 companies with a total asset value of TRY 109.9 billion at the end of 2022. There is neither a schedule for releasing all companies from trusteeship, nor appropriate, effective, and timely means of legal redress.

Another factor disrupting the smooth functioning of the market is widespread distortion in the allocation of government contracts and assets. Türkiye lacks preventive and anti-corruption bodies while severe flaws in the anti-corruption legal framework allow undue political influence in the allocation of public resources. Public procurement is especially prone to corrupt activities on account of a number of exceptions allowed under public procurement law. Tender procedures covered by exceptions have significantly increased in recent years, while the number of contracts awarded via open auctions has fallen relative to the total number of contracts awarded. The increasing use and wide scope of exemptions in procurement procedures have undermined the integrity of public procurement. The government continued to award several large public-private partnership contracts for big infrastructure projects to a small number of companies.

Finally, the legal framework regulating the **fight against money laundering** and terrorist financing needs to be improved in line with recommendations by the Financial Action Task Force and the Venice Commission.

The informal economy continues to distort the level playing field for businesses and thus undermines competitiveness. Despite a gradual decline, the informal sector still accounts for a significant share of economic activity, well above OECD average. Türkiye has finished implementation of the 2019-2021 strategy and action plan and for the fight against the informal economy but the results are difficult to measure since no concrete performance indicators had been identified. The 2023-2025 action plan was adopted at the end of 2022. It aims to reduce the informal economy and help to improve certain macroeconomic indicators such as income distribution, economic growth and employment.

Geopolitical uncertainties, the build-up of macroeconomic imbalances and an unpredictable business and regulatory environment, remain the main obstacles to attracting foreign investment. In 2021, foreign direct investment in Türkiye amounted to USD 6.8 billion, while in the first 11 months of 2022, net foreign direct investment inflows increased by USD 937 million compared to the same period in 2021 and totalled USD 7.1 billion. Türkiye's foreign direct investment strategy (2021-2023) continued to be implemented. Still, major obstacles discouraging potential investors have not yet been addressed. These include difficulties in getting approvals, weak enforcement of industrial and property rights and hidden market restrictions. The uncertainties and risks for investors increased further due to the strong depreciation of the lira, and the unpredictability of the overall direction of Turkish economic policy.

Limited financial resources hamper business development and the growth of companies. While economic growth was strong in 2022 (5.6%), driven by both domestic demand and exports, access to finance remains limited, especially for SMEs. SMEs receive a smaller share of business loans than medium-capitalisation and large firms – around 25% of total loans granted to Turkish firms. SMEs are financed mostly through short-term loans or equity. Other forms of financing are not available due to the inability of most SMEs to provide financial statements or robust collateral. It is, however, worth noting that the OECD found that alternative sources of finance are present in Türkiye, and that some efforts have been made to provide companies with start-up financing. ([99]) In particular, the OECD underlined that non-bank finance opportunities are present across Türkiye, offering alternative sources of finance, although at a smaller scale (e.g. by way of leasing and factoring). Progress has also been made in providing equity-finance opportunities for early-stage companies, and previous efforts to develop a local market for venture capital are beginning to reap their benefits. Finally, there is a number of financial support schemes in place to boost venture capital activity, also by establishing a platform for crowdfunding. A new crowdfunding legislation entered into force in late 2019 and was further strengthened in 2020 and 2021. This legislation enabled, and now regulates, both equity- and debt-based crowdfunding, in addition to the previously existing reward-based model.

Measure 5a: 'Prioritizing technological product investments to increase the technology level and export capacity of SMEs and supporting the commercialization of R&D projects' and **Measure 5b: 'Enhancing the R&D and innovation activities of SMEs; and the development and implementation of mechanisms to encourage and facilitate technology based and innovative SMEs access to finance, participation in mentoring and cooperation networks'** are both ambitious initiatives, but they do not appear to be part of a coherent policy. The government does not seem to be targeting either highly productive firms or firms with potential to grow (e.g. start-ups). The distribution seems to be rather arbitrary.

On digitalisation, **measure 7: 'Establishing Model Factories (SME Competency and Digital Transformation Centers) and Innovation Centers to increase the efficiency of SMEs and their digital transformation'** has been rolled over from the previous ERP. As the measure has been in place for some years now, some impact-related indicators could usefully be added. Currently all indicators are about the service provided, rather than the real objective of the measure.

Key structural challenge 3: Improving energy security, primarily through supporting the green transition of the economy and increased energy efficiency

([99]) OECD, 'SME Policy Index: Western Balkans and Turkey 2022', 8 July 2022.

Türkiye faces critical environmental and climate challenges, both in terms of mitigation and adaptation. Due to strong economic and demographic growth and the use of a high-emission energy mix, greenhouse gas emissions have increased by more than 185% (including land use, land-use change and forestry - LULUCF) since 1990, making Türkiye the fastest-growing emitter among G20 countries. Air quality, water pollution and pollution generally are a major concern, especially in large cities and industrialised regions. Global warming is depleting water resources in Türkiye's already semi-arid climate. More ambitious climate and environment policies are needed to make the Turkish economy effectively more sustainable and fir for future challenges.

Türkiye ratified the Paris Agreement on 6 October 2021 and adopted a first Nationally Determined Contribution including an objective of reducing greenhouse gas emissions by 21% below a business-as-usual scenario. Türkiye released a 'Green Deal action plan' on 16 July 2021. While this roadmap demonstrates the willingness of the Turkish government to engage with the green transition, **it does not set a time-bound and clear overall objective; most importantly, it fails to turn the Green Deal into an actual economic and social development strategy**. Moreover, while **Türkiye pledged to reach net zero emissions in 2053**, to date, it has not formally adopted its long-awaited climate law nor has it updated its Nationally Determined Contribution for 2030. Disappointingly, Türkiye announced at COP27 an updated Nationally Determined Contribution, setting 2038 as an emission peak year. This translates into increasing today's greenhouse gas emissions by more than 30% until 2030, a perspective that is hardly compatible with net-zero in 2053. In addition, a detailed long-term strategy is still necessary in order to substantiate the goal of reaching net-zero by 2053. The establishment of a national emission trading system (ETS) aligned with the EU ETS and with a sufficient level of ambition notably in the overall cap of allowances remains a necessary pre-condition for the Turkish economy's cost-effective decarbonisation; a pilot ETS is expected to start in 2024.

The long-term national energy strategy was released in December 2022 and Türkiye announced its **national energy plan for 2020-2035**. The government aims to reach a total installed electricity capacity of 189.7 GW (of which 7.2 GW nuclear, 52.9 GW solar and 29.6 GW wind) by 2035. The planned scenario also involves significant climate mitigation elements, such as reducing energy intensity by 35.3%, increasing the share of renewables in total electricity generation capacity to 64.7% and sharply cutting the share of fossil fuels in primary energy consumption by 2035, in line with the net zero emissions pathway toward 2053. To support these objectives, continued coordination between energy subsidies, taxation and overall green policies is vital, in particular a phase-out of fossil fuel subsidies and increased taxation weighing on fossil energy compared to renewables. In line with this, **measure 8: 'Technical assistance for the Green Deal action plan'** included in the ERP, once again, does not seem be sufficiently ambitious given the scale of the changes required in production and consumption patterns. Still missing are a clear roadmap and concrete policy steps and milestones to be undertaken to reach the objectives.

Additionally, a first draft of **national (climate) adaptation strategy** was shared with the Climate Change Presidency and internal consultations within the Ministry of Environment, Urbanisation and Climate Change are to be completed by mid-February 2023. The strategy will then be shared with other stakeholders, and unless major problems occur down the line, the strategy is set to be adopted by May 2023. The reconstruction process of areas devastated by the 6 February earthquakes must be based on the highest standards in terms of green and resilient buildings and infrastructure.

From an economic point of view, the ability to decarbonise, adapt to climate change and to move from linear to circular, sustainable, use of resources is key if businesses are to enjoy a competitive advantage in future. The Turkish 'Green Deal action plan', proposes an ETS system that is aligned with the EU system and that fosters the circular economy. Setting up such a system would help to decarbonise the economy and prepare for the implementation of the EU carbon border adjustment mechanism. Equally important is to foster the ability of agriculture, forestry and ecosystems to store more carbons and become more resilient to climate change. Eco-innovation is emerging in Türkiye, especially in the automobile and energy sectors. A first Climate Council was held in February 2022 to draw up a road map in line with the Paris Agreement to reach net-zero emissions by 2053. **Measure 10: 'Support mechanism will be established for the replacement of inefficient electric motors used in industry with more efficient ones'** was carried over from the 2022 ERP. While the target set for the number of replaced electric motors was 2000 in the last ERP, only 363 motors at 48 SMEs had been replaced as of November 2022. This is a commendable, modest contribution to addressing the challenges mentioned above and it can hardly be seen as a structural reform measure.

Türkiye has been steadily making progress on **diversifying energy supplies and increasing the share of energy generated from renewable sources**. Last year, renewables accounted for 53% of the country's installed capacity and 33% of electricity generation. However, the share of energy generated from renewable sources has not increased since the last ERP cycle and the overall share of renewables in total energy consumption has remained stable for the last 4 years. In addition, Türkiye's dependency on external energy supplies, in particular natural gas imports from Russia, is still significant. This dependency, combined with volatile international markets, has led to very high energy prices, which are among the key factors contributing to high inflation and putting pressure on the state budget. Türkiye's energy dependency on Russia is likely to increase with the completion of the nuclear power plant in Akkuyu, scheduled for 2023. Russia and Türkiye agreed in 2010 that the nuclear power plant would be built, owned and operated by a subsidiary of the Russian Rosatom. Türkiye still relies very much on coal-powered electricity generation and is still planning to open several coal-fired power plants – a move that is at odds with its commitment to the Paris Agreement and the latest recommendations from the International Energy Agency. Its gas sector is still dominated by the state-owned, vertically integrated gas company operating with subsidised tariffs, which does not promote competition in the sector. At the same time, Türkiye has high ambitions of becoming a regional energy hub, and is investing heavily in the exploration of new gas fields in the Mediterranean and the Black Sea, as well as in building new LNG terminals.

Achieving a balance between energy security, growing demand and decarbonisation is challenging. However, ensuring affordable, green and stable energy supplies is key for sustainable economic development. Increased use of renewable energy sources and greater energy efficiency are essential for transitioning to sustainable and secure energy and for dealing with the risks posed by the changing international energy market. Therefore, more ambitious climate and environment policies need to be established and implemented to create the necessary enabling environment for transition to a more modern and competitive economy. Further encouragement for the development of renewable energy installations (in full compliance with Türkiye's obligations under the customs union with the EU) can help to lower energy dependency and create new opportunities for businesses. A strong focus on reducing energy consumption through investment in energy efficiency, decarbonisation of transport, sustainable finance, support for research and development (R&D) activities and addressing the corresponding skills is key in moving towards a resource-efficient and zero-emission economy.

Developing sustainable finance – in particular by strengthening the legal framework (e.g. introducing green bonds) and working on a green taxonomy – is crucial, to encourage private investment in innovative and green industries. R&D activities also need to be supported to enable the development and the dissemination of green production technologies. According to a recent OECD analysis, SMEs in Türkiye have access to a broad range of financial support (grants, subsidised loans and similar) for their greening efforts, in particular support for improving energy efficiency and investing in eco-innovation.

Finally, the green transition requires developing new activities and skills to turn these challenges into economic opportunities. Addressing corresponding employment and professional training needs is key to ensure a smooth transition to a resource-efficient and zero-emission economy.

6.5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2022

Türkiye implemented the 2022 policy guidance to a limited degree. Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye has adopted targeted policy guidance for all partners in the region. The guidance represents the participants' shared view on the policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The underlying rationale for the policy guidance is similar to that of the country-specific recommendations usually adopted under the European Semester for EU Member States. Implementation of the policy guidance is evaluated by the Commission in the following year's ERP assessments. The following table accordingly presents the Commission's assessment of the implementation of the 2022 policy guidance jointly adopted by the EU and the Western Balkans and Türkiye at their Economic and Financial Dialogue at Ministerial level on 24 May 2022.

Overall: limited implementation (26.3%) ([100])	
2022 policy guidance (PG)	**Summary assessment**
PG 1:	There was **limited implementation** of PG 1:
Rebalance the policy mix and use the available fiscal space in the 2022 budget to cushion the impact of adverse shocks through targeted support to vulnerable households and firms.	1) **Limited implementation.** The policy mix remained imbalanced as the central bank continued cutting its policy rate, despite the very high inflation. The fiscal stance tightened, as the government achieved a better-than-expected budget execution in 2022. It had to adopt a revised budget in July 2022 to allocate supplementary resources amid a surge in global energy prices and rampant inflation. Throughout the year, the government increased its support for households and firms via different channels (such as minimum wage hikes, support for energy bills, support for students, government-backed loan packages), although the massive increase in expenditure to cushion the negative impact of high energy prices was not well targeted. The budget funds allocated to current transfers for households and businesses in 2022 were increased but their share in the overall budget only increased marginally.
Increase the share of local currency in new borrowing and reduce the share of public banks holdings in domestic government debt.	2) **Limited implementation.** Despite an explicit commitment by the Ministry of Treasury and Finance to reduce the share of foreign currency-denominated debt in total debt stock, it has decreased only marginally from 66.0% in 2021 to 65.5% in December 2022. Meanwhile, the share of public banks' holdings in domestic government debt decreased from 38.6% in December 2021 to 36.7% in November 2022 and the share held by private and foreign banks increased from 26.9% to 32.9%. Both outcomes were achieved as a result of heavy-handed regulatory measures, forcing banks to hold lira-denominated government debt.
Expand the tax base by developing a plan to gradually	3) **No implementation.** The government has enacted a

([100]) For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission's overview and country assessments of the 2017 economic reform programmes. This is available at https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en.

streamline tax exemptions and reductions.	series of temporary tax reductions, consecutive debt restructuring and amnesty practices over the last couple of years. Contrary to the commitments expressed in policy documents, tax restructuring and capital repatriation, which have adverse effects on the sustainable voluntary tax collection mechanism, have become established practice. The government recently proposed a new tax exemption bill to enter into force before the elections.
PG 2: Adopt the new framework legislation on Public Private Partnerships in order to improve their management and monitoring. Simplify public procurement procedures and reduce the number of exemptions. Phase out the FX value guarantees on lira time deposits as envisaged by the end of 2022 or earlier.	There was **no implementation** of PG 2: 1) **No implementation.** PPP framework legislation is still at the preparation stage and parliamentary approval is pending. In the last few annual presidential programmes, the government had also committed to producing guidelines for feasibility reports, expenditure-return analysis and contract drafting and management, and to delivering training on project preparation, monitoring and evaluation with the aim of standardising PPP contracts. However, the implementation stage of these plans has not been announced. 2) **No implementation.** The Law on public procurement contains a large and growing- number of exemptions (with consecutive amendments), affecting the transparency and accountability of public expenditure. Moreover, the government continues to make excessive use of negotiated procedure, which allows the contracting authorities to limit competition and transparency by referring to discretional criteria, which cannot be objectively measured. 3) **No implementation.** By the end of 2022, the volume of FX-protected deposits under the scheme amounted to TRY 1 415 billion. The implementation period for the FX value guarantees on lira time deposits and the incentives applied to the scheme have been extended. New incentives have been adopted to attract investors to the scheme (such as FX conversion support corresponding to 2% of the amount converted into TRY for companies).
PG 3: Use all available monetary policy instruments in line with the central bank's mandate of price stability to ensure a permanent fall in inflation towards the target.	There was **limited implementation** of PG 3: 1) **No implementation.** Interest rates have been lowered further and the monetary policy stance has been too loose on account of various metrics. The current policy framework has also undermined the role of the policy rate as the primary instrument of monetary policy, blurring the policy signal and weakening transmission. To remedy the fallout from an overly loose monetary policy stance, a complex and distortive system of various macroprudential and regulatory measures is used. The absence of a clear nominal anchor and of a credible commitment to the

	inflation target exacerbates the risks of inflation becoming entrenched at very high levels.
Enhance the institutional basis for sustainable price stability in line with operational central bank independence and bolster market confidence.	2) **No implementation.** No improvements have been made to safeguard central bank independence after the dismissal of three central bank governors and several central bank policymakers since 2019. Monetary policy decisions have often been preceded by political guidance on interest rates. The complex system of measures adds unpredictability to the policy framework, further eroding policy credibility and market confidence, as evidenced, for example, by dis-anchored inflation expectations.
Further strengthen the integrity of financial sector regulatory framework in line with international and EU standards, withdraw the regulatory flexibilities provided to the financial sector during the pandemic, particularly with regard to loan restructuring and NPL recognition practices, encourage high quality credit risk management and enhance confidence by conducting more transparent asset quality reviews and publish its methodology and outcomes.	3) **Limited implementation.** The regulatory flexibilities provided to the financial sector during the pandemic were fully unwound and the banking system maintains high levels of provisioning. However, capitalisation and asset quality remain blurred by forbearance and the NPL regulatory framework lacks transparency and allows for unwarranted flexibility. Several measures introduced in 2022 have added further complexity to the regulatory framework while potentially creating financial vulnerabilities, by undermining banks' ability to price risk, distorting capital allocation and increasing operational, compliance and governance risks. The regulatory framework further departed from international and EU standards, with no progress in improving credit risk management and the transparency of asset quality.
PG 4: With the aim to improving the business environment, further strengthen the rule of law and the regulatory environment and improve consultation mechanisms with business organisations and social partners on relevant new legislation.	There was **limited implementation** of PG 4: 1) **Limited implementation.** Shortcomings in the independence of regulatory authorities have not been addressed. The 12th development plan (2024-2028) is being drafted with the wide participation of stakeholders and social partners under 80 thematic committees. Meetings with private sector representatives under the Coordination Council for Improvement of the Investment Environment continued in 2022, but the results of these meetings and related action plans are not reported. The related website of the Council is not updated. Besides this, there has been no improvement in the use of social dialogue mechanisms to develop relevant legislation.
Implement legislation and enhance transparency regarding state aid.	2) **No implementation.** Since Law No 6015 on monitoring and supervision of State aids came into force, the government has not implemented State aid monitoring and supervision. It has failed to set up a functioning organisational structure or to adopt the necessary secondary legislation. Instead, it has set up a new legislative structure responsible for the effective implementation, coordination, monitoring and evaluation of State aid. This new system is

	not geared towards alignment with EU *acquis*. It lacks independence in the enforcement of State aid legislation. The lack of transparency regarding the actual amount of State aid provided continues to be a source of concern.
Finalise the legislation on easing private investments and prepare its implementation.	3) **No implementation.** The legislation on easing private investments has not been finalised. Comprehensive draft legislation had been prepared and was being revised in light of feedback from stakeholders.
Prepare a new Action Plan for the fight against informal economy and set concrete performance indicators.	4) **Substantial implementation.** Türkiye has drafted a 2023-2025 action plan for the fight against informal economy. However, this new action plan fails to set specific performance indicators and the outcome of the previous action plan is not publicly available.
PG 5:	There was **partial implementation** of PG 5.
Take steps to set up a domestic carbon pricing.	1) **Limited implementation.** The work is ongoing on domestic carbon pricing with a number of studies and preliminary analysis being carried out. Türkiye published its 'national energy plan' in December 2022, which indicates that carbon prices in several sectors have been determined but does not provide details about prices. Discussions on carbon pricing and the ETS continued as part of the EU-Türkiye High-Level Climate Dialogue.
With a view to meeting the national decarbonisation objective, finalise the long term national energy strategy.	2) **Full implementation.** The long-term national energy strategy was released in December 2022 and Türkiye announced its national energy plan for 2020-2035. The government aims to reach a total installed electricity capacity of 189.7 GW (of which: 7.2 GW nuclear, 52.9 GW solar and 29.6 GW wind) by 2035. The planned scenario also involves significant climate mitigation elements, such as reducing the energy intensity by 35.3%, increasing the share of renewables in total electricity generation capacity to 64.7% and sharply cutting the share of fossil fuels in primary energy consumption by 2035 in line with the net zero emissions pathway toward 2053. Concrete steps to swiftly decarbonise the energy sector, notably its reliance on domestic coal and lignite in a just way, need to be undertaken.
In order to adapt to climate change, finalise the update of the national adaptation strategy.	3) **Limited implementation.** A first draft of national (climate) adaptation strategy, which was shared with the Climate Change Presidency and internal consultations within the Ministry of Environment, Urbanisation and Climate Change, was due to be completed by mid-February 2023, although it has not – to date – been published. The strategy will then be shared with other stakeholders and, unless major problems occur down the line, adopted by May 2023.

PG 6: Improve the transition of young people into the labour market through active labour market measures, better access to education and improvements in the vocational education and training system.	There was a **partial implementation** of PG 6: 1) **Partial implementation.** The transition of young people into the labour market remains a challenge. The youth unemployment and NEET rates, particularly for women, remained high despite some improvements in youth employment in the third quarter of 2022. Implementation of the national youth employment strategy and action plan (2021-2023) continued, with active labour market activities on career guidance and vocational training.
Incentivise female labour market participation through legislative and fiscal measures and provision of appropriate and affordable childcare infrastructure beyond the big urban centres of Turkey.	2) **Partial implementation.** Gender gaps in the labour market remain high. The government continues to provide employment subsidies, but their impact on female labour market participation needs to be followed up. Women continued to benefit from vocational and on-the-job training, but no new tailor-made programme has been initiated to promote women employment. The provision of pre-primary education services was expanded with investment in public schools across the country (3 000 pre-primary schools included under the investment programme). The minimum number of children needed for the opening of pre-primary classrooms in rural areas was reduced from 10 to 5. However, municipalities still face legal barriers to set up childcare centres. Overall, progress has been achieved in terms of appropriate and affordable pre-primary education for 5-year olds. However, for younger ages, childcare infrastructure did not improve significantly.
Increase offers and participation in lifelong learning measures and step up re- and upskilling possibilities for the labour force.	3) **Substantial implementation.** The recent reforms and flexible structure of vocational education made vocational training centres quite attractive, especially for poor families. Consequently, the number of students increased from 159 506 in December 2021 to 1 033 000 at the end of November 2022, exceeding the 1 000 000 target for the end of 2022. Vocational training centres provide on-the-job training, as well as reskilling and upskilling, through tailor-made training. However, the quality of the former needs to be ensured with qualification certificates in line with the Turkish Qualifications Framework.

6.6. POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TÜRKIYE

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

Brussels, 16 May 2023

[…]

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

1. Keep an appropriately tight fiscal stance in 2023 to help disinflation, including by reducing budget support to state-owned enterprises in the energy sector in view of the prevailing international energy prices, while providing timely and transparent support to alleviating the consequences of the February earthquakes. Present a credible medium-term strategy to support the envisaged gradual return to a primary surplus of at least 1% of GDP. Expand the tax base by streamlining tax exemptions and reductions.

2. Reduce fiscal risks by – inter alia – gradually phasing out the FX value guarantees on lira time deposits. Revise public procurement legislation to further align it with the 2014 EU Directives on public procurement, including utilities, concessions and public private partnerships and reduce the number of exemptions that are incompatible with the EU acquis. Prepare an options paper for the possible adoption of a fiscal rule and the setting up of an independent body to monitor its implementation.

3. Use all tools of the central bank, including interest rates, more decisively in order to accelerate the disinflation process and bring financial conditions in line with achieving price stability over the medium term and central bank independence. Provide more guidance and efficient communication with regards to policy tools as well as the evaluations of their potential effects, and increase the efficiency of the operational framework. Improve the transparency and predictability of the financial sector regulatory framework by aligning it with international and EU standards, and enhance confidence by conducting transparent asset quality reviews and publish its methodology and outcomes.

4. With the aim to improving business environment, further strengthen the rule of law and, improve the regulatory environment and consultation mechanisms with business organisations and social partners on relevant new legislation. Implement legislation and enhance transparency regarding State aid to maximise the benefit of the EU-Türkiye economic and trade relationship, as well as to achieve a meaningful level-playing field. Increase the number and improve the efficiency of specialised courts for business, with a view of streamlining commercial disputes.

5. Take further steps to implement the ETS carbon pricing mechanism. Continue to ensure the steady growth of renewables (both traditional and hydrogen-based) in Türkiye's energy mix and reflect this objective in the country's subsidies policy. Prioritise energy efficiency for new and existing buildings in order to adapt to climate change, especially in light of the reconstruction efforts that will follow the devastating earthquakes of 6 February 2023.

6. Support the school-to-work transitions and the activation of young people who are not in education, employment or training (NEET) and incentivise female labour market participation through legislative and fiscal measures, as well as through strengthened efforts on the provision of appropriate and

affordable childcare infrastructure beyond the big urban centres of Türkiye. Support investments in the care economy in the provinces affected by the Earthquakes in order to provide victims with health and care services and create employment intensive opportunities, in particular for women. Continue increasing the participation of adults in lifelong learning, in particular to reinforce green and digital skills, in order to ensure just transition.

ANNEX A: ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE 2023-2025 ERP

Education and skills

This area and reform measures 1, 2, 3, 4, 13 and 14 are analysed above in Section 4 under **key structural challenge 1**.

Research, development and innovation

Türkiye's industry and technology strategy has set ambitious targets to be reached by 2023. Although there has been some progress since 2018, the gap between actual figures and the 2023 targets remains significant. For example, in 2021, Türkiye's R&D spending amounted to 1.13% of GDP, still short of the targeted 1.8%.

Türkiye remains an 'emerging innovator' according to the European Innovation Scoreboard for 2022, performing at 47.7% of the EU average. Despite small performance improvements last year, the gap between Türkiye's performance and the EU average has grown larger since 2015. Türkiye's top three strengths are in medium and high-tech goods exports, government support for business R&D and job-to-job mobility of human resources in science and technology.

Measure 5: 'Enhancing the R&D and innovation activities of SMEs' (2022-2024 ERP measure 7)

Measure 5a: 'Prioritising technological product investments to increase the technology level and export capacity of SMEs and supporting the commercialisation of R&D projects' (2022-2024 ERP measure 7a)

This measure is a continuation of measure 7a in the previous ERP (2022-2024). As in previous years, the measure describes only output-based indicators, i.e. the number of SMEs supported. The measure could benefit from moving focus towards impact-related indicators, such as increase in value added, increase in the share of high-technology products in SMEs' exports, increase in patent applications and patents etc.

Moreover, green technologies and clean energy solutions could be prioritised to increase the positive impact in terms of the green and digital transformations.

Measure 5b: 'Enhancing the R&D and innovation activities of SMEs; and the development and implementation of mechanisms to encourage and facilitate technology based and innovative SMEs access to finance, participation in mentoring and cooperation networks' (2022-2024 ERP measure 7b)

The measure has been rolled over from the previous ERP (2022-2024). It is based, in particular, on TÜBİTAK's calls/programmes for enhancing SMEs' research, development and innovation activities. These programmes are comprehensive and reach out to almost all stakeholders in the research and innovation ecosystem. They should be viewed as positive for the way they support SMEs' innovation activities through access to finance, know-how and networks.

The allocated budget is ambitious and, if implemented, it will have a significant impact by increasing Türkiye's R&D spending as a percentage of GDP.

Moreover, it is declared that, in some of these calls, projects contributing to EU Green Deal goals will be prioritised. The alignment of at least some calls with EU Green Deal goals should be viewed as positive.

The Commission also agrees with the suggestions provided in the 'Impact Assessment of TÜBİTAK and KOSGEB Supports' prepared by the General Directorate of Strategic Research and Productivity within the Ministry of Industry and Technology ([101]). The study recommends supporting:

integration of high-technology companies in international value chains; and

access to venture capital and risk equity networks.

Nonetheless, the expected impact of the measure on environment and climate change should be clarified.

Measure 6: 'Performance-based support of the research infrastructures supported under Law 6550 within the new legal framework' (2022-2024 ERP measure 8)

This measure is a continuation of measure 8 in the previous ERP (2022-2024). It is in line with the 11th development plan.

While the Commission's view on the measure remains positive, there has been relatively little progress on implementation since 2020. There are still only seven research institutions within the scope of Law No 6550 on supporting research infrastructure. As a result, the plan to support nine new centres over the course of the next 3 years might prove challenging.

While the supported research areas cover fields such as nanotechnology, biomedicine and genome research, and solar energy technologies and should, in theory, support green transition and access to healthcare, the expected impacts of the measure on climate change and social outcomes are not clearly defined.

Measure 7: 'Establishing Model Factories (SME Competency and Digital Transformation Centres) and Innovation Centres to increase the efficiency of SMEs and their digital transformation' (2022-2024 ERP measure 9)

This measure is a continuation of measure 9 in the previous ERP (2022-2024). However, as in previous years, the expected impact of this measure is unclear, as all indicators used focus on the provided service itself, not on the goal. Some impact-related indicators with measurable and objective targets could include: (i) increase in total factor productivity; (ii) increase in value added in production of the serviced SMEs; and (iii) increase in the share of exports with high-technology content.

Green transition

This area and reform measure 8 are analysed above in Section 4 under **key structural challenge 3**.

Digital transformation

Over the last few years, Türkiye has been steadily developing its information and communication technology infrastructure. Türkiye's internet penetration rate has been on the rise, although it remains below the EU average.

The Digital Transformation Office has been set up and charged with the digitalisation of public services in Türkiye. The 2022 eGovernment benchmark estimates the country's eGovernment maturity at 72%, slightly above EU average of 68%.

([101]) https://www.sanayi.gov.tr/assets/pdf/birimler/SAVGMAr-GeDestekleriDegerlendirmesi2.pdf

Measure 9: 'Increasing the secure sharing and accessibility of public sector data with new data strategy' (2022-2024 ERP measure 12)

This measure is a continuation of measure 12 in the previous ERP (2022-2024). It is a good measure addressing a well-defined obstacle and providing concrete indicators to assess its impact.

Energy market reforms

This area and reform measure 10 are analysed above in Section 4 under **key structural challenge 3**.

Agriculture, industry and services

Agriculture remains a major contributor to Türkiye's economy. In 2021, this sector accounted for 6.2% of Turkish gross value added and 17.2% of total employment, way above EU averages of 1.8% and 3.8%, respectively. Hence, it still plays a significant role in providing employment opportunities and generating income.

Despite the country's favourable conditions for agriculture, the sector faces various challenges, fuelled in particular by climate change, such as water scarcity, soil degradation and outdated farming practices. Increased temperatures, changes in rainfall patterns, and more frequent extreme weather events are already negatively affecting crop production and livestock farming. That is why it is vital for Türkiye to invest in the long-term sustainability of agriculture and support solutions to increase the resilience of the sector, reduce its contribution to climate change and improve the ability of agricultural land to store carbon.

Following the impressive increase in the share of total gross value added in the second half of the last decade by around 10%, Türkiye's industry has continued its strong and stable growth. In 2022, this sector accounted for almost 30% of Turkish value added, significantly above the EU average. Industry's contribution to employment has remained more or less constant at levels around 20%.

At the same time, key structural weaknesses persist. The high dependency on foreign energy sources and raw materials has hardly diminished. The productivity gap between large companies and SMEs has grown, except for start-ups. The commercialisation of R&D is still hindered by the low capacity of Turkish SMEs to adopt process innovations. To maintain its competitiveness, Türkiye's needs to accelerate its green and digital transformations as well as improve business and investment environment.

Services are a critical component of Türkiye's economy, accounting for almost two-thirds of gross value added and over half of total employment. This sector includes a wide range of activities, such as tourism, finance, transportation, and telecommunications, as well as various professional services like consulting, legal, and healthcare.

Tourism is a particularly important sub-sector of the services industry. The further expansion and diversification of tourism in Türkiye was one of the priorities in Türkiye's economic programme for 2020-2022 with a view of restoring sustainable growth and increasing employment. In spite of the tourism sector' already strong performance, average expenditure per person remains very low, and there is still a largely untapped potential in the tourism sector.

Measure 11: 'Increasing tourism market share and brand value' (2022-2024 ERP measure 15)

This measure is a continuation of measure 15 in the previous ERP (2022-2024). Compared with previous years, the measure is more clearly defined. Nonetheless, there is still no clear budget allocation for the planned activities.

Since Türkiye has been becoming one of the leading health tourism destinations, the measure could benefit from activities supporting Türkiye's potential in this area. Additional actions could involve improving existing regulations, increasing the quality of healthcare and healthcare-related services, implementing more rigorous licensing, etc.

Social protection and inclusion

The rate of people at risk of poverty or social exclusion (AROPE) was already very high prior to COVID-19 and continued to deteriorate as a result of the pandemic. In 2020, 34.1% of the population and 43.4% of children were at risk of poverty or social exclusion, compared with the EU averages of 21.9% and 24.2% respectively. This can be partly explained by the very weak impact of social transfers on poverty reduction which slowly improved in 2020 to reach an estimated 9.45%, which was still far below the EU average of 32.68%. Income distribution remains the most uneven in the region with the income quintile ratio at 9.20 compared to the EU average of 5.24.

Measure 12: 'Raising awareness of hygiene, healthy eating, nature protection, food waste prevention in schools and institutions' (2022-2024 ERP measure 17)

This measure is a continuation of measure 18 in the previous ERP (2022-2024). Overall, the implementation of the measure has been progressing in line with expectations. As of 2022, 90% of schools affiliated with the Ministry of National Education have been prepared in accordance with the guidelines, and inspection and certification activities are ongoing.

Measure 15: 'Dissemination of family-oriented social services models' (2022-2024 ERP measure 18)

This measure is a continuation of measure 18 in the previous ERP (2022-2024) and concerns social services for children at risk of falling into institutional care. It envisages the expansion of two government-led schemes: (1) the socio-economic support scheme for families of children at risk (due to economic deprivation); and (2) foster care services.

The Social and Economic Support Service (SED) needs to be modelled and enhanced further to prevent child labour, i.e. providing the most vulnerable families with sufficient support, conditional on children attending school. At the same time, the foster care system needs to be strengthened to provide emergency foster care services. Moreover, children with disabilities and refugee children should receive tailored treatment.

Healthcare

Türkiye has a comprehensive health insurance system aiming for universal coverage. Despite generally affordable premiums, about 10% of the population is still not covered.

One of the challenges for the Turkish healthcare system is a shortage of doctors. This factor, combined with a lack of a referral system, results in long waiting times, and does not allow doctors to devote sufficient time to patients. The 11th national development plan (2019-2023) aimed to improve the quality and efficiency of primary care. However, its effectiveness in addressing this challenge has not yet been determined.

The COVID-19 pandemic put extreme stress on Türkiye's healthcare system, hindering its capacity to deliver essential services. However, in 2022, its effects were no longer felt.

Measure 16: 'Increasing the access of Syrian nationals under temporary protection to health services' (2022-2024 ERP measure 21)

This measure is a continuation of measure 21 in the previous ERP (2022-2024) aiming to increase access to healthcare services for Syrian nationals under temporary protection. The migrant health centre model is sufficient to provide appropriate quality healthcare services for migrants. Structural reforms are needed to further integrate migrant health services into the Turkish health system, to ensure a sustainable continuation of services.

The measure is expected to have a significant impact on public health, if implemented successfully. However, it is largely financed by the EU and will not have a clear impact on growth or competitiveness.

No measures presented in the following areas:

Public finance management

No measure was presented in this area in this ERP (2023-2025), and the section on public finance management focuses exclusively on transition to the performance-based programme budget system. It fails to present the main challenges, such as the need to revise public procurement legislation, adopt new framework legislation on public-private partnerships or strengthen budget transparency and accountability (for instance, improving *ex post* monitoring and reporting).

Business environment

No measure was presented in this area in this ERP (2023-2025). This area is analysed in detail above in Section 4 under **key structural challenge 2**.

Economic integration reforms

No measure was presented in this area in this ERP (2023-2025). The section on economic integration reforms stresses the significance of the free trade agreements and preferential trade agreements Türkiye's has negotiated and concluded with non-EU countries. However, it does not include any diagnostic analysis or provide suggestions for any reform measures. To improve its competitiveness and ensure better integration in global value chains, Türkiye should focus on identifying and removing existing impediments. Ad hoc protective measures and extensive use of restrictive practices disrupt the functioning of supply chains and undermine the predictability of the business environment, negatively impacting investment.

Transport market reforms

No measure was presented in this area in this ERP (2023-2025). The section lacks an in-depth analysis of the main obstacles. Instead, it presents decontextualised data, among others, on the railway network and passenger traffic.

The section fails to acknowledge Türkiye's transport market's dependency on fossil fuels. Following the Russian war of aggression against Ukraine, high natural gas and petroleum prices have negatively impacted the Turkish economy. As already described in Section 4 under key structural challenge 3, dependency on energy imports remains a major structural challenge for Türkiye. Since 90% of transport depends on fossil fuels, measures aimed at decarbonisation of this sector could play a critical role in addressing these challenges. Moreover, decarbonisation of transport will be essential to decrease Türkiye's carbon footprint in line with the country’s net climate neutrality ambitions and international commitments under the Paris Agreement.

Türkiye is one of the key players in the European aviation market and has a key role to play in accelerating the provision and uptake of low-carbon or zero-carbon alternative fuels (biofuels, hydrogen). The development of alternative fuel infrastructure at airports should be considered one of the priorities for the development of more sustainable aviation. The ERP would benefit from discussing challenges and efforts made to support the decarbonisation of this mode of transport.

The ERP could also focus more concretely on Türkiye’s maritime decarbonisation ambitions. As part of the Instruments for Pre-accession Assistance, the EU supported a project to encourage the use of innovative and environmentally friendly technologies in ports and ships in Türkiye. The project supports the green transition to low-carbon energy and a fuel-efficient maritime fleet, the development of infrastructure for alternative fuels such as hydrogen, and the establishment of port electricity infrastructures in port facilities. More details would be welcome on Türkiye’s plan with regard to maritime decarbonisation.

Türkiye might also consider including maritime and aviation sectors in its emission trading scheme.

In the context of the war in Ukraine, Türkiye’s strategic role as a transit country to the Middle East, Central Asia, and China has only increased. The commercial feasibility of new trade corridors linking Turkish ports with other Black Sea ports, especially Varna and Constanza, will be tested. Nonetheless, Türkiye’s full potential can only be realised on the shoulders of an efficient and effective railways network. In this respect, inter-modal integration with key airports, roads and ports is emerging as a necessary condition.

Despite significant investment in the last decade, rail has not increased its share of the transport market. Turkish railway legislation is still not fully aligned with the market pillar of the EU rail *acquis*, in particular as regards the independence of the infrastructure manager in the holding structure of the national railway undertaking; there must be a clear functional separation of the activities, and a strict separation of financial and accounting systems. For railways to become an attractive alternative to medium and long-range hauls, Türkiye should increase efforts to address these challenges. An efficient market-based railway sector in Türkiye – given its strategic geographical location – is key in the international context of Euro-Asia transport connectivity and the extension of rail services eastwards beyond the EU. Further investments in the modernisation of the railway infrastructure are needed. Completion of the flagship the Halkali-Kapikule Railway Line project should be considered a priority.

ANNEX B: OVERVIEW OF THE MAIN INDICATORS PER AREA/SECTOR OF THE ECONOMY

Area/Sector	2016	2017	2018	2019	2020	2021	EU-27 Average (2021 or most recent year)
Energy							
Energy imports dependency (%)	75.5%	77.2%	73.8%	70%	70.6%	N/A	55.6%
Energy intensity: kilograms of oil equivalent (KGOE) per thousand euro	175.03	175.30	167.69	168.42	162.79	N/A	110.35
Share of renewable energy sources in final energy consumption (%)	13.7% [w]	12.8% [w]	13.7% [w]	N/A	N/A	N/A	21.7%
Transport							
Railway network density (metres of line per km^2 of land area)	12.92 [w]	13.08 [w]	13.22 [w]	13.31 [w]	13.30	13.50 [w]	N/A
Motorisation rate (passenger cars per thousand inhabitants)	142	149	151	150	157.5	N/A	N/A
Agriculture							
Share of gross value added	7.0%	6.8%	6.4%	7.1%	7.5%	6.2%	1.8%
Contribution to employment (% of total employment)	19.5%	19.4%	18.4%	18.1%	17.6%	17.2% [w]	4.3% (2020)
Utilised agricultural area (% of total land area)	4.91%	4.89%	4.90%	4.84%	4.84%	N/A	40.6% (2020)
Industry							
Share of gross value added (except construction)	22.2%	23.3%	24.9%	24.2%	25.6%	29.1%	19.9%
Contribution to employment (% of total employment)	19.5%	19.1%	19.7%	19.8%	20.5%	21.3% [w]	16.1%
Services							
Share of gross value added	61.2%	60.3%	60.8%	62.7%	61.0%	59.1%	79.2%
Contribution to employment (% of total employment)	53.7%	54.1%	54.9%	56.6%	56.2%	55.3% [w]	70.9%

Area/Sector	2016	2017	2018	2019	2020	EU-27 Average (2020 or most recent year)
Research, development and innovation						
R&D intensity of GDP (R&D expenditure as % of GDP)	0.94%	0.95%	1.03%	1.06%	1.09%	2.26%
R&D expenditure – EUR per inhabitant	93.6	90.8	83.5	88.1	82.1	EUR 734,5
Digital economy						
Percentage of households with internet access at home	76%	81%	84%	88%	91%	92.5%(2022)%
Share of total population using internet in the 3 months prior to the survey (% of population aged 16-74)	58.3% w	64.7% w	71% w	73.98% w	78%	90%(2022)
Trade						
Export of goods and services (as % of GDP)	23.1%	26.0%	31.2%	32.7%	28.7%	50.4%
Import of goods and services (as % of GDP)	25.2%	29.7%	31.4%	30.2%	32.2%	46.7%
Trade balance (as % of GDP)	-6.5%	-8.9%	-7.0%	-4.1%	-6.7%	N/A
Education and skills						
Early leavers from education and training (% of population aged 18-24)	34.3%	32.5%	31.0%	28.7%	26.7%	9.9%
Young people not in employment, education or training (NEET) (% of population aged 15-29)	27.8%	27.5%	27.6%	29.5%	32.0%	13.7%
Children aged less than 3 years in formal childcare (% of children aged under 3)	N/A	N/A	N/A	N/A	N/A	35.3% (2019)

Individuals who have basic or above basic overall digital skills (% of population aged 16-74)	28%	34%	N/A	36%	N/A ([102])	56%(2019)
Employment and labour market						
Employment rate (% of population aged 20-64)	54.4%	55.3%	55.6%	53.8%	51.0%	71.7%
Unemployment rate (% of labour force aged 15-74)	10.9%	10.9%	10.9%	13.7%	13.2%	7.1%
Long term unemployment rate (% of labour force aged 15-74)	2.2%	2.4%	2.4%	3.2%	3.3%	2.5%
Gender employment gap (percentage points difference between the employment rates of men and women aged 20-64)	42.3 pps.	41.6 pps.	40.8 pps.	38.8 pps.	38.1 pps.	11.0 pps.
Disability employment gap (percentage points difference in employment rates between people with and without a disability)	18.8 pps.	20.3 pps.	19.4 pps.	19.5 pps.	18.9 pps.	24.5 pps.
Real gross disposable income of households (per capita increase, index = 2008)	N/A	N/A	N/A	N/A	N/A	107.23

([102]) The value data for 2021 is 30.12%.

Social protection system						
At-risk-of-poverty or social exclusion rate (AROPE) (% of population)	26.6%	32.3%	32.4%	33.2%	34.1%	21.9%
At-risk-of-poverty or social exclusion rate of children (% of population aged 0-17)	35.6%	41.9%	42.5%	43.3%	43.4%	24.2%
Impact of social transfers (other than pensions) on poverty reduction	7.69%	8.64%	7.88%	8.94%	9.45%	32.68%
Income quintile share ratio S80/S20 for disposable income by sex and age group (comparison ratio of total income received by the 20% with the highest income to that received by the 20% with the lowest income)	8.65	8.68	8.66	8.35	9.20	5.24
Housing cost overburden (% of population)	10.1%	9.5%	9.7%	10.5%	10.2%	9.9%
Healthcare						
Self-reported unmet need for medical care (% of people aged over 16)	3.8%	2.6%	2.9%	3.0%	1.9%	1.8%
Out-of-pocket expenditure on healthcare (% of total health expenditure)	16.47%	17.38%	17.49%	16.89%	N/A	15.57%(2018)

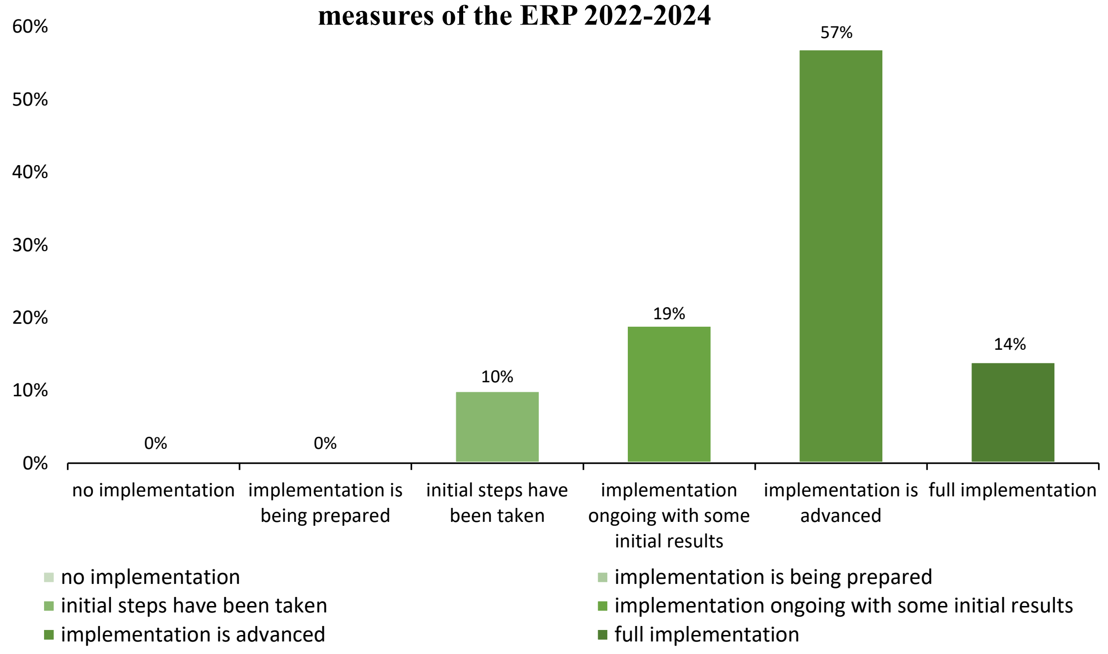
w: *data supplied by and under the responsibility of the national statistical authority and published on an "as is" basis and without any assurance as to their quality and adherence to EU statistical methodology'*

Source of data in Annex B: Eurostat, unless otherwise indicated.

ANNEX C: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM 2022-2024 ERP

There was a steady progress in implementing the measures in 2022. The average score for implementing the measures in 2022 is 3.76 out of 5, which is slightly worse than the previous year (3.8).

Graph II.6.2: **Türkiye - Implementation of the structural reform measures of the ERP 2022-2024**



Measure 1: 'Job clubs'

Although some activities planned for 2022 were carried out, they fell short of the targets set for the year. Out of the 10 new job clubs planned, only four started up in 2022. A score of '4 - implementation is advanced' would be more appropriate.

Türkiye decided to exclude this measure from the 2023-2025 ERP. In the future, a new measure on the quality of services provided by job clubs could be considered.

Measure 2: 'Professions of future'

The Commission agrees with the reporting and scoring. While the planned activities were carried out, the targets set for the year have not been fully met. The impact of training should also be followed up.

Measure 3: 'Youth employment will be increased by strengthening vocational training centres'

The Commission agrees with the reporting and scoring. The activities were implemented, but the targets have not been fully met. The impact of this training should also be followed up.

Measure 3: 'Youth employment will be increased by strengthening vocational training centres'

The Commission agrees with the reporting and scoring.

Measure 4: 'Reducing unregistered employment by focusing on increasing audit capacity in non-agricultural sectors'

The Commission agrees with the reporting and scoring.

Türkiye decided to exclude this measure from the 2023-2025 ERP because there are no plans to recruit more social security controllers.

Measure 5: 'Access to preschool education will be provided based on equal opportunity principle'

The Commission agrees with the reporting and scoring.

Measure 6: 'Specialized institutional guidance and inspection branches will be established depending on school and program types'

The Commission agrees with the reporting and scoring.

Measure 6: 'Specialized Institutional Guidance and Inspection branches will be established depending on school and program types'

The Commission agrees with the reporting and scoring. The overall score assigned for this measure is 4.

Measure 7a: 'Prioritizing technological product investments to increase the technology level and export capacity of SMEs and supporting the commercialization of R&D projects'

The information provided on implementation is insufficient. There is no information on indicators. The score is most likely overestimated and 4 would be more appropriate.

Measure 7b: 'Enhancing the R&D and innovation activities of SMEs; and the development and implementation of mechanisms to encourage and facilitate technology based and innovative SMEs access to finance, participation in mentoring and cooperation networks'

The information provided on implementation is insufficient. There is no information on indicators. The score is most likely overestimated and '4 - implementation is advanced' would be more appropriate.

Measure 8: 'Performance-based support of the research infrastructures supported under Law 6550 within the new legal framework'

This measure was given a score 5, which means full implementation. Nonetheless, there has been relatively little progress on implementation of this measure since 2020. There are still only seven research institutions within the scope of Law No 6550 on supporting research infrastructure. Hence, we suggest lowering the score to 4.

Measure 9: 'Establishing model factories (SME competency and digital transformation centres) and innovation Centers to increase the efficiency of SMEs and their digital transformation'

The Commission agrees with the scoring. However, the information provided on implementation is insufficient and there is no information on indicators.

Measure 10: 'Support mechanism will be established for the replacement of inefficient electric motors used in industry with more efficient ones'

Out of the planned 2 000 motors, only 363 inefficient electric motors used in industry were replaced with more efficient ones. Therefore, the score should be lowered to '3 - implementation ongoing with some initial results.'

Measure 11: 'Technical assistance for the Green Deal action plan'

The Commission agrees with the reporting and scoring.

Measure 12: 'Increasing the secure sharing and accessibility of public sector data with new data strategy'

The Commission agrees with the reporting and scoring. The overall score assigned for this measure is 4.

Measure 13: 'Update of Türkiye-EU customs union'

This is not considered a reform measure.

Measure 14: 'Improvement of data collection processes and increasing the capacity of evaluation in agriculture statistics'

The information provided on implementation is insufficient. The original measure envisaged three results indicators – a project output report (1), a number of training courses (10), and a number of trained personnel (1 000). Out of the 10 planned training courses, only eight were conducted in 2022. No details have been provided as regards the scope of these training activities. Moreover, no information has been given on other results indicators. The score is most likely overestimated and should be lowered to 3.

Measure 15: 'Increasing tourism market share and brand value'

The Commission agrees with the reporting and scoring.

Measure 16: 'Preparing the digital contents of the courses taught in Open Education Schools and presenting them to the students through the Education Information Network (EBA) platform and preparation of digital contents of course-certificate-authorization programs organized for individuals within the scope of lifelong learning'

The Commission agrees with the reporting and scoring.

Measure 17: 'Raising awareness of hygiene, healthy eating, nature protection, food waste prevention in schools and institutions'

The Commission agrees with the reporting and scoring.

Measure 18: 'Dissemination of family-oriented social services models'

The Commission agrees with the reporting and scoring.

Measure 19: 'Supporting clinical trials on vaccines and drugs'

Given the problems with implementation, such as clinical test delays, and the failure to meet the targets set for 2022, the scoring seems too high and should be lowered to 3.

Measure 20: 'Strengthening of the Ministry of Health's Covid-19 response capacity'

The project was scheduled for completion by January 2023. Given the unspent funds due to COVID-19 containment measures, the project duration has been granted a no-cost extension (of 15 months) until the end of April 2024.

Türkiye has been successful in implementing the project. The physical and human resources infrastructure of the national virology laboratory has been enhanced, and a molecular surveillance component has been included in the national surveillance system for communicable diseases, attaining a 500-fold increase in the laboratory's sequencing capacity in 2 years.

To fully utilise the capacity developed through the project, a national strategy on genomic surveillance will be developed during the extended implementation period. However, for a longer-term reinforcement of Türkiye's emergency preparedness and response capacities, the Ministry of Health has to:

ensure continuity in the workforce empowered with relevant technical and practical skills;

earmark national funds for the kits that sequencing requires;

upgrade the surveillance programmes to incorporate microbial genomic sequencing methods and,

ensuring laboratory information is digitally plugged into public health monitoring systems at national and international levels.

Although implementation is advanced, the scoring seems too high given that no steps have yet been taken to ensure the sustainability of the measure. Therefore, the score should be lowered to 4.

Measure 21: 'Increasing the access of Syrian nationals under temporary protection to health services'

The Commission does not agree with the reporting. The tender process for the procurement of medical equipment and supplies is characterised by unpredictability, with plans undergoing constant changes. As a result, the figures provided in this section might prove to be no longer valid. Moreover, counter to the information provided, no migrant health centre has been constructed or became operational to date.

ANNEX D: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The 2023-2025 ERP was submitted to the Commission on 31 January 2023. Overall, it has followed the Commission's guidance note.

Inter-ministerial coordination

The Presidency of Strategy and Budget has been responsible for central coordination of the ERP since 2019. The Presidency works closely with the Ministry of Treasury and Finance for the macroeconomic outlook and public finance and all other line ministries and institutions for the structural reforms.

Each line ministry has designated a coordinator for the ERP, which has helped significantly to ensure a smooth inter-ministerial ERP coordination process. The proposed measures for the new ERP were discussed in a workshop held in November 2022 by the Presidency of Strategy and Budget with the ERP coordinators, experts responsible for the measures and Instrument for Pre-Accession Assistance (IPA) coordinators. Afterwards, the ERP coordinator remained in contact with the different line ministries and relevant institutions in the preparation of the document.

Stakeholder consultation

The line ministries and related institutions were involved in the preparation of the ERP document. It is mostly based on the 11th national development plan (2019-2023), the medium-term programme (2023-2025) and the 2023 Presidential annual programme. The 11th national development plan and the other policy documents were developed in a broad consultation process with stakeholders and experts (including private-sector representatives, NGOs, and academia).

As part of the preparatory work for the structural reform measures, two training programmes were organised in cooperation with the Connecting Europe Facility in October and in November 2022. These provided a major opportunity for the line ministries to discuss their proposed structural reform measures and to work out the scope of the measures. The line ministries thus had sufficient time to work out the details of these measures over a couple of months in light of the exchanges made during the training and separately with the Presidency of Strategy and Budget.

However, no specific consultations took place with external stakeholders on the draft ERP and no draft was made available to the public before its adoption. The ERP document does not provide sufficient information on the feedback and how it has been worked in. Written comments were not annexed to the ERP.

Macroeconomic framework

The chapter on the macroeconomic framework broadly follows the outline provided in the guidance note. It succinctly covers nearly all of the required elements with one major exception – it does not present an alternative scenario. This is a repeat omission and is a major drawback, especially in view of the high levels of domestic and global uncertainty. The analysis would have benefited from better linkage between the macroeconomic and fiscal framework sections and with the macro-relevant structural reforms. The presentation and analysis of risks is rather schematic and could be expanded and deepened.

Fiscal framework

The chapter on the fiscal framework closely follows the outline provided in the guidance note. It covers all major elements and provides information on the 2023 budget, although a more systematic presentation of the main discretionary fiscal measures (equal to or above 0.1% of GDP) would have been welcome.

The chapter lacks detail on the medium-term plans and the underlying measures. The section on contingent liabilities could be expanded to systematically cover all sources of liability. The section on public finance risks could be further developed. The fiscal framework chapter could be expanded to cover elements related to fiscal rules and the medium-term budgetary framework.

Structural reforms

Reporting on the implementation of the policy guidance is, at times, not well developed. It fails to provide a good overview of all the measures implemented for the different policy recommendations. Furthermore, for some policy recommendations, no indications are provided on the implementation process. Similar shortcomings are noticeable in the reporting on the implementation of the structural reform measures from the 2022-2024 ERP, with visible inconsistencies in the reporting and scoring in Table 10. In many cases, the information provided on implementation is not well developed. The maximum number of reforms (20) is respected; the current ERP (2023-2025) presents a total of 16 measures. However, the page limit (50) is not respected, as the section on the structural reform stretches to 81 pages. The ERP document includes the two Tables 9, presented as 8a *'Social Scoreboard Indicators'* and 8b *'Other Selected Indicators'*, which provide some information requested under Table 9. The ERP document presents *'Table 10a: Costing of structural reform measure'* as *'Table 9a'*. The table contains information for each measure. The ERP document presents *'Table 10b: Financing of structural reform measure'* as *'Table 9b'*, but there seem to be some inconsistences as it includes a measure on *'profession of future'* but was not presented among the measures of this ERP cycle. The ERP document also includes *'Table 11: Reporting on the implementation of the structural reform measures of the ERP 2020-2022'*, which is presented as *'Table 10'*.

The Annex 2 table, *'linking reform areas and relevant policy document'* does not cover all the reform measures presented in the ERP document. Furthermore, the links between the reform areas and the relevant policy documents need further elaboration (especially as regards the Enlargement Package). There is significant room for improvement.

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7. KOSOVO

7.1. EXECUTIVE SUMMARY

Following a slowdown in economic activity in 2022, Kosovo's economic reform programme (ERP) expects economic growth to pick up, mainly on the back of a robust rebound in private and public investment. Annual output growth eased markedly to 3.5% in 2022, primarily due to a strong contraction of investment and a deceleration in household consumption growth. The ERP baseline scenario projects an annual average GDP growth of 6.1% in 2023-2025, which is above the historical trend and appears to be optimistic. In particular, the strong rebound in investment, a key growth driver in the ERP scenario, is likely to face constraints. These constraints are related to weak planning and insufficient implementation capacity for public investments and an uncertain economic environment for private investments. Major downside risks to this outlook come from higher-than-expected energy and food prices resulting from Russia's war of aggression against Ukraine and the related energy crisis. These could also lead to less dynamic trade developments with Kosovo's main EU (and non-EU) trading partners. Further risks stem from tighter financing conditions and lower-than-expected financial inflows from the diaspora.

After 2 years of substantial fiscal consolidation, the ERP expects a strong fiscal impulse in 2023 while ensuring compliance with the deficit rule in 2023-2025. Supported by high revenue growth and a significant under-execution of public capital spending, the headline budget deficit fell to 0.5% of GDP in 2022, continuing the fiscal consolidation that started in 2021. The 2023 budget plan expects the headline budget deficit to rise to 3.4% of GDP, implying a strong fiscal stimulus mainly through an increase in public spending driven by investment and higher wages. However, the deficit (according to the fiscal rule definition) would not exceed the prescribed ceiling of 2% of GDP. In the medium term, the ERP expects the deficit to fall again thanks to contained current spending. Immediate fiscal risks, some of them described in the programme, stem from lower-than-expected revenue and pressure to roll out new social benefits.

The main challenges facing Kosovo are the following.

- **The expected compliance with the deficit rule will serve as an anchor for fiscal policy but necessitates reforms to support public finances.** Given the high degree of uncertainty amid Russia's war of aggression against Ukraine and the related energy crisis, it seems appropriate to use the fiscal space in the 2023 budget to continue providing temporary and well-targeted policy support to vulnerable households and firms as needed. To comply with the 2% deficit ceiling in 2023-2025, policies must be implemented that strengthen the revenue base and contain current spending. A review of existing tax exemptions and preferential tax rates would help mobilise revenue. Current spending would benefit from a review and streamlining of social benefits, including war veteran pensions, and a proper assessment of the fiscal impact of new social initiatives.

- **The significant increase planned in public investment requires comprehensive reforms to improve project planning and implementation.** Kosovo has made little progress in strengthening public investment management, and steps should be taken to improve the execution of capital spending by implementing the recommendations of the International Monetary Fund (IMF) Public Investment Management Assessment. The fiscal risks related to publicly owned enterprises (POEs) should be mitigated by improving their financial oversight and accountability. This can be advanced by approving and publishing annual performance reports. Related investment decisions should be properly assessed, incorporated into budgetary planning and contribute to the overall investment strategy.

- **The unreliable and undiversified supply of energy is inadequate to meet rapidly growing demand and is one of the main constraints on Kosovo's competitiveness, acting as a brake on productivity and exacerbating the energy crisis.** The lack of energy security gives rise to significant costs for businesses and represents a major obstacle to attracting high-quality foreign direct investment (FDI). To develop a secure and sustainable energy supply, Kosovo needs to find attractive alternatives to polluting sources of energy and invest in energy efficiency measures. In March 2023, Kosovo approved a new national energy strategy. Preparations have been made to establish a competitive auction-based system for renewables, but the legislative and regulatory work has yet to be finalised the first auction is delayed by at least one year. Progress in regional integration of electricity markets could support the financial stability of the Kosovo transmission system operator (KOSTT).

- **The digitalisation of the economy is advancing step by step.** Kosovo has a small but rapidly growing ICT sector, particularly in the export of software development, smart phone application development and web design. More needs to be done to train skilled workers in this sector where demand for employees outstrips supply. The Economic and Investment Plan for the Western Balkans will continue supporting investment in digital infrastructure to deploy ultra-fast and secure broadband to ensure universal access. Kosovo needs to continue developing the legal framework and infrastructure needed to stimulate e-commerce, increase the adoption of e-commerce practices among SMEs and make international electronic payments possible.

- **Further reforms are needed to improve the quality and relevance of the education system to increase employment and reduce skills mismatches.** The labour market is dominated by agriculture, the public sector and micro, small and medium companies. Many young people, particularly young women, struggle to find their first professional experience. The government has not made the necessary reforms to the education system so that it meets the needs of the labour market. Indeed, the education system has not made the necessary reforms to adapt to the needs of the labour market. The informal economy and clientelism are still an alternative to working or seeking work ('inactivity') and emigration. The authorities have initiated a number of major structural reforms to address these issues. These include facilitating access to pre-primary schools, including in rural areas, introducing dual education, reforming the social protection system, and modernising employment services. In line with the Western Balkans Declaration on ensuring sustainable labour market integration of young people ([103]), the authorities are committed to implementing the Youth Guarantee.

- **Persistent, widespread informality and a weak business environment remain a key structural challenge for Kosovo's economy. The** informal economy limits the fiscal space for public spending in priority areas, deters the development of the private sector and prevents a significant part of the workforce from accessing proper levels of social protection and training. There has been good progress in recent years with work on formalisation and compliance helping to increase tax revenues. However, there is still room for improvement. Preparations have begun to improve the business environment by simplifying and digitalising licences and permits although more effort is needed. Kosovo has yet to attract significant foreign direct investment in the productive economy. Although the government has initiated plans to address this, strong political support, effective implementation and close monitoring are required to achieve the desired outcomes.

- **The Common Regional Market and the Economic and Investment Plan for the Western Balkans are important tools to leverage sustainable growth and competitiveness.** The Common Regional Market will help integrate Kosovo into regional and European value chains and help increase the attractiveness of the economy for foreign direct investment in tradeable sectors. Further connectivity with neighbouring countries in transport and energy will strengthen access to, and integration into, the regional market. The creation of a regional digital space and labour markets that are more integrated with neighbouring economies will offer new opportunities for Kosovo's young people, which is

([103]) Bolstering the resilience of youth in the Western Balkans | ETF (europa.eu) important given the high rate of youth unemployment. Kosovo's regional integration faces an additional challenge due to the political issues related to non-recognition.

Kosovo has partially implemented the policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2022. Strong public revenue and a significant under-execution of public investment substantially improved the budget balance. Compliance with the fiscal rule's deficit ceiling of 2% of GDP is expected in 2023. Some of the measures to mitigate the impact of high inflation could have been better targeted. There has been no progress in reviewing social security schemes and war veteran pensions. The new law on public-sector salaries, combined with a suitable value of the wage coefficient set by the government, ensures that the public wage bill does not exceed its legal ceiling. Tax revenue grew strongly on the back of high inflation and a reduction in the informal economy, but there was little progress on reviewing tax exemptions. The financial oversight of POEs has improved but work to set up a fiscal oversight body has not advanced. Investment management also remains a major weakness. The government recently approved a 10- year national energy strategy but has yet to draft a National Energy and Climate Plan. Some energy efficiency measures have been implemented and preparations have been made to launch competitive auctions for renewable energy projects. However, little has been achieved in the area of market liberalisation. The new action plan to combat the informal economy was adopted, and the tax authorities have had some recent success in tackling this problem. However, there was no progress on price transparency for real estate transactions, and many measures in the existing action plan are yet to be implemented. The youth guarantee implementation plan has been finalised, but more human resources in the public employment service are needed to deal with the increased number of registered unemployed people.

The ERP sets out reform plans that are broadly in line with the key challenges and priorities identified by the Commission. It reflects the government's intention to support the economic recovery in 2022 and strengthen the sustainability of public finances in the medium term. It includes measures to improve the business environment, attract investment and reduce the informal economy. The ERP also partially addresses energy access challenges and the capacity of the education system to respond to labour market needs. Although the proposed measures in the ERP are aligned with the main structural challenges and much work has been done to prepare reforms, their implementation has so far been delayed.

7.2. ECONOMIC OUTLOOK AND RISKS

Kosovo's economic rebound moderated significantly in 2022 due to the impact of Russia's war of aggression against Ukraine on energy prices and inflation, as well as a decline in investments and remittances. Real GDP growth eased to 3.5% in 2022 ([104]), primarily due to a strong decline in gross fixed capital formation, mainly driven by shrinking public investment and tighter financing conditions, and a deceleration in household consumption growth due to an inflation-induced drop in real disposable incomes. Economic activity was propelled by temporary government support measures (3.5% of GDP in 2022) to mitigate the impact of the energy crisis. Moreover, a strong increase in exports of goods and services together with a sharp slowdown in real imports growth resulted in a positive contribution of net exports to GDP growth. At the same time, diaspora-related inflows provided less support to growth; the share of net inflows of remittances in GDP dropped moderately.

The ERP's baseline scenario projects a robust acceleration of economic activity with GDP growth to go above the historical trend in 2023-2025. Real GDP is set to increase by 5.5% in 2023 and by 6.1% and 6.7% in 2024 and 2025, respectively. This is well above pre-pandemic growth rates, which averaged almost 5% in 2015-2019. Growth acceleration is expected to be driven by a surge in public investment in 2023 (+10.4% year-on-year). Public investment look set to benefit from: (i) implementing planned projects; (ii) the easing of some bottlenecks, including the Procurement Review Body board becoming operational again, and (iii) implementing the public works support law, which compensates contractors for higher input prices. Private investment is also expected to increase due to government support, less uncertainty and the private sector's improving balance sheets. The ERP projects annual investment growth to remain high at around 8.5% in 2024-2025. Negatively affected by inflation but supported by higher bank lending and social transfers, private consumption is set to increase marginally by 0.2% in 2023, and to accelerate to around 5% on average in 2024-2025, although the key reasons for this are not described in the programme. Public consumption is projected to rebound strongly by 8.6% in 2023 and increase marginally after that. This is due to a significant rise in expenditure on goods and services, as well as on public-sector salaries following the new wage law coming into effect. Real exports are set to increase by 4.7% in 2023 and continue growing by around 7% on average in 2024-2025. Imports are expected to rise marginally by 0.8% in 2023 although this appears to contradict the projected strong investment recovery. As a result, the ERP projects net exports to still provide a positive contribution (1.4 pps) to GDP growth in 2023, albeit much lower than in 2022. In 2024-2025, accelerating import growth (up to 4.7% on average) will cause net exports to negatively contribute to GDP growth. The programme expects the output gap to remain slightly negative in 2023 and to turn positive after that as real growth is projected to exceed potential growth.

Amid high levels of economic uncertainty, the ERP's baseline scenario looks overly optimistic. GDP growth rates for 2023 and 2024 have been markedly revised downward from the previous year. However, the rates still appear rather optimistic and well above the 3.8% average annual expansion projected by the IMF. In particular, the rebound in investments, a key growth driver in the ERP scenario, is likely to face constraints caused by weak planning and insufficient implementation capacity for public investments and an uncertain economic environment for private investments. The ERP itself notes that macro-fiscal risks have increased significantly due to the economic fallout from Russia's war of aggression against Ukraine and the related energy crisis. Further rises in energy and food prices, a continued tightening of the monetary policy stance and the associated economic slowdown in the euro area will likely affect Kosovo by dampening demand for its exports and may cause a further slowdown in inflows of remittances. A

([104]) Macroeconomic and fiscal estimates and forecasts covering the period 2022-25 have been taken from the ERPs themselves; if available, preliminary macroeconomic and fiscal outturn data for 2022 have been taken from the relevant national sources (national statistical office, ministry of finance, central bank).

substantial domestic risk stems from high import costs and outdated power generation capacity, which may result in more power cuts and higher energy subsidies. The ERP's 'low growth' scenario results in an average annual growth rate of around 3% in 2023-2025, which currently appears more realistic than the baseline. The scenario's main assumptions are the under-execution of public investment, lower foreign demand, a slowdown in remittances and higher import prices.

Table II.7.1:
Kosovo - Macroeconomic developments

	2021	2022	2023	2024	2025
Real GDP (% change)	10.7	4.1	5.5	6.1	6.7
Contributions:					
- Final domestic demand	11.3	-3.2	4.5	6.3	7.4
- Change in inventories	-0.3	-1.1	-0.4	-0.1	-0.1
- External balance of goods and services	-0.3	8.3	1.4	-0.1	-0.7
Employment (% change)	10.4	:	:	:	
Unemployment rate (%)	20.7	:	:	:	
GDP deflator (% change)	6.1	8.1	4.2	1.6	0.8
CPI inflation (%)	3.3	11.6	4.3	2.2	1.2
Current account balance (% of GDP)	-8.7	-6.1	-5.4	-6.2	-6.5
General government balance (% of GDP)	-1.2	-0.5	-3.4	-2.2	-1.1
Government gross debt (% of GDP)	21.5	19.8	22.6	23.0	23.8

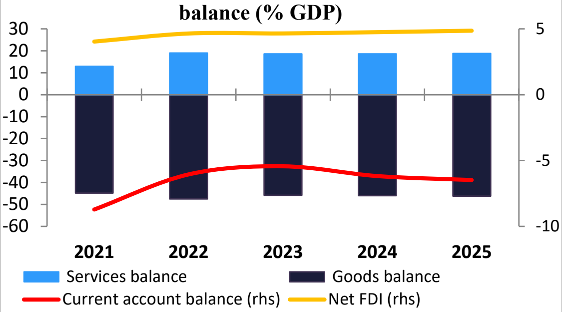
Sources: Economic Reform Programme (ERP) 2023.

After peaking in 2022, average inflation is expected to decline in 2023-2025. After some slowdown in the last 3 months of the year, consumer price inflation averaged 11.6% in 2022, notably higher than the 3.3% rate registered in 2021. The main causes were rising food, energy and transport prices. Inflation inched up to 12.1% in January 2023, before slowing to 10.5% in February. The ERP expects average annual inflation to fall to 4.3% in 2023 and further to 2.2% and 1.2% in 2024 and 2025, respectively, on the back of the high base in 2022 and gradually decelerating commodity prices in international markets. The ERP's inflation projection appears rather benign, compared with the IMF forecast of an annual inflation rate of about 5% in 2023. The programme rightly acknowledges the external risk of a further escalation of the war in Ukraine. This would leave Kosovo exposed to high inflationary pressures caused by higher import prices of food, agricultural and energy products, the latter potentially exacerbated by shortfalls in domestic electricity production. Inflation risks also come from demand pressures from higher public-sector salaries, included in the 2023 budget, and a potential increase in social benefits.

The current account deficit widened significantly in 2022, but the ERP projects it to decrease to around 6% of GDP over the programme period. The strong energy-balance-driven increase in the merchandise trade deficit outweighed the continued rebound of services exports. This resulted in the current account deficit widening to 10.5% of GDP in 2022 from 8.7% of GDP in 2021. The strong rebound of services exports, mainly driven by diaspora tourism from Western Europe, fuelled a 2.4 pps increase in the services surplus to 15.4% of GDP. Exports of goods, which are much lower than exports of services, rely on a narrow product base, including base metals, various manufactured articles, and plastic, rubber and mineral products. These exports shot up by 22.8% year-on-year despite the high electricity prices in 2022 affecting the price of base metals, the main export product. Imports of goods also rose quickly (by 21.2%) mainly due to higher energy imports. This resulted in the traditionally high merchandise trade deficit widening from 44.8% of GDP in 2021 to 47.9% in 2022. The overall trade deficit increased to 32.5% of GDP in 2022 from 31.8% in 2021, and the ERP projects it at around 27% in 2023-2025. The primary income surplus fell to 1% of GDP from 1.9% in 2021. Remittances also decreased to 13.7% of GDP in 2022 from 14.5% in 2021, and they are forecast to follow historical trends in 2023-2025 with an annual average growth of 5%. Large errors and omissions (2.7% of GDP) may reflect unrecorded services exports and remittances, thereby the actual current account deficit could be smaller than the official estimates. The current account deficit is expected to narrow significantly in 2023 (to 5.4% of GDP). This appears optimistic given the 2022 reading, even if lower commodity prices, an overall stable trade surplus in services and a sustained growth of remittances are assumed. A gradual increase in the current account deficit in 2024-2025 (reaching 6.5% of GDP in 2025) appears in line with higher import growth reflecting rising domestic demand and higher investment.

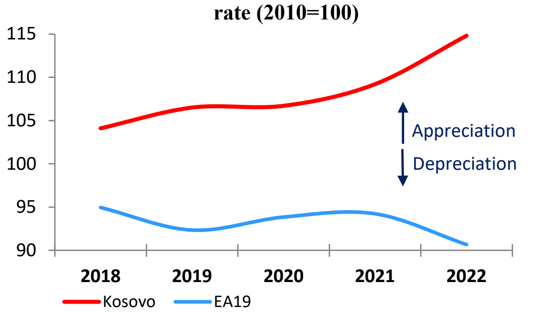
External competitiveness and current account

Graph II.7.1a: **Kosovo - Current account balance (% GDP)**



Source: Economic Reform Programme (ERP) 2023.

Graph II.7.1b: **Kosovo - Real effective exchange rate (2010=100)**



Source: Economic Reform Programme (ERP) 2023 and ECB.

Net foreign direct investment, mainly driven by inflows from the diaspora into real estate, remains the main financing source of the current account deficit. Net foreign direct investment inflows grew strongly to 6.7% of GDP in 2022, covering 64% of the current account deficit. The bulk was directed to non-tradeable activities, with real estate and financial and insurance services accounting for 67% and 7% of all foreign direct investment inflows respectively, doing little to improve export capacity. The ERP projects that net foreign direct investment inflows will increase from EUR 0.5 billion in 2023 to about EUR 0.6 billion in 2025. These inflows are therefore expected to stabilise at around 4.8% of GDP, which is not enough to fully cover the current account deficit. Kosovo's net international investment position deteriorated tod-18% of GDP in 2022, compared -11.5% in 2021. Around two thirds of gross liabilities consist of foreign direct investment, which is typically considered a more stable source of financing, limiting external vulnerabilities. Reserve assets are falling, from 2.5 months of imports in 2021 to 2.2 in 2022. They are expected to fall further to around 2 months in 2023-2025.

Table II.7.2:
Kosovo - Financial sector indicators

	2018	2019	2020	2021	2022
Total assets of the banking system (EUR million)	4 186	4 761	5 365	5 960	6 762
Foreign ownership of banking system (%)	86.8	86.7	86.5	85.5	84.9
Credit growth (aop)	10.9	10.0	7.1	15.5	16.1
Deposit growth (aop)	8.7	16.2	11.6	12.4	13.3
Loan-to-deposit ratio (eop)	81.9	77.6	74.5	76.5	78.3
Financial soundness indicators (%, eop)					
- non-performing loans to total loans	2.7	2.0	2.7	2.1	2.0
- regulatory capital to risk-weighted assets	17.0	15.9	16.5	15.3	14.8
- liquid assets to total assets	38.5	38.7	39.8	37.4	36.5
- return on equity	20.4	18.9	14.0	17.6	20.6
- forex loans to total loans	14.7	14.2	7.2	5.5	14.8

Source: National Central Bank.

The predominantly foreign-owned banking sector remained resilient and continued to expand. Annual credit growth accelerated slightly to 16.1% in 2022, largely on the back of businesses needing more credit to cover higher input costs. However, new loans to households, mostly for spending purposes, only grew slightly. There are non-negligible risks from a weaker economic outlook, higher commodity prices, and lower-than-projected remittances. These could weaken deposit growth, tighten liquidity, reduce demand and affect asset quality; therefore, the banking sector should be monitored closely. Moreover, as new mortgage lending to households has been growing relatively strongly, it appears appropriate to strengthen surveillance of the housing market, including by compiling residential sector statistics using bank loan data. The growth of deposits picked up from 12.4% in 2021 to 13.3% in 2022. Financial soundness indicators remained satisfactory, e.g. the loan-to-deposit ratio and non-performing loan (NPL) ratio ([105]) stood at 78.3% and 2%, respectively. Bank profitability has improved in nominal terms with the average return-on-equity ratio reaching 20.6% in 2022, up from 17.6% in 2021. The ERP does not provide quantified forecasts for the financial sector. However, the underlying assumption, which appears plausible, is that the NPL ratio will grow to 3.5% in 2023. Furthermore, the pressure on the liquidity of the largely foreign-owned banking sector is expected to grow stronger. There appears to be scope to increase the financial sector's role in reaching climate and energy targets in line with European and international commitments by adopting policy measures in the area of sustainable finance (such as sustainability disclosures, sustainable finance taxonomies etc.).

7.3. PUBLIC FINANCE

Fiscal consolidation continued in 2022 with a further reduction of the headline deficit due to solid revenue performance and a significant under-execution of the public investment budget. The headline budget deficit stood at 0.5% of GDP in 2022, which corresponds to a surplus of 0.2% of GDP under the fiscal rule definition ([106]). The 2022 deficit outturn was lower than in 2021 (1.2% of GDP) and significantly undershot the target of 5.4% set in the revised 2022 budget. Government deposits fell slightly to 3.5% of GDP from nearly 4% in 2021 mainly caused by financial support packages targeting vulnerable households and public energy companies. The lower deficit resulted primarily from a strong and higher-than-projected increase in government revenue (+13.2% year-on-year), largely on the back of high inflation and some formalisation gains. Tax revenue increased by 14.3% with direct and indirect tax income growing healthily by 24% and 13% respectively in 2022. Public expenditure grew by 10.5% year-on-year, mainly driven by transfers and subsidies (26.3%), in particular energy subsidies. The temporary support packages adopted to mitigate the impact of the energy crisis, including energy subsidies and transfers to households and businesses amounted to 3.5% of GDP in 2022. The execution of overall current expenditure was roughly in line with the revised budget plan. Wages and allowances recorded an annual decrease of 2.2% while spending on goods and services rose by 9.4%. Capital spending almost stagnated compared to 2021 and only reached around 60% of the revised budget allocation. It was affected by insufficient technical capacity and higher input prices, which led to a surge in project costs.

The ERP objective for 2023-2025 is to maintain stable public finances and comply with fiscal rules while supporting the economic recovery mainly through higher capital spending. The fiscal strategy is frontloaded. The ERP expects public revenue to rise by 1.5 pps to 29.3% of GDP in 2023 before falling back to 28% in the following 2 years. This is chiefly due to an expected tax revenue increase to an historical high of 26% of GDP in 2023 compared to 25.2% in 2022. Non-tax revenue is projected to rise to 3.3% in 2023 and then stabilise at around 2.5% of GDP on average. Public expenditure is projected to

([105]) Stable NPL ratio was also supported by the denominator effect, i.e. continued credit growth.
([106]) The fiscal rule places a cap on the fiscal deficit of 2% of forecast GDP, excluding capital projects financed by privatisation proceeds and donors ('investment clause'). This exemption for donor-financed investments can be invoked until 2025, provided the public debt ratio remains below 30% of GDP. A further rule provides that the increase in the public wage bill cannot exceed nominal GDP growth. Government deposits used as fiscal buffers are legally required to stay at 4.5% of GDP as long as the government uses privatisation proceeds. The debt rule provides that public and publicly guaranteed debt cannot exceed 40% of GDP.

increase by 4.4 pps to 32.8% of GDP in 2023 and decrease gradually to 30.4% and 29.2% in the following 2 years. The ERP assumes a very large upfront increase in capital spending in 2023, bringing public investment to above 8% of GDP, and it is expected to remain at around this level over the programme period. Current spending is set to fall gradually, from 23.8% of GDP in 2023 to 20.5% in 2025, mainly on the back of a steady decrease in social transfers and subsidies. The headline deficit is expected to widen to 3.4% of GDP in 2023 and narrow afterwards. According to the fiscal rule's definition, the deficit is projected to fall to 1.1% of GDP in 2024 before turning into a marginal surplus of 0.1% in 2025. The implied fiscal impulse of about 2 pps in 2023 seems appropriate to support economic activity given the economic slowdown in 2022 and the estimated negative output gap before fiscal consolidation resumes in 2024-2025.

The 2023 budget plan aims to provide a significant fiscal impulse primarily through a big increase in spending driven by investment. The 2023 budget projects public revenue at 29.3% of GDP, compared to the 2022 outturn of 27.8% of GDP. Tax revenue gains are expected to come from higher GDP growth, a further reduction of the informal economy and improved tax compliance. Revenue growth will also benefit from a large increase in grants to 1% of GDP, mostly from EUR 75 million of EU budget support to Kosovo to cushion the impact of energy price increases on households and firms. The assumed rise in tax proceeds looks ambitious, especially without any policy measures to widen the tax base.

Total expenditure is planned to increase sharply to 32.8% of GDP from 28.4% of GDP in 2022, mainly due to the GDP rise of 3.6 pps in public investment spending. Compared to the outturn of 2022, capital spending is set to roughly double. Such a surge appears overly optimistic given the previous track record of implementing spending and would require a comprehensive overhaul of the institutional framework for investment planning and management. Current expenditure is set to increase by 0.6 pps to 23.8% of GDP in 2023, largely driven by higher spending on goods and services. Implementation of the Law on salaries of public officials, which came into force on 9 February, is expected to increase the wage bill by 0.3% of GDP. Subsidies and transfers are forecast to fall to 11.2% of GDP. This reflects the government's intention to gradually improve the quality of public spending by decreasing less growth-enhancing budget allocations as well as the withdrawal of support related to the energy crisis. Debt interest payments are set to increase marginally to 0.5% of GDP in 2023. The 2023 budget includes an allocation for contingencies of 3.5% of GDP, out of which 2.7% of GDP is a blanket allocation. Such large blanket allocations undermine fiscal transparency and budget planning unless they are justified as part of a concrete risk assessment framework. The headline deficit is forecast at 3.4% of GDP, which would keep the deficit (as measured according to the fiscal rule's definition) at the prescribed ceiling of 2% of GDP. Government cash deposits are planned to rise slightly to 4% of GDP from 3.5% in 2022, which is still in line with the prescription of the fiscal rule as no privatisation proceeds are planned.

Table II.7.3:
Kosovo - Composition of the budgetary adjustment (% of GDP)

	2021	2022	2023	2024	2025	Change: 2022-25
Revenues	27.7	27.8	29.3	28.1	28.0	0.2
- Taxes and social security contributions	24.8	25.1	26.0	25.7	25.7	0.5
- Other (residual)	2.9	2.7	3.3	2.5	2.4	-0.3
Expenditure	28.9	28.4	32.8	30.4	29.2	0.8
- Primary expenditure	28.5	28.0	32.3	29.9	28.7	0.7
of which:						
Gross fixed capital formation	5.3	4.7	8.3	8.4	8.0	3.3
Consumption	12.5	11.3	12.6	11.7	11.1	-0.2
Transfers & subsidies	10.6	11.9	11.2	9.6	9.4	-2.5
Other (residual)	0.1	0.1	0.2	0.2	0.2	0.1
- Interest payments	0.4	0.4	0.5	0.5	0.5	0.1
Budget balance	-1.2	-0.5	-3.4	-2.2	-1.1	-0.6
- Cyclically adjusted	-1.2	-0.1	-2.0	-1.7	-1.6	-1.5
Primary balance	-0.8	-0.1	-3.0	-1.8	-0.6	-0.5
- Cyclically adjusted	-0.8	0.3	-1.5	-1.2	-1.1	-1.4
Gross debt level	21.5	19.8	22.6	23.0	23.8	4.0

Sources: Economic Reform Programme (ERP) 2023, Commission calculations.

General government debt is projected to remain well below the ceiling of 40% of GDP set in the fiscal rule although weaknesses linked to a narrow investor base and a lack of market access remain. On the back of a marginal primary deficit and high nominal GDP growth in 2022, the debt-to-GDP ratio decreased to 20.7% from 21.5% in 2021. This is well below the 2022 ERP projection of 26.5%. However, the figures do not factor in the liability from COVID-19-related tax-free withdrawals of 10% of pension savings from the Kosovo Pension Saving Trust (KPST), which the government promised to reimburse from 2023 ([107]). Domestic debt, which is held by a narrow investor base, increased marginally by 0.5% in 2022. The share of domestic debt held by the KPST grew to 49% compared to 44% in 2021, whereas the share of commercial banks fell to 25% from 29%. The Central Bank of Kosovo holds a further 19% of domestic debt. In February 2023, the KPST's investment in government bonds amounted to 22.2% of its total assets; therefore, it still has some room to buy new bond issuances before it reaches the legal limit ([108]). However, there is a lack of quorum in the KPST Board, and the KPST may not be able to participate in the auction of Kosovo government securities before new board members are appointed. Foreign debt rose by 11.2% in 2022 on the back of financing from international donors. This includes loans from the World Bank (EUR 60.1 million), the European Investment Bank (EUR 23.8 million), the European Bank for Reconstruction and Development (EUR 14.5 million) and the Council of Europe Bank (EUR 10.8 million). The ERP assumes a 2.8 pps increase in the public debt ratio in 2023 to 22.6% and a continued gradual drift upwards to 23.8% in 2025. It projects government deposits to reach 4% of GDP in 2023-2025, which would provide sufficient capacity to absorb potential new shocks.

Kosovo cannot access international debt markets as it does not have an international credit rating, and risk management policies limit the ability of commercial banks to hold more government debt ([109]). Therefore, the investor base for government securities needs to be more diversified to ensure adequate financing. This could include insurance companies, non-financial private firms and possibly retail investors, including among the diaspora. Together, these categories currently hold only 7% of domestic debt. In

([107]) The IMF estimates the liability to KPST at 1.8% of 2020 GDP.
([108]) Government securities should not exceed 30% of KPST assets.
([109]) The absence of a sovereign risk rating results in a 100 per cent capital risk weight for Kosovo's government securities.

2021, Kosovo issued its first diaspora bonds totalling EUR 10.4 million, most of them being 5-year bonds, in an effort to tap additional sources of financing. The new Law on public debt and state guarantees aligning the legal framework with EU standards and international practices was adopted at the end of 2022, and the secondary legislation will be reviewed and approved by the end of 2023. According to this new law, the definition of public debt will also include debt issued on behalf of municipalities. The law regulates municipality borrowing, including the power to borrow, reporting requirements and debt limits.

Box.II.7.1: **Debt dynamics**

Kosovo

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

	2021	2022	2023	2024	2025
Gross debt ratio [1]	**21.5**	**19.8**	**22.6**	**23.0**	**23.8**
Change in the ratio	-0.9	-1.7	2.8	0.3	0.8
Contributions [2]:					
1. Primary balance	**0.8**	**0.1**	**3.0**	**1.8**	**0.6**
2. “Snowball” effect	**-2.8**	**-1.9**	**-1.3**	**-1.1**	**-1.1**
Of which:					
Interest expenditure	0.4	0.4	0.5	0.5	0.5
Growth effect	-2.1	-0.8	-1.0	-1.3	-1.4
Inflation effect	-1.2	-1.6	-0.8	-0.3	-0.2
3. Stock-flow adjustment	**1.1**	**0.1**	**1.1**	**-0.3**	**1.3**

[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) 2023, Commission calculations.

The sustained though steadily decreasing primary deficit in 2023-2025 is expected to be the main factor behind the gradually increasing public debt ratio. This debt-increasing factor is set to be partly offset by the impact of robust economic growth and inflation. Interest expenditure is forecast to stay low and stable at 0.5% of GDP in 2023-2025. Positive contributions to the debt-to-GDP ratio are expected to come from stock-flow adjustments in 2023 and 2025, although this is not explained in the ERP.

The fiscal scenario is subject to significant fiscal risks and uncertainties. Fiscal projections are likely to underestimate current spending while the assumption of a huge surge in capital spending in 2023 appears unrealistic. On the spending side, the increase in allocation for social transfers seems rather moderate; the programme remains elusive as to the factors that could trigger the expected and significant drop in social and transfer spending as a percentage of GDP over the programme period. The ERP does not provide much detail about continuing the economic revival programme and energy subsidies to households and firms in 2023. In addition, risks of higher-than-planned growth in social spending persist due to new initiatives included in the government programme such as raising basic pensions or extending maternity and child benefits; existing schemes might prove more costly than expected. In particular, transfers and subsidies in 2023 might increase more than the targeted 3.4% compared to the 2022 outcome because of the recurring spending overrun on war veteran pensions in the absence of a reclassification of beneficiaries. The proposal to decouple war veteran pensions from the minimum wage would, once adopted, help contain overspending risks. The projected almost doubling of capital spending, compared to the 2022 outturn, seems overly ambitious given the track record in previous years and limited progress in improving planning, selection and management capacities of public investment.

Additional fiscal risks stem from the poor financial oversight and accountability of publicly owned enterprises (POEs), which could require (further) large subsidies from the budget, especially due to the energy crisis. The newly established sovereign wealth fund managing state assets is set to have a key role in improving POEs' financial performance. The stipulated reimbursement from the budget for the COVID-19-related 10% withdrawal of pension savings from the Kosovo Pension Saving Trust (KPST) is EUR 101.5 million, and it has been included in the medium-term expenditure framework (MTEF). The framework provides for five annual instalments of EUR 20 million each as of 2023. However, the 2023 budget only allocates EUR 5 million for reimbursement. It is positive that the government has rejected a recent proposal to withdraw more funds from the KPST. On the revenue side, the projected rise in tax revenue of around 14% in 2023 looks ambitious, with revenue gains expected to come from increased formalisation of the economy and sustained price increases. However, the ERP does not outline any reforms to widen the tax base. Overly optimistic GDP growth projections are also a downside risk for revenue.

Box.II.7.2: **Sensitivity analysis**

The ERP analyses the sensitivity of the debt-to-GDP ratio to three specific shocks:

1) A slowdown in GDP growth of 2 percentage points would bring the debt-to-GDP ratio to 32.6% by the end of 2035 instead of 29.8% in the baseline scenario if the deficit rule is followed in 2025-2035.

2) If, due to higher spending, the primary balance deteriorates by 2 percentage points of GDP in 2025-2035 and the deficit rule is not followed, debt would increase to 34.3% of GDP by the end of 2035, i.e. 4.5 percentage points higher than in the baseline scenario.

3) A 1 percentage point increase in interest rates on loans combined with no compliance with the deficit rule would bring the debt-to-GDP ratio to 35.8% by the end of 2035, i.e. 6 percentage points higher than in the baseline scenario.

The sensitivity analysis underscores the importance of compliance with the 2% deficit rule, which acts as a debt stabiliser. Furthermore, it is important to keep current expenditure under control, in anticipation that financing from privatisation funds will end over the medium term.

A narrow tax base, unsuitable targeting and transparency of social transfers, and weaknesses in managing investments continue to harm the quality of public finance. The government allocated 4.3% of GDP in 2022 as fiscal support to vulnerable households, pension and salary bonuses, and subsidies for the energy and agricultural sectors. The measures could have been better targeted and more transparent, as some of them were aimed at all consumers and not just vulnerable households, such as energy tariff subsidies. A substantial share of specific category-based social transfers, including war-related pensions, that are non-contributory and financed from the budget do not directly target poverty reduction.

Further progress is needed to improve public investment management. The administrative guidelines on capital project selection and prioritisation, drawn up by the Ministry of Finance, Labour and Transfers in 2019, have not been implemented effectively. Project oversight is also weak, which impedes corrective action when needed. On a positive note, steps were taken to unlock the potential of project implementation, including through paid land expropriations and making the Procurement Review Body board operational again in the second quarter of 2022. Furthermore, the Law on public works support, adopted at the end of 2022, compensates contractors up until mid-2023 for higher project costs resulting from very high inflation; this may also improve the execution rate of capital spending. Kosovo should address shortcoming in managing public investment by progressing in the implementation of the recommendations made under the IMF Public Investment Management Assessment.

In addition to streamlining expenditure, Kosovo's public finances would benefit from strengthening the revenue base, which is weakened by the widespread informal economy, numerous tax exemptions, preferential tax rates and special regimes. Moreover, customs revenue in 2022 was lower as a result of the implementation of the free trade agreement with Türkiye and the Stabilisation and Association Agreement with the EU.

Kosovo's fiscal rules are the main anchor for macro-fiscal stability and safeguard high out-of-budget capital spending. The 2023 budget appropriately targets the deficit (according to the fiscal rule's definition) to be below the prescribed ceiling of 2% of GDP. The deficit is then expected to decrease further to 1.1% in 2024 before turning into a marginal surplus of 0.1% in 2025. However, the enforcement of the fiscal framework suffers from the unfinished reclassification of war veteran pension beneficiaries and continuously expanding social commitments. According to the fiscal rule definition, the exemption from the 2% deficit ceiling of capital projects financed by privatisation proceeds and donors can be invoked up until 2025, provided that public debt remains below the prescribed ceiling of 30% of GDP. A benign ERP projection of public debt is dependent on high GDP and public revenue growth, which are beset by uncertainty. The implementation of the Law on salaries of public officials is expected to increase the wage bill by 0.3% of GDP in 2023, which is lower than the nominal GDP growth in 2021, thus the wage bill rule will be respected. Fiscal governance would also benefit from moving ahead with plans to set up an independent body for fiscal oversight. This can be done by reviewing and selecting one of the options described in the paper that had been prepared with the help of the IMF. The proper functioning of Kosovo's fiscal framework is also conditional on the quality of macro-financial statistics, which require substantial further improvement.

7.4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

The Commission has conducted an independent analysis of Kosovo's economy and identified the main structural challenges to competitiveness and inclusive growth, drawing on Kosovo's own ERP and other sources. The analysis highlights a number of structural challenges across many sectors. The three most significant challenges are:

(i) Improving energy security and sustainability by reforming the energy sector, transitioning to renewables and tapping energy saving potential;

(ii) Encouraging sustainable employment by improving quality education and labour market needs

(iii) Reduction of the informal economy and improving the environment for doing business.

While there are several obstacles to inclusive economic growth and competitiveness, the identified key structural challenges have the most potential for boosting inclusive growth and competitiveness and therefore have real reform leverage. The government identified the same three issues as key challenges in their ERP.

Kosovo also needs to continue to tackle corruption, improve the rule of law, strengthen its institutions and improve the administration's capacity in order to promote competitiveness. Addressing these fundamental concerns is a prerequisite for the successful transformation of the economy. The Commission has been closely monitoring the issues of strengthening the rule of law and fighting corruption in the annual enlargement package report on Kosovo.

Furthermore, the country should proactively implement the Energy Community's Decarbonisation Roadmap to achieve the agreed climate and energy targets, and strive towards establishing a carbon pricing instrument compatible with the EU ETS.

Key challenge #1: Improving energy security and sustainability by reforming the energy sector, transitioning to renewables and tapping energy saving potential

An unreliable and undiversified energy supply and an extremely fragile energy sector remains a major bottleneck for Kosovo's economic development. The reliability of energy supply is still below the average for Europe and Central Asia. Despite some improvements, Kosovo ranks 90th in the world for ease of getting electricity (World Bank, 2020b). The lack of energy security gives rise to significant costs for business and represents the biggest obstacle to attracting high-quality foreign direct investment. According to data from the latest World Bank Enterprise Surveys, 59.9% of firms experienced electrical outages and there were 3.8 outages per month on average ([110]). Energy demand and consumption continues to grow quickly, and has doubled since 2000. Kosovo also suffers from high technical and commercial losses in the distribution and transmission grids due to poor infrastructure (around 20%).

Kosovo is particularly dependent on outdated, unreliable and highly polluting energy production sources (brown coal/lignite). This, together with inefficient consumption and insufficient flexibility to adapt to consumption in peak periods, means that electricity must be imported and exported to balance the system. Since Kosovo tends to import at times of high prices and export at times of low prices, this mismatch creates significant costs. The cost of electricity imported from November 2021 to March 2022 reached EUR 204 million. The issue of energy security has become an even more urgent issue amid Russia's war of aggression against Ukraine and the global rise in energy prices.

Addressing Kosovo's energy issues is also challenging from an environmental point of view. The highly polluting Kosovo B thermal power plant requires an environmental upgrade while Kosovo A thermal power plant was to be decommissioned until the government recently included in the new national energy strategy the possibility to extend the lifetime of at least one of its units. Fuelwood, remains a significant energy source for heating homes due to cheaper prices, leading to significant air pollution and the attendant negative health effects, particularly during winter months. Furthermore, limited efforts have been made to improve support schemes for renewable energy projects. Lessons learned from the IPA 2015 biomass based heating plant with cogeneration technology in Gjakova should be taken into consideration because the power plant appears not to be sustainable at this stage.

The green transition has become a priority following Kosovo's endorsement of the Green Agenda for the Western Balkans during the Sofia Summit in November 2020. Kosovo has begun to diversify its energy supply. Renewable energy sources, currently account for just over 5% of electricity supply. By the end of 2021, Kosovo recorded a total of 276.2 MW of renewable electricity generation, 96 MW of small hydropower, 32 MW of large hydropower, 137 MW of wind, 10 MW of solar, and 1.2 MW of biomass. Kosovo has recorded a 24.4% share of renewables in 2020 just under its official target for the year of 25% 2020. While the share of energy from renewable sources in gross final energy consumption reached 24.2% and 22.4% in 2019 and 2021 respectively. However, this was mainly achieved by revising the definition of renewable energy sources to include biomass for heating. The roll out of renewables is expected to accelerate through the newly adopted national energy strategy 2022-2031 and the law on renewable energies which is due to be adopted by the Assembly in Q3 2023. The draft law provides for a competitive bidding process for support for renewable energy projects to replace the previous system of feed-in tariffs. There has been an increase in renewable energy investments and several projects to develop significant wind and solar energy sources are already planned, including merchant projects to be operated outside of the auction process. In particular, the Western Balkans Investment Framework board has approved two public-sector blending projects including the construction of a photovoltaic plant (100MW) and a solar district heating facility that will also involve the construction of solar collectors.

The potential for savings through energy efficiency measures remain significant. Some efforts were made to increase energy efficiency incentives for the private sector and households. There is some

([110]) Data collected from business owners and top managers in 271 firms interviewed from December 2018 to October 2019.

progress on energy efficiency retrofitting of the public buildings implemented by the Kosovo Energy Efficiency Fund with financing from EU, World Bank and Kosovo budget. The fund intends to expand the operation in the residential sector starting in 2023 with financing from the EU under the Energy Support Package. The government has taken progressive steps to help overcome the current energy crisis, and already rolled out Energy Efficiency measures for subsidising efficient heating equipment in the residential sector. Under the Energy support package, the energy efficiency fund will provide subsidies up to 50% for the implementation of the energy efficiency measures in the residential sector. Further work is under way towards the finalisation of the national energy efficiency programme. The European Bank for Reconstruction and Development, supported by the EU and in partnership with local partner banks and micro-finance institutions, has begun providing credit for households (which account for 39% of final electricity consumption) to make their homes more energy efficient, and there is scope for more such investment. In 2022, Kosovo introduced new block tariffs to incentivise energy efficiency by increasing the price of electricity for users consuming over 800 kilowatts per month. Despite this step toward liberalisation, electricity prices remain highly regulated and are below the regional and EU averages.

The Economic and Investment Plan and the Green Agenda for the Western Balkans will contribute to the green and digital transition, in particular the use of renewable energy sources, which will benefit Kosovo's competitiveness. A substantial investment package, which is at the heart of the Economic and Investment Plan, will direct most support to key productive investments and infrastructure. This will reflect and support the twin green and digital transition and the development of a thriving economy that is connected, competitive, knowledge-based, sustainable and innovation-oriented. Circular economy principles, which form the basis of the Economic and Investment Plan and are defined in the Green Agenda for the Western Balkans, could boost levels of sustainable energy production and consumption significantly. Labour market transition can be difficult for some workers in particular of the mining sector. It is crucial to help workers to gain the needed skills to facilitate their transition towards the green economy by training, re-training and up-skilling.

***Reform measure 1: "Energy market reform*"** carries over reform measure 6 from last year's ERP and aims to address the problem of low levels of competition in the energy market by reviewing and amending legislation and regulation in the sector. The flagship activity under this measure is the operationalisation of the wholesale day ahead and intra-day electricity price markets within the framework of a joint Albania-Kosovo electricity exchange (ALPEX). Market integration will increase the utilisation of cross-border transmission capacities, enabling more efficient utilisation of electricity networks, and increasing competition for the benefit of customers. ALPEX is expected to be fully operational by Q3 2023. Although authorities see no obstacles to achieving this goal, the measure has already been delayed from last year and the authorities are dependent on the day-ahead and intra-day markets being established in Albania before Kosovo is connected to them.

Critically, around 90% of Kosovo's electricity production and supply is regulated under a bulk supply agreement between Kosovo Energy Corporation (KEK) and Kosovo Electricity Supply Company (KESCO). End prices for consumers are regulated by tariffs set by the Energy Regulatory Office (ERO). The authorities are currently exploring ways to reform the agreement to further liberalise the market, however this may prove to be complicated legally due to the agreement's indefinite duration. The establishment of a wholesale electricity market via ALPEX can be seen to serve as a pilot liberalisation of part of the market but the unreformed bulk supply agreement is significant legal obstacle to full market liberalisation. The retail market for supplying of high-voltage customers is deregulated.

Furthermore, this measure includes an activity to establish a platform for the comparison of electricity supply prices. It is unclear what benefits this platform bring given that there are currently only two suppliers of electricity operational in the market at present.

Reform measure 2: "Promotion of energy efficiency and renewable energy sources with a view to the green transition", combines two measures rolled over from last year's ERP and aims to prioritise energy efficiency in all sectors and increase energy generation through renewable sources. The roll out of renewables will be accelerated through the new national energy strategy 2022-2031 which has already been adopted by the government and Assembly.

Activities included under this measure are the adoption of the law on renewables as well as associated secondary legislation to provide for the introduction of a competitive bidding process for renewable energy projects to replace the previous system of feed-in tariffs. A first pilot auction is expected to take place in Q2-2023 before the law on renewables is in place. A project location has been found, preliminary studies are being conducted and the first tender currently being drafted. The financial impact assessment on the law on renewables is ongoing which is expected to be approved in Q3. Auctions under the new law are expected to begin before the end of 2023. State aid approval is still required for the auctions and may constitute an obstacle. Streamlining of permitting processes which can be a major obstacle to implementation of projects is not mentioned under this measure although some provisions for this are included in the draft law. In addition, the role of merchant structures including corporate Power Purchase Agreement (PPAs) should be reflected in the RES law, as there is a strong interest in this area from the private sector.

In relation to energy efficiency, activities include implementation of energy efficiency measures in public and private buildings. Currently the government and the Energy Efficiency Fund are in the process of designing the measures to increase energy efficiency in the residential and private sector and to provide energy efficiency incentives for households and the private sector. Financing of these measures will partially come from the EUR 75 million Energy Support Package for Kosovo.

It should be noted that the new national energy strategy sets the target of completing all preparations for implementing a carbon pricing system by 2025. This ambition is not fully reflected in the ERP submission and progress is needed on this front to avoid adverse effects due to the EU's Carbon Border Adjustment Mechanism.

Key challenge #2: Encouraging sustainable employment by improving quality education and labour market needs.

Micro, small and medium companies and subsistence farming are the backbone of Kosovo's economy and main employers. 99.9% of all Kosovan companies are SMEs and family-run businesses. They account for 80.4% (2020) of employment in non-financial businesses (significantly above the EU rate of 65.2%) and generate 81% of the total value added of the country ([111]). The SME sector consists overwhelmingly of distributive trade businesses, which includes wholesale and retail trade and the repair of motor vehicles and motorcycles. 62% of the population lives in rural areas. Around 20% of the workforce works in agriculture, and there is many informal jobs. However, the sector's contribution to growth remains limited, and the loss of jobs in agriculture does not lead to retraining in other sectors. Net trade of IT services increased by over 200% compared to the first half of 2021, accounting for 11% of the total share of trade in services in the first half of 2022. Nevertheless, developments in digital technology and artificial intelligence have sparked concerns about new risks of poverty and social exclusion. Kosovo's Human Development Index (HDI) and Human Capital Index (HCI) are among the lowest in the region. About one third of the population lives below the national poverty line.

The public sector is the largest employer in the job market with 30.8% of total employment ([112]) (2018) compared to 27.2% across the Western Balkans and 23.7% in OECD-EU countries. Publicly owned enterprises in Kosovo provide important services, such as water supply, waste collection,

([111]) SBA fact sheet Kosovo, 2019
([112]) Kosovo Country Economic Memorandum, World Bank.

electricity production, transport and telecommunications ([113]). However, public utilities in Kosovo face challenges from over-staffing and poor performance among others. Staff recruitment is often in violation of fair and transparent recruitment processes. Over the years, publicly owned enterprises have paid higher salaries than the rest of the public sector, and the average salary is almost twice the amount of the private one.

The statistical data confirm a worrying situation in the labour market, particularly for young people and women. According to the 2021 Labour Force Survey (LFS), about 66% of the population are of working age (15-64); however, the official workforce participation rate is 39%. The discrepancy between the active labour supply and labour demand is very high. The gender divide is also significant. The inactivity rate for men is 43.4% (LFS 2021) compared to 78% for women ([114]). The employment rate for men is 45.9%, while it is 16.5% for female. The unemployment rate (20.7%) further underlines the gender gap. Women make up 25% of unemployed people compared to 19% for men. 38% of young women (aged 15-24) are unemployed. The rate of young people not in education, employment or training (NEET) is 36.6% (group age 15-29). Publicly owned companies perform poorly when it comes to equal opportunities. Women's access to the labour market, especially in rural areas, is low due to many factors, including the traditional role given to women as housewife, limited access to childcare and flexible working arrangements, lack of care for older people, discouraging laws (for example, on maternity leave) ([115]) and ethnic discrimination. As indicated in the recent OECD report ([116]) 51% of women in the working-age population (15-64 years old) were only educated up to lower secondary education, compared to 27% of men.

The lack of work fuels the significant informal economy (around 31% of GDP) and emigration. 56.5% (LFS 2021) of employees have a temporary contract, which denies people their rights, including in the public sector where the use of special service agreements ([117]) is widespread. This flexibility for employers creates insecurity for employees and an incentive to take on informal jobs. According to estimates, 40% of the workforce is not declared or is under-declared. Clientelism makes the public sector a more attractive place to work than the private sector ([118]). In the 2021 May Public Pulse survey ([119]), the top three issues reported were unemployment (34.3%), poverty (19.3%) and corruption (9.3%). This leads to major emigration and the brain drain of mostly young, educated and skilled people looking for a better life. The Western Balkans is expected to lose around 1 million young people to other countries in the coming decade ([120]). The loss of human capital, especially through emigration as well as demographic decline, is a big risk. It hinders economic growth, weakening the ability of the government to improve services, including education and social protection. The state strategy on migration for 2019-2023 underlined that brain drain has been emphasised as a concern by the government. Beyond the substantial remittances they generate, the skills and experience gained by emigrants abroad can benefit the Western Balkans if policies are in place to reap the full benefits ([121]).

([113]) Financial Management and Transparency of Publicly Owned Enterprises, December 2022, GAP Institute (GAP), Group for legal and Political Studies (GLPS) and Institute for Development Policy (INDEP).
([114]) This is the largest gender employment gap among all WB6 economies.
([115]) Implementing legislation for the Law on protection from discrimination still has to be adopted. The current draft Law on labour proposes shifting the burden of paying maternity leave from businesses to government; however, it has yet to be adopted by the national assembly.
([116]) Labour Migration in the Western Balkans, 2019, OECD.
([117]) Special service agreements (SAAs) or fixed-term appointments represent a way of recruitment with limited timeframe in civil service. SAAs are contracts concluded between the institution and one person who is a professional in a certain field and is assigned to provide that expertise for a period not longer than six (6) months.
([118]) Review of national career development support systems in the Westerns Balkans, European Training Foundation (ETF)
([119]) Public Pulse Brief XX | United Nations Development Programme.
([120]) State Strategy on Migration 2019-2023. The number of emigrants of Kosovan origin (period 1969-2011) is estimated to be about 703 978 people, while in 2017 it was estimated to be about 833 739 (net migration stock) people. Most of them live in Germany (39%), Switzerland (23%), Italy (7%), Austria (7%) and Sweden (7%), and 17% live in other countries.
([121]) Labour migration in the Western Balkans: mapping patterns, addressing challenge and reaping benefits, 2022, OECD.

Many reports highlight the urgency to invest in quality education at all levels to create better jobs, living conditions and prospects for young people. Kosovo has the youngest population in Europe with around 70% of the population under the age of 35. However, the country is unable to give these young people the education and the skills needed so that they can live from their work. According to these reports, based on the results of international tests, the education system is not geared to developing the necessary key skills, nor adequately aligned with the demands of the labour market. Based on regional surveys, the OECD ([122]) stresses that, 17% of respondents disagree with the claim that skills learned in the education system meet the needs of their job and 44% of surveyed firms identify applicants' lack of skills as a reason for unfilled vacancies. Students reach a bottleneck when they are old enough to earn a living. Without decent work, they are exposed to many other risks like poverty, human trafficking or health problems. Many find a job that does not correspond to their level of education. 41.7% of students (aged 15-24) in Kosovo are estimated to be over-skilled and employed in semi-skilled occupations (ISCO08 ([123]) groups 4-8), usually requiring lower levels of formal qualifications. 32% of over-educated individuals hold jobs below their (ISCED) level of education ([124]). European Training Foundation reports that many young Kosovars are opting for higher education since this improves their chances of employment even if this is in jobs requiring lower skills ([125]).

Career guidance is crucial for youth employment. Employers are reporting significant skills shortages ([126]). The early identification of young talent to provide them with relevant education and opportunities is weak. Without relevant and real-time data, it is difficult to align policies, training programmes and curricula with the current and future needs of the labour market and guide students into careers best suited to their skills and preferences ([127]). For instance, the 2017-2026 Energy Strategy mentions that implementing energy efficiency measures includes creating new jobs and developing local businesses. However, no details are given about the type of skills required or the benefits for local businesses. Consequently, the Public Employment Services, with its network of training providers and with the participation of donors, provide targeted training but for a limited number of jobseekers. Older people, women, people with low or no qualifications and the long-term unemployed may face particular challenges to access training courses that lead to employment. These particularities are hardly taken into account. The authorities have recently started to use tools that will give them an overview of market needs and let them publish the results ([128]).

Limited practical skills and work experience opportunities is a major constraint for the school to work transition. Due to their small size, businesses are not sufficiently involved in education or training and do not provide enough opportunities ([129]) to their staff, including further skills development ([130]). However, progress is being made, notably the launch of dual-education and work-based learning programmes. For instance, the K-GenU platform ([131]) was created and aims to empower 10 000 young people by giving them internship opportunities, mentoring and training in the next 2 years. The implementation of the youth guarantee should also ensure a better partnership between all the relevant bodies (Relevant ministries, employment services, training providers, social services, civil society and social partners) supporting those who are furthest from employment. Although a Donor Coordination Group within the Ministry of Finance, Labour and Transfers and the Ministry of Education, Science,

([122]) Labour Migration in the Western Balkans: Mapping Patterns, Addressing Challenges and Reaping Benefits, 2022, OECD.
([123]) International Standard classification of occupations.
([124]) KIESE 2022, European Training Foundation ETF.
([125]) Review of national career development support systems in the Westerns Balkans, European Training Foundation ETF.
([126]) Findings show that the most in-demand skills are socio-emotional, foreign language, and computer skills.
([127]) Busulla.com is the official portal of the Ministry of Education, Science and Technology for professional orientation, education and career consulting.
([128]) Atomi project – Raiffeisen Bank.
([129]) Job Creation and Demand for Skills in Kosovo: What Can We Learn from Job Portal Data? "The absence of internships on the main job portals is of concern for young people looking for experience in a labour market dominated by informal networks", Calogero Brancatelli, Goethe University Frankfurt, Alicia Marguerie, World Bank, Stefanie Brodmann, World Bank.
([130]) STEP survey, World Bank Kosovo.
([131]) The Ministry of Finance, Labour and Transfers, in partnership with UNICEF, Reifaisen in Kosovo and the Kosovo CSR Network.

Technology and Innovation exist, the coordination among donors remains weak as well as the degree of ownership and steering by the authorities.

The lack of financial autonomy of vocational schools is a major reason for skills mismatches. Part of the upper-secondary education, the vocational education and training (VET) system involves many stakeholders, which makes its governance complex. According to the education law, municipalities are responsible for paying salaries of the support/administration staff and teaching staff and deciding on the allocation and reallocation of funds for each VET school. Municipalities are not sufficiently monitored by the central level (ministries of finance and education) whether they use the grants earmarked for education or VET purposes. Around 90% of the budget goes on wages, and the remaining amount is insufficient for maintenance and investments in quality teaching. VET funding – and pre-university education in general – is a delicate matter but needs to be tackled quickly. The IPA-ADA ALLED2 project has suggested a valid, new financing formula for VET.

The VET curriculum is too theoretical and does not teach the necessary practical skills. Only a few VET curricula or courses offered by public VET institutes (schools or training centres) are based on qualifications accredited by the National Qualifications Authority ([132]). A lack of skills affects all firms looking for staff, but it affects large, dynamic and innovative firms even more. Therefore, the firms that are more likely to be competitive and productive are also the ones facing the largest skill constraints when recruiting. VET school infrastructure remains insufficient with either outdated equipment or no equipment at all. Teachers need proper training to face fast-changing technologies. Employers should be more involved and encouraged to participate in the improvement of programmes alongside international experts. However, professional practice is not currently implemented in a systemic way and does not follow the curricula. Hiring new state inspectors is ongoing and needs to be reinforced; inspectors should mainly check the quality of teaching rather than compliance with the law. A number of donor initiatives are being implemented on work-based learning and the ongoing implementation of incubators providing support and coaching for new businesses (i.e. Innovation Center Kosovo ([133]) is a promising initiative.

Early childhood development recently became a top priority in the national development agenda ([134]). The draft Law on early childhood education (ECD) was adopted by the government in July 2022 and is now in parliamentary procedure. A high-level ECD Steering Committee, with strong leadership and representation from key government ministries, has been set up to improve implementation and coordination of programmes. Funding will also be increased in line with quality benchmarks to develop infrastructure, in particular in rural areas, to revise and adapt the curriculum (to be approved in 2023) and to train qualified staff. Communication will be improved to better inform parents about the benefits of preschool education and early childhood development. Municipalities play a central role in financial allocations to schools. However, due to this decentralised model, the allocated funds are insufficient and can be reallocated. A child who starts school at the age of 4 can expect to complete 13.2 years of school by their 18th birthday, but their education level is equivalent to completing 7.9 years of school ([135]). Only 15% of children aged 3-4 in Kosovo attend some form of early childhood education ([136]). While ECD enrolment is low, the system itself is diverse with public, private, and community-based services. The preschool enrolment rate is expected to rise rapidly now that enrolment is made compulsory.

([132]) Job Creation and Demand for Skills in Kosovo: What Can We Learn from Job Portal Data? Calogero Brancatelli, Goethe University Frankfurt, Alicia Marguerie, World Bank, Stefanie Brodmann, World Bank.
([133]) Innovation and Training Park in Prizren (ITP). The main sectors developed within the ITP are: information technology, agriculture and food processing, creative and cultural industries and vocational training. The park is now open, and businesses are applying to become part of the ITP.
([134]) Why investing in the early years of children's lives is critical in Kosovo, Worldbank.
([135]) World Bank.
([136]) Annual Report 2021, Unicef Kosovo.

The Education Strategy 2022-2026 has been adopted and aims to raise the quality of pre-university education and, in particular, harmonising education and professional training based on the 'Evaluation of the Implementation of the Kosovo Education Strategic Plan 2017-2021' (KESP). This evaluation report provides an overview of steps that have been taken so far to meet the strategic objectives. It also makes recommendations about how to use the KESP as a platform to improve the quality of education. In particular, in the Education Strategy, the authorities make a commitment to improve the link between education and the needs of the labour market. They commit also to develop the use of digital technologies to improve the quality of education. A planned priority is for the Kosovo Accreditation Agency ([137]) to strictly monitor the criteria for accrediting higher education programmes.

With the cooperation of the Kosovo government, the European Training Foundation carried out an evidence-based rapid education diagnosis ([138]) of the entire education system addressing three main thematic areas: inequality, financing and governance. The analysis aimed to identify key issues and actions to improve the quality and delivery of education services overall. The Foundation drew up a set of recommendations for the Kosovo authorities to consider. These recommendations include: (i) setting up adequate monitoring and evaluation mechanisms; (ii) improving cross-ministerial cooperation; (iii) boosting institutional capacity, particularly for financial management; and (iv) setting priorities in the Education Strategy.

Reform measure 3: 'Adapting Vocational Education and Training to the needs of the labour market'. This measure is carried over from previous years and presents an integrated approach to address long-term issues in the VET sector. The reform seeks to give young people a first work experience and recognise qualifications for increased employability according to labour market needs. A large part of the current VET profiles and curricula is still outdated: only 30% of the more than 180 VET profiles are based on occupational standards (Bajrami 2021). VET programmes need to be further revised and developed, but no related concrete activities or indicators are described. Preparatory work is particularly important before further implementing dual-learning. Currently there are only four active dual-learning profiles with around 100 students concentrated in low-skilled professions while some 5,000 VET students (funded by donors) from schools and programmes benefit from company internships. Furthermore, ensuring the autonomy of VET institutes and a better collaboration with employers is necessary to improve teaching and practice of trades.

Reform measure 4: 'Increasing and ensuring quality in higher education by strengthening the KAA and profiling higher education institutions' is rolled over from last year's reform measure 2 and is well designed. However, there have been implementation delays. The adoption of the law on the Kosovo Agency for Accreditation has been rolled over from last year. The draft law addresses the recommendations made by the European Association for Quality Assurance in Higher Education (ENQA) and the European Quality Assurance Register (EQUAR). The draft law must be passed and resources secured for its implementation this year. The measure does not include activities that could improve the quality of courses or better link education with businesses.

Reform measure 5: 'Reforming labour market institutions and policies to raise the level of employment, participation in the labour market and effective protection of labour rights' is rolled over from last year's ERP measure 5. The measure focuses on the reform and modernisation of the

([137]) The Kosovo Accreditation Agency (KAA) is an independent body responsible for assessing and promoting the quality of higher education. It is currently in the process of applying for membership in the European Network for Quality Assurance in Higher Education (ENQA) and European Quality Assurance Register (EQAR). KAA has been granted the status of affiliated member of ENQA recently, and this is an assurance that the agency is on the right path towards its full membership of the organisation (9 out of 11 recommendations has been fully addressed, while the other two have already been addressed through legislation and will be considered implemented as soon as the Law on Accreditation Agency is enforced). Through quality assessments and quality audits, KAA is firmly establishing a quality of higher education in Kosovo that meet the demands and expectations of the European Network.

([138]) Kosovo Rapid Education Diagnosis (RED): addressing the weak links, European Training Foundation ETF, forthcoming (2023).

employment service (EARK), and the activities outlined would provide a good start to implementing the youth guarantee scheme. Strengthening human resources in the employment agency depends on recruitment opportunities in the public sector. This is crucial issue given the retirement of many employees. Digitalisation of services would accelerate the flow of information and improve the quality of services in line with supply and demand. The development of employment and skills surveys must be continued to give greater visibility to the needs of the labour market. The lack of financial resources is still a challenge in tackling inactivity and unemployment.

Restructuring the labour inspection service and employing 100 new labour inspectors are welcome initiatives. The 2023 budget has already earmarked budget for this measure, and this will help the formalisation of employment and the effective protection of labour rights.

Box.II.7.3: **Monitoring performance on the European Pillar of Social Rights**

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

For most of the Pillar's principles, Kosovo performs considerably below the EU average according to the Social Scoreboard indicators ([139]). Nevertheless, the downward trend is now being reversed due to reforms launched or in progress. The share of young people and women in the job market, which is still very low due to skills mismatches and a lack of opportunities, should increase as a result of several initiatives. However, the pace of legislative approval of these initiatives needs to accelerate.

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

The reform of the education system is ongoing but still at an early stage. The focus is on expanding early childhood education and care, which is well below EU levels. This should benefit the poorest families. The independent agency responsible for the external evaluation (accreditation, re-accreditation, validation and follow-up) of higher education institutions in Kosovo is now operational.

There are still limited employment opportunities on the labour market. Clientelism remains widespread in the public sector, which is the country's main employer. Enforcing labour laws and working conditions remains unclear despite some progress in the private sector. Brain drain is a threat.

Ambitious reforms of the social assistance and healthcare systems are planned. However, the social assistance reforms have been delayed in the legislature, and healthcare reforms have been slowed due to the COVID-19 pandemic.

The statistical system is at an early stage of development. Kosovo Agency of Statistics conducts a quarterly Labour Force Survey based on EU methodology. The quality of the data needs to be improved. Statistics on Income and Living Conditions are not yet collected. Specific challenges exist in setting indicators based on population data, e.g. in education.

([139]) The table in this box includes 14 of the Social Scoreboard's headline indicators, of which 12 are used to compare the performance of EU Member States (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators) and also of the Western Balkans countries and Türkiye. There is just one small adjustment in the age bracket for the unemployment rate (reducing the upper-age limit to 64 instead of 74) for Albania and Kosovo due to data availability. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; 2019 data are generally used for this comparison) and a review of the trend for the indicator based on the latest available 3-year period for the country (improving/deteriorating/no change). Data from 2017-2019 are used and can be found in Annex A.

Key challenge #3: Reduction of the informal economy and improving the environment for doing business.

The informal economy has a widespread and significant impact on Kosovo's GDP (31% according to the most recent estimates, against a European average of 15-20%). An EU-funded project estimated the preliminary cost of this problem to be around EUR 106.8 million as a result of lost income tax revenue and VAT alone (IMF, 2019). This harms Kosovo's competitiveness and attractiveness for private investors, including foreign direct investment (4% of GDP in 2021 and 5% in 2022, largely driven by diaspora investment in the real estate sector), formal employment levels (39.3% in 2021) and the associated social and fiscal benefits and the public budget.

Informality has many significant negative consequences for the economy. First, it reduces the tax base, limiting the fiscal space for more investment in priority areas, such as education, health and infrastructure. Second, it creates an uneven playing field amongst businesses and is a deterrent for additional, much-needed private sector investment, including foreign direct investment. Unfair competition from informal businesses has consistently been identified as a major obstacle to doing business in Kosovo (World Bank et al, 2019a; EBRD, 2016) ([140]). The informal economy also affects the competitiveness and export potential of Kosovo's private sector: firms in the informal sector have more difficulty accessing finance and tend to engage less in research and development and innovation and to hire fewer workers. Lastly, workers in informal sectors have more limited (or no) access to social protection and additional benefits and are more vulnerable when they lose their job or leave the labour market. Their access to training is also negatively affected, which further exacerbates the inadequacy of the skills of the workforce and contributes to the migration of specialised and skilled workers to markets where better labour and wage conditions can be found. Conversely, the lack of social and other benefits in formal employment – given the lack of existing structures to provide them – discourages many informal employers and employees from formalising working arrangements.

Kosovo's widespread informal economy is linked to the general low level of trust in government and institutions and to weak enforcement. High tax rates are not considered to be a major contributor to the phenomenon in Kosovo (income, individual and VAT tax levels are relatively low when compared to regional and other European economies). In a global ranking, Kosovo was placed in a mid-ranking 48th place in the 'paying taxes' subcategory of the 2020 World Bank *Doing Business* Report. This indicates an overall low level of law enforcement and tax control on the part of local authorities as a potential underlying cause of high levels of informal work, though there has been recent progress on this front. In addition, efforts must be made to improve trust and confidence in the judicial system in order to improve certainty in contract enforcement. In a recent survey, 43% of firms identified the court system as a major obstacle to doing business (World Bank, 2020). Other challenges include: (i) the weak institutional set-up for updating and exchanging information on businesses; (ii) an inefficient and costly inspections system; (iii) the large number of licences and permits required; and (iv) slow, and unreliable contract enforcement. The digital transition offers an opportunity tackle this issue. A range of measures could be taken to improve the business environment, including the simplification, merging and abolition of licences and permits and speeding up commercial dispute settlements. However, some progress has been made recently with the establishment of a dedicated Commercial Court. The ambition set out in the new Administrative Burden Reduction programme is a good basis, but further work is needed on its implementation. Some progress has already been made on the digitalisation of public services, but Kosovo is still at an early stage of development in this area compared to its peers in the region.

([140]) The *2019 Enterprise Survey* put informality as the single most pressing obstacle perceived by business in Kosovo, with 26% surveyed companies listing it first, well above the 19% of surveyed firms in the region selecting this option (WB et al., 2019). Similarly, according to the 2016 business environment and enterprise performance survey (BEEPS V), competition from informal competitors was signalled as the single most important issue in Kosovo. In all, 66% of firms reported that having to compete against firms in the informal sector was a major issue, the highest among all 30 countries covered in BEEPS V (the average was 39%). (EBRD, 2016).

The National Strategy of the Republic of Kosovo for the Prevention and Combating of Informal Economy, Money Laundering, Terrorist Financing and Financial Crimes 2019-2023, was adopted in May 2019. It sets out measures to address the informal economy and provides for improved monitoring mechanisms. An implementation report covering the first half of 2022 showed that only 50% of the planned actions were implemented. A second action plan covering the period 2022-2023 was adopted in 2022 and contains improved indicators and activities in key areas such as statistics, business registration and better inter-agency cooperation. Among the targets set for 2023 are the reduction in the size of the informal economy to 26% of GDP, the reduction of the informal employment rate to 10% and an increase in the final confiscation of criminal assets.

Recent formalisation and compliance efforts by Kosovo's Agency of Statistics (KAS), and Customs have produced results. According to recent IMF estimates, formalisation and improved compliance have contributed to a cumulative change in tax revenues in 2020–22 of around 35%. Inflation, which contributed to around 65% of the cumulative increase in revenues, reflected price pressures, such as commodity prices and wage increases (IMF 2023). These efforts include emergency measures taken during the early stages of the COVID-19 crisis. The measures prompted undeclared and informal workers to register, and businesses to disclose turnover and profit figures in order to be considered for business and employment support schemes.

Reform measure 7: "Reducing the informal economy by improving intelligence-based oversight" is rolled over from measure 10 in last year's ERP. It aims to increase formalisation primarily through improved compliance. Recent progress made in the area of tax compliance serves as a basis for this measure. The activities outlined seem credible and significant to tackle to some degree the issue of the informal economy. The 2023 budget law provides for increased staff in the Tax Administration, Customs and Labour inspectorate making more inspections and oversight possible. The development and improvement of electronic services to facilitate filing and paying of taxes is a welcome activity. A measure to increase the number of electronic payments in the economy is not included, even though this would help to formalisation.

The proposed indicator of higher tax revenue is not suitable as progress can be skewed by inflation. A better indicator would focus on the size of the tax gap, for which more consistent monitoring is required. The indicator measuring the number inspections is credible and welcome.

Kosovo's formal entrepreneurial landscape is dominated by non-specialised, family-owned micro-companies characterised by low productivity and export competitiveness. This is directly reflected in the persistently high current account deficit figures (8.7% in 2021 and 6.1% estimated. in 2022) ([141]). and more so in the much higher deficit in trade of goods (47.6% in 2021 and 51.4% estimated. in 2022). The export of goods did increase by 26.1% (January to October 2022) with "base metals and articles of base metals" continuing to make up the largest share (23.8% in total exports). However, there were also increases in exports for other categories (e.g. furniture, mattresses, plastic and rubber). While the increase in export of services of 32.6% (January to October 2022) was driven largely by tourism, exports of ICT services also grew by 119.8%. ICT services remain a small share of total exports but have the potential for rapid growth. The narrowing of the current account deficit in 2022 was driven mainly by the dramatic increase in the export of services; remittances only increased moderately.

While the increase in the export of goods and services is welcome, Kosovo's exports are too concentrated and dependent on a few key sectors. Kosovo lacks a clear strategy to reduce its overall trade deficit and needs to diversify its exports especially into higher value-added goods and services If no action is taken in this area, Kosovo's trade and current account deficits are likely to remain high and the economy will continue to depend on remittances.

([141]) The government projects a reduced current account deficit of 6.1% for 2022 off the back of significant increases in services' exports. Although this is at odds with IMF forecasts of 10.4%.

Foreign direct investment (FDI) and remittances, which could help offset the current account's deficit, are unable to fill the gap and have not led to an increase in domestic productivity. Kosovo has primarily attracted investment in areas with limited scope for productivity spill overs such as construction and real estate representing 80% of FDI (IMF, 2023). According to authorities, real estate accounted for 67.8% of total FDI, followed by "financial and insurance activities" with 7.3% between January and October 2022. Kosovo lacks a comprehensive strategy to proactively target investors and attract FDI. Inter-agency coordination mechanisms in this area are also weak. The Kosovo Investment and Enterprise Support Agency (KIESA) is active in this area but its resources and capacities are not sufficient to match the ambition of its broad mandate (OECD, 2021b). The restructuring and reform of KIESA is long overdue. Additionally, FDI is limited to a handful of countries, namely states where a sizeable, well-established Kosovo diaspora exists. Export-oriented FDI has been very scarce, and overall figures are relatively low, passing the EUR 300 million figure only once in the past 7 years. Remittances are used almost exclusively for consumption purposes and are four times higher than overall FDI (World Bank, 2020a).

Increasing private sector productivity would improve export competitiveness, increase job opportunities and allow for higher wages. This is particularly the case considering the increase in the average wage over the past decade partly resulting from growth in public sector wages. To regain labour cost competitiveness in export markets, productivity will need to increase more quickly.

Reform measure 6: "Improving the environment for doing business by reducing the administrative burden and reforming inspections" is rolled over from measure 9 in last year's ERP. It aims to reduce the administrative burden through simplification and digitalisation of permits as well as a reform of the inspection's regime. Activities are presented broadly and are repetitive over the years making it difficult to grasp the systematic progress envisaged. Overall, the activities and indicators presented fail to give an accurate overview of the scale of the administrative burden reduction and digitalisation effort making the measure difficult to assess.

The government has adopted an improved Administrative Burden Reduction programme for the public and businesses and has increased the number of services provided on the E-Kosova platform from 21 in 2021 to around 140 in 2023. However, this progress is not mentioned in the ERP. The ERP also fails to mention significant financial assistance provided in this area from the EU's IPA instrument.

The indicators are difficult to assess as the method to measure progress has changed from last year's ERP. After several years of little progress, the indicators appear ambitious with a large reduction in the number of inspection bodies and a large increase in the number of simplified and digitalised permits. The activities and resources outlined under this measure appear insufficient to meet these targets.

7.5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2022

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Türkiye has adopted targeted policy guidance for all partners in the region. The guidance represents the participants' shared view on the policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The underlying rationale of the policy guidance is similar to that of the country-specific recommendations usually adopted under the European Semester for EU Member States. Implementation of the policy guidance is evaluated by the Commission in the following year's ERP assessments. The following table accordingly presents the Commission's assessment of the implementation of the 2022 policy guidance jointly adopted by the EU and the Western Balkans and Türkiye at their Economic and Financial Dialogue at Ministerial level on 24 May 2022.

Overall: Partial implementation (45.8%) ([142])	
2022 policy guidance (PG)	**Summary assessment**
PG 1:	There was **partial implementation** of PG 1.
If needed, use the available fiscal space in the 2022 budget to cushion the potential impact of adverse shocks through targeted support to vulnerable households and firms; provided the economic recovery is well entrenched, and as envisaged by the ERP, target in the 2023 budget and medium-term expenditure framework a return to the 2% deficit ceiling of the fiscal rule.	1) **Substantial implementation.** In 2022, the government allocated and implemented around EUR 316 million (3.5% of GDP) in temporary support to vulnerable households, pension and salary bonuses and subsidies to the energy and agricultural sectors. The measures could have been better -targeted and more transparent, as some of them went beyond the target of vulnerable households, such as energy tariff subsidies for all consumers. The government ended 2022 with a roughly balanced budget driven by slower than anticipated implementation of capital projects and solid revenue performance. Using the available fiscal space, the authorities plan a strong fiscal stimulus, which is nonetheless in line with the envisaged compliance with the fiscal rule deficit ceiling of 2% of GDP in 2023.
Ensure proper costing of new pension and social policy initiatives and compliance with the legal ceiling applicable to the public wage bill and spending on war veteran pensions.	2) **Partial implementation.** While the Law on salaries of public officials, which came into force on 9 February, provides for an increase in salaries for most public employees, including specialist doctors, teachers and police officers, the value of the wage coefficient was set at the level of EUR 105 for 2023. In this way, the increase of around EUR 100 million (0.3% of GDP) in the public wage bill is lower than the nominal GDP growth in 2021, thus the wage bill rule was respected. The government has not achieved any concrete results so far in terms of reforming the social security system. The planned implementation of the reform of social assistance schemes through a World Bank loan and technical assistance has recently been passed by the Assembly. In relation to war veteran pensions, there has been no

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

	progress in re-classifying the beneficiaries list, and actual expenditure for this pension scheme exceeded the initial annual budget allocation, by around EUR 5 million in 2022.
Undertake and publish a review of tax expenditure quantifying the size of the revenue forgone from all exemptions and reduced rates.	3) **Limited implementation.** While a comprehensive tax expenditure report was not finalised, the government published in December 2022 a report summarising the main fiscal developments in 2021. The report provides a preliminary quantification of the size of the revenues forgone due to some of the tax exemptions and reduced rates in 2021.
PG 2: Improve the execution of capital spending by implementing the recommendations made under the IMF's Public Investment Management Assessment.	There was **limited implementation** of PG 2: 1) **Limited implementation.** The under-execution of capital expenditure remains a challenge for Kosovo, despite the authorities' efforts to improve it by implementing the PIMA recommendations. The execution rate was negatively affected by the COVID-19 pandemic and recent rising inflation. On average, only 60% of the annual budgeted capital expenditure (both central and local governments) has been executed since 2019. The authorities' continued efforts to improve the execution rate requires further attention especially when planning investment projects. Many of the projects do not undergo a proper appraisal and selection process as set out in the administrative instructions on project selection and the related public investment programme manual. These projects are therefore not ready for implementation when approved.
Improve the financial oversight and accountability of publicly owned enterprises (POEs) and continue regular quarterly reporting on all POEs.	2) **Partial implementation.** During the reporting period, the Ministry of Finance continued to include the fiscal risk analysis of main central POEs in the medium-term expenditure framework (MTEF), annual budget and the ERP. The fiscal risk analysis has been expanded beyond the POEs overseen by the Ministry of Economy to include the Kosovo Electricity, Transmission, Market and System Operator (KOSTT), which is overseen by the Assembly. However, the analysis is limited to high-risk POEs, excluding other companies. As of Q1-2022 a quarterly report on the financial situation of POEs is published on the Ministry of Finance's website with better data quality. A section on POEs' borrowing is also included in the quarterly debt report (in line with the requirements of the new Law on state debt adopted in December 2022). The Ministry has also started assessing fiscal risks on loans that are requested by POEs. In December 2022, the government approved the 2021 performance monitoring report on POEs prepared by the Ministry of Economy (in charge of supervising the central POEs). The report is pending Assembly approval and will then be published on the Ministry of Economy's website. The 2020 report was not approved by the Assembly.

	The government has not amended the Law on POEs and has not included it in the 2023 legislative programme. A working group will be set up to draft a new concept document and prepare a new law on POEs from scratch.
Review the options paper on the establishment of an independent body for fiscal oversight, so that the suggested options ensure operational independence and adequate budgetary safeguards.	3) **No implementation.** The government has not taken any steps to set up the independent body for fiscal oversight, following finalisation of the options paper on the matter.
PG 3: Carefully assess and analyse price developments, publish time series for core inflation and stand ready to use the limited tools available under the chosen monetary framework to ensure price stability.	There was **partial implementation** of PG 3. 1) **Substantial implementation.** The central bank carefully monitored the evolution of price dynamics and started publishing a monthly series of core inflation. However, no macroprudential tools were used so far for instance to curb credit growth, and the concentration of fiscal spending on transfers also contributed to increasing demand.
Ensure that core areas of the central bank, including financial stability and banking supervision, are adequately staffed.	2) **Partial implementation.** The central bank made progress in terms of staffing in core policy areas. In 2022, two additional employees were hired in the Financial Stability and Economic Analysis Department as well as in the Banking Supervision Department. Given the low starting level of staffing, as well as high turnover, additional recruitment seems to be still needed. In addition, proper and equal training opportunities need to be ensured to deepen analytical and technical skills of staff in the core policy areas.
Continue to ensure a transparent and accurate reporting of asset quality and adequate provisioning, further reduce remaining obstacles to NPL resolution and continue to reduce data gaps in particular as regards the real estate sector.	3) **Partial implementation.** Asset quality is reported in line with International Financial Reporting Standards (IFRS9), the NPL ratio continued to stand at low levels, and provisioning remained adequate. The central bank approved the regulation on the liquidity coverage ratio in line with Basel III, which entered into force in January 2023. The central bank plans to change legislation to enable the development of a secondary market for NPLs. A new stand-alone commercial court has been established, which might increase the efficiency of the court system but still faces a large backlog of cases. Significant data gaps, in particular as regards the real estate sector remained.
PG 4: Adopt a coherent long-term energy and climate strategy for lowering carbon emissions, including plans for a phase-out of coal and fossil fuels subsidies as committed under the Sofia Declaration.	There was **partial implementation** of PG 4. 1) **Partial implementation**. The new 10-year national energy strategy is finalised and was approved by both government and the Assembly Energy strategy does not cover all sectors of the economy. A long-term decarbonisation strategy is planned but not yet drafted.
In line with the commitments of the Green Agenda for the Western Balkans: increase energy efficiency incentives for the private sector and households and improve the support schemes for renewable energy projects with the introduction of	2) **Partial implementation**. The Energy Efficiency Fund continued to support improvements in energy efficiency of public buildings and plans to extend financing to the private and residential sector are ongoing. The Law on renewable energy sources is finalised and its approval by

competitive bidding/auctions	the government is expected soon. Competitive auctions for renewable energies planned for 2022 have been delayed.
Adopt an action plan for the gradual adjustment of energy tariffs reflecting actual costs and providing mitigation measures for vulnerable consumers, and implement the plan to liberalise the retail energy market.	3) **Limited implementation**. The Energy Regulatory Office (ERO) announced new electricity tariffs which entered into force in February 2022 following an extraordinary review of tariffs in light of rising energy costs in 2021 and 2022. Prices remained the same for households consuming up to 800 kWh (approximately 78% of households) and increased for those consuming more than this. There were no changes for business operators. In February 2023, the ERO announced a further increase in of 14%. There is currently no action plan for the gradual adjustment of energy tariffs to reflect actual costs. The government committed EUR 90 million to subsidise energy costs for regulated tariff customers.
PG 5: Update the action plan of the 2019–2023 National Strategy for the Prevention and Combating of Informal Economy, Money Laundering, Terrorist Financing and Financial Crimes, and ensure its implementation.	There was **partial implementation** of PG 5: 1) **Substantial implementation.** The government adopted the updated action plan for 2022 and 2023 of the strategy on preventing and combating the informal economy and has published a 6 monthly report on implementation of the strategy covering the first half of 2022. Nevertheless, authorities need to enhance the efforts on implementation of the strategy and its action plan considering that only 50% of the foreseen actions were implemented as highlighted in the monitoring report.
Improve the business environment through measures to simplify, merge, abolish and digitise licenses and permits with an aim to reduce the barriers to formalisation of employment and businesses and continue to address tax evasion in identified high-risk sectors in line with the strategy and the action plan, which should be updated based on sector risk assessments and tax gap analysis.	2) **Partial implementation.** The government adopted in September an improved programme for the reduction and prevention of the administrative burden of citizens and businesses. At the same time, the e-Kosova platform has increased the number of services that are available through the platform from 21 in 2021 to 140 today. The application of grants and subsidies for the agricultural sector has recently been put up on the platform, for example. The government has also published in the Official gazette secondary legislation making transparent the required documentation for the approval of permits and licences.
With an aim to prevent evasion of property income tax, improve transparency by publishing all sales prices of real estate property.	3) **No implementation.** No sales prices of real estate property have been published so far.
PG 6: Thoroughly apply existing quality assurance mechanisms at all levels of education through increased school inspections, including training of inspectors, and effectiveness of quality coordinators, as well as monitoring and follow up procedures of higher education institutions and their study programmes by the Accreditation Agency.	There was **partial implementation** of PG 6: 1) **Partial implementation.** As regards basic education, besides initiatives to amend legislation, there is little evidence of progress. The government increased budgetary allocations to hire an additional 30 education inspectors; however, due to problems with the law on public officials, it is not realistic to expect recruitments to happen this year. The number of inspections of teaching staff and schools remains very low. The situation is better

	in higher education. The Accreditation Agency has slightly increased their number of staff. Thanks to the digital platform, the agency has managed to complete accreditation processes smoothly and in a timely fashion and also carry out more post-accreditation monitoring.
Narrow the skills mismatch gap by upgrading and using existing skills needs monitoring and forecast mechanisms as well as by increased cooperation with social partners and businesses for an informed planning of initial and continuous vocational education and training, curriculum development and adequate active labour market measures.	2) **Partial implementation.** There are positive developments but still mainly driven by donors. Crucial data and studies are not available yet to first provide an evidence-based baseline - quality data are needed. The Education Strategy 2022-2026 fully recognises the need to develop a real-time information system on labour market needs and to develop a methodology for standardized methodology for labour market research and forecasting the labour market needs. This commitment has yet to be translated into action. Recent achievements include Kosovo Generation Unlimited (K-GenU) and Superpuna which brings together government institutions, development partners, private sector actors, civil society organizations and young people. These partnerships aim to empowers and engages young people by connecting them with opportunities to improve their transition from school to work through skills development, mentorship, internship or employment. Nevertheless,priority should be given though to longer term and sustainable solutions such as the Youth Guarantee (preparation ongoing).
Finalise, in co-operation with all relevant ministries, their agencies and stakeholders, a Youth Guarantee Implementation Plan, adopt it and initiate its implementation.	3) **Substantial implementation.** The youth guarantee implementation plan was adopted, legislative changes are planned and there are ongoing reforms in the Employment Agency.

7.6. POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS AND TÜRKIYE

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

Brussels, 16 May 2023

[…]

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

1. If needed, use the available fiscal space in the 2023 budget to provide well-targeted and temporary energy crisis-related support to vulnerable households and businesses whilst ensuring compliance with the 2% deficit ceiling of the fiscal rule as envisaged by the ERP. Ensure that spending on war veteran pensions as well as public-sector salaries according to the new wage law comply with the prescribed legal ceilings. Undertake and publish a comprehensive review of tax expenditure quantifying the size of the revenue forgone from all exemptions, preferential rates and special regimes.

2. Increase the execution rate of capital spending by implementing the recommendations made under the IMF's Public Investment Management Assessment. Improve financial oversight and accountability of Publicly Owned Enterprises (POEs), including by approving and publishing their annual performance report. Review the options paper on the establishment of an independent body for fiscal oversight and inform the Commission about the follow-up.

3. Continue to carefully assess and analyse price developments and stand ready to use the limited tools available under the chosen monetary framework to ensure price stability. Continue efforts to ensure that core areas of the central bank, including financial stability and banking supervision, are adequately staffed to deepen the central bank's analytical and technical capacities. Strengthen further the reporting and risk management frameworks across the banking system to ensure an accurate reporting of asset quality, further reduce remaining obstacles to NPL resolution and reduce data gaps in particular as regards the real estate sector.

4. In line with the Green Agenda for the Western Balkans, enhance energy resilience and transition by completing the legal framework and launch the pilot auction on renewables. Implement the 2023 Energy support action plan including energy efficiency measures. Improve system resilience, modernize the electricity grids and operationalise the wholesale day-ahead and intra-day electricity price markets on the path toward retail electricity market liberalisation.

5. Increase the implementation rate of the action plan of the 2019–2023 National Strategy for the Prevention and Combating of Informal Economy, Money Laundering, Terrorist Financing and Financial Crimes. Continue to incentivise formalisation of employment and businesses and address tax evasion in identified high-risk sectors through better inter-institutional cooperation. Simplify the system of licenses and permits, and complete the restructuring of SME and investment promotion agencies and ensure adequate resources.

6. Develop a roadmap for the implementation of key reforms of the education system, including the recommendations under the ETF Rapid Education Diagnosis. Align education, particularly higher education programmes and vocational education and training, with labour market needs by closely cooperating with the business community, to further develop the employment barometer and skills barometer. Speed up the ongoing restructuring of public employment services and significantly increase their capacity to provide relevant services in particular in view of the implementation of the Youth Guarantee and the delivery of relevant active labour market measures for the unemployed and those at risk of becoming unemployed.

ANNEX A: ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP 2023-2025

Public financial management

Including a specific measure on public financial management reform in this year's ERP is welcome. The ERP highlights a number of key areas where Kosovo has made progress including the finalisation of a new law on public procurement and the publishing of fiscal risk assessments. Unfortunately, the ERP does not analyse or provide an overview of the main obstacles facing Kosovo in this area. The specific reform measure relating to the digitalisation of the Ministry of Finance is a good step forward. Reform of public financial management should be built on in future ERPs, and the link between the activities and broader challenges and priorities should be made clearer.

Specifically, public financial management systems should be strengthened by (i) linking strategic policy and budget planning for sectoral policy priorities and credibly reflecting these in the medium-term expenditure framework; (ii) improving the public investment management system along Public Investment Management Assessment (PIMA) recommendations, while making the Public Procurement Review body functional and integrating the module on green investments; (iii) improving the domestic revenue mobilisation by aligning the current tax policy with international standards to combat informal economy; (iv) developing capacities to conduct spending reviews and to ensure that findings inform budgeting, in order to support expenditure prioritisation and create fiscal space for new priorities (i.e. improving social services and green transition).

The ERP notes that broader public financial management challenges and priorities will be addressed comprehensively in the soon to be adopted Public Financial Management Strategy 2022-2026.

Reform measure #8: *"Restructuring and consolidation of all IT system resources in support and development of public finance management"*. This is a new measure which aims to integrate systems and services of agencies and departments within Ministry of Finance to align the budget with policy priorities, improve tax compliance and deliver services more effectively.

The measure appears to be well thought out, precisely costed and contains a number of detailed and ambitious indicators. The activities in this measure relate only to the Ministry of finance. This will help with implementation and ownership of the process, but it does create the risk of a piecemeal approach to digitalise government services. Greater alignment with reform measures 6 and 7 would be preferable.

Green transition

The parts of this sector related to energy market reform, energy efficiency and renewable energy are analysed in Section 4 above, under key challenge #1.

Kosovo continues to face numerous environmental challenges such as climate change and air, water, waste and soil pollution. The country has some of the worst air pollution in Europe, with an annual mean exposure to particulate matter almost three times the World Health Organization recommended highest levels. The ERP acknowledges this situation and its causes (reliance on coal power plants, emissions from the transport sector, etc.) and describes the air quality monitoring system currently in places. However, no further significant measures are proposed to tackle air pollution. Kosovo is generally lagging behind in the implementation of the Green Agenda for the Western Balkans; the budget foreseen for the environment sector for 2023 is very limited (EUR 5 million). The ERP analysis focuses primarily on recycling, biodiversity and wastewater treatment.

Reform measure 9: Reducing environmental pollution and preserving biodiversity is rolled over from measure 7 in last year's ERP. The proposed activities under this measure are only partial and are insufficient comparing to the existing problems. The majority of the activities concern legislative or strategic planning measures, while the concrete implementation measures are not clearly described. The foreseen implementation activities in the waste management sector include only the introduction of some recycling for some waste streams, but the introduction of the system for integrated waste management is not described. However, the drafting and adoption of a long-term decarbonisation strategy is welcome.

Indicators are detailed and ambitious but provide for little progress initially and dramatic improvements in later years. This does not appear credible or justified based on the activities planned and resources available. The establishment of a deposit refund system for glass, plastic bottles and cans is welcome but not credible. The targets to increase the number of protected nature areas does not address the problem highlighted in the diagnostic part that the management of existing nature areas is still ineffective. Continuous damage to forests from illegal logging is identified as a high-risk factor but little is planned to mitigate this risk.

Digital transformation

The digitalisation of the economy is advancing. 100% of households nationwide now have access to fixed broadband electronic communications infrastructure. On building a gigabite digital infrastructure, there are bottlenecks in the backbone infrastructure and insufficient capacity for international connections. Fixed access internet penetration is estimated to be 125% of households compared to 89% ([143]) in the EU and mobile telephony penetration is around 95% of the population. An estimated 78% of the population have access to 3G and 4G networks compared to 100% in the EU. The Economic and Investment Plan for the Western Balkans will continue to support investments in digital infrastructure to deploy ultra-fast and secure broadband to ensure universal access. Kosovo has a small but rapidly growing ICT sector with around 17 000 employees and exporting IT services amounting to around EUR 100m in 2021. Exported IT services include software development, smart phone application development and web design. The industry appears to show some resistance to the brain drain phenomenon as more than half of the companies (61.29%) have had a turnover rate of less than 10% (STIKK, 2021).

Kosovo has been engaged constructively in high-level regional dialogue on digital transformation and the implementation of Regional Roaming Agreement since 1 July 2021. Kosovo hosted the Western Balkans Digital Summit in Pristina in September 2022. While progress in digitalisation among SMEs, the overall uptake of e-commerce has decreased. A regional survey found that only 17% of Kosovar companies used the Internet to sell their goods and services in 2021, compared to 30% in 2019. Thus, despite some improvements in implementing e-commerce programmes, there seems to be little progress in increasing

([143]) https://ec.europa.eu/eurostat/documents/3888793/14209569/KS-TC-21-008-EN-N.pdf/99f04bbe-235d-35f7-4f1c-890a04d8e09e the adoption of e-commerce practices among SMEs (OECD, 2022). Kosovo needs to continue to develop the legal framework and necessary infrastructure to stimulate e-commerce and allow for international electronic payments. According to the latest OECD SME Policy Index (OECD, 2022), the rollout of e-governance services is still at an early stage and going forward, Kosovo should adopt a comprehensive policy framework for digital transformation and ensure horizontal co-ordination of digital service delivery. On cybersecurity, Kosovo is improving its legislation to ensure the security of network and information systems; however, it should step up the implementation of relevant measures in this field, particularly by allocating the necessary financial and human resources.

Reform measure 10: "Extension of ICT infrastructure and services for socio-economic development, advanced public services, as well as digitalisation of the education system" The measure to extend ICT infrastructure is rolled over from last year's ERP and revised to include different policy actions. The measure is comprehensive, well planned and substantial progress is possible if described activities are implemented. Challenges facing the sector are well identified and opportunities and ways forward are highlighted. Indicators are detailed and credible. In terms of budgeting, the implementation is planned through a combination of national and IPA funds.

Business environment and reducing the informal economy

This sector and the reform measures 6 and 7 are analysed in Section 4 above, under key challenge #3.

Research and innovation (R&I)

Kosovo's performance is still very poor in research and innovation (policy governance, public research system, public-private linkages, innovation in firms and human resources for innovation); the country has one of the lowest scores in the Western Balkans region ([144]). The sector suffers from a chronic fragmentation in implementing innovation policy and no overall coordination among line ministries and the SME agency KIESA. Financial support for research and development is also very limited (less than 0.1% of GDP compared to an average of 2.2% in the EU), particularly for business innovation. Over the past year however some positive developments took place that might pave the way for a new dynamic in the sector. The authorities appointed a National Scientific Council in 2021, which by law is in charge of drafting the national research programme. Kosovo has successfully completed negotiation with EU and is now a fully associated member of the Horizon Europe programme, although it needs to improve its performance in accessing grants. Efforts are under way to develop the Kosovo Research Information System and make it operational. In the Government Programme 2021 – 2025, Kosovo has planning to set up an "Innovation and Entrepreneurship Fund", to collect innovation-related statistical data, and application to participate in the European Innovation Scoreboard. Work on preparing a Smart Specialisation Strategy has commenced in 2019 in line with the methodology of the EC's Joint Research Centre. Although it completed an analysis of identifying scientific priorities and a communication mechanism to enable stakeholder consultation has been put in place, a more systemic involvement of stakeholders (industry, academia) is needed.

Reform measure 11: "Improving the environment for research, innovation and entrepreneurship"

Since the previous ERP, Kosovo has improved the activities under this measure and taken on board feedback from the previous ERP assessment and other policy dialogue fora. There are a number of positive activities for which a greater of focus on outcomes would be welcome, for example the aim to join the European Scoreboard and the establishment of a National Innovation Fund. In general, there is a need to explain how certain funding measures are complementary to ongoing support from the EU and other international partners such as the EBRD, for instance support to businesses and incubators. This component should provide resources such as trainings, business consulting services and mentorship that

([144]) OECD (2021), Competitiveness in Southeast Europe – a policy outlook 2021.

are essential to the success of start-ups and idea generation. There were no activities related to support for or focus on young entrepreneurs or partnerships with relevant stakeholders including industry, the diaspora, the NGO sector, etc. As in previous years, key indicators for the R&D sector and the benefits of innovation processes are lacking. The envisaged financial support appears adequate for the activities targeted and is entirely funded from the national budget but is still far below the required 0.7% of GDP stipulated by law (at 0.1%). There is no mention of how Kosovo will make the most of its new Horizon 2020 membership, nor reference to the research data (data on researchers, publications, funding per Higher Education Institute spent on R&I, research infrastructure) currently being conducted by the Erasmus+ Kosovo Research Information System (KRIS) project, led by the International Business College - Mitrovica in cooperation with the Austrian Development Agency. Lack of data is a challenge in Kosovo, and this is the first such whole-scale initiative to aim to tackle it.

Economic integration reforms

Kosovo is highly reliant on imports and suffers from a chronically current account deficit (8.7% in 2021 and an estimated 6.1% in 2022) ([145]). Despite the fall in exports of base metals due to higher energy prices, the export of goods has increased in 2022 due to improved exports of furniture, plastic and rubber products. The balance of services has also improved due to higher tourism spending (mostly diaspora related). Trade with the EU and the Central European Free Trade Agreement (CEFTA) region represents almost the totality of trade exchanges. Due to higher growth of exports than imports over the last 10 years, Kosovo has experienced an improved export coverage ratio with the region, from 9.1% in 2008 to 20.3% in 2019. The CEFTA area has remained the main destination for the export of goods, amounting to 276.7 million EUR or 36.9% of total exports. The opposite trend is observed in trade between Kosovo and the EU. Kosovo's goods exports to EU Member States amounted to 235.1 million EUR, about 31.3% of total exports in 2021. CEFTA remains an important market for Kosovo exporters, but obstacles and barriers to trade persist.

Major progress was made with the opening of Customs Office at the Port of Durrës in Albania and the conclusion of the Berlin Process Agreements Customs clearance for all goods with a final destination of Kosovo will now be cleared directly on arrival at the port of Durrës, thus eliminating the need for further checks on entry into Kosovo. This step toward regional economic integration has led to a substantial reduction of costs for business and a more timely delivery of goods. The authorities have fully ratified the “Berlin Process Agreements” on free movement of people, and mutual recognition of academic and certain professional qualifications. Once fully operational, these agreements will further boost economic integration in the region.

Kosovo is encouraged to implement all aspects of the Common Regional Market as set out in the Economic and Investment Plan for the Western Balkans. The Common Regional Market will facilitate Kosovo’s integration into regional and European value chains and help make the economy more attractive for foreign direct investment in tradeable sectors, notably by extending the size of the market. Further connectivity with neighbouring countries in transport and energy will strengthen access to, and integration into, the regional market. The ratification of CEFTA’s additional protocols 5 and 6 will help liberalise trade in goods and services and will also create new export opportunities in the dynamic service sectors; it should therefore be implemented swiftly. The creation of a regional digital space and labour markets that are more integrated with neighbouring economies will offer new prospects for young people in Kosovo, which is also important given the high rate of youth unemployment.

Despite being among the most open economies, foreign direct investment (FDI) in Kosovo remains limited (averaging slightly over 4.0% of GDP in 2013-2021), and mainly comes from the large Kosovo diaspora. By year end 2021, FDI amounted to EUR 320 million, which was 11.8% higher than

([145]) Kosovo authorities project a narrowing of the current account deficit to 6.1% of GDP in 2022 off the back of strong increases in the export of services. This is at odds with IMF projections of 10.4% in 2022.

2019. The sectoral distribution of FDI remains dominated by non-productive sectors, namely real estate and construction, which have a limited impact on the efficiency of Kosovo firms. There is potential to attract more FDI: Kosovo has a good strategic location, a young population and relatively low labour costs, and a growing educated workforce with increasing ICT and foreign language skills. Other key issues affecting FDI are the lack of basic infrastructure and stable electricity supply, poor education skills, weak rule of law, corruption and the slowdown in the privatisation process. The measures planned under this area address these challenges.

Reform measure 12: "Improving business environment through trade facilitation and quality infrastructure development". This measured rolls over and combines last year's measures 12 and 13 and aims to address both regional economic integration and improved product standards and certification. The ratification of additional protocols 6 and 7 of CEFTA has long been stalled by the government due to disputes over recognition. Ratification of protocol 6 does not appear among the activities while ratification of protocol 7 appears under 2024. Some activities under this measure, related to CEFTA or WTO membership negotiations, carry political risk and are dependent on external factors. The activity relating to making free public customs terminals functional is welcome, but it is unclear if this activity has been costed. In terms market surveillance, Kosovo has allocated a substantial budget of over EUR 6 million for certification of industrial products with the aim of increasing exports. The funding is to be allocated from the government funds. Indicators for the measure are realistic but could be more ambitious.

Energy market reforms

This sector and the reform measures 1 and 2 are analysed in Section 4 above, under key challenge #1.

Transport market reforms

Transport links are less of a constraint to Kosovo's competitiveness than issues in other sectors, but improving connectivity with neighbouring countries would strengthen the country's integration into the regional market. Investments have been primarily focused on road infrastructure rather than other modes of transport, without the right allocation of resources to road and railway networks maintenance and with an increasing amount of capital investment directed to prestige projects without clear transport, environmental or development rationale. On rail, the continuing works on Route 10 linking southern and northern Kosovo, the Serbian border and Pristina with the capital of North Macedonia represents the biggest investment in Kosovo's railway in four decades (around EUR 200 million) and is poised to improve Kosovo's railway network and its connections to the wider European network both for passengers and freight. However, a much more ambitious plan, including maintenance and integration with European networks, as well as an upgrade of the legislative framework to align it with the EU *acquis*, to improve the efficiency of Kosovo's railway networks. Regarding aviation, status issues, including a lack of revenue from upper air space management, continue to constrain Kosovo's ability to invest in training, infrastructure and safety. The flagship policy of the Economic and Investment Plan will be the finalisation of the 'Peace Highway' in Kosovo, directly linking Pristina with Niš in Serbia and thus helping to overcome the transport-related constraints on Kosovo's economy.

Reform measure 13: "Further development and modernisation of transport". This measure was introduced for the first time in last year's ERP and has been rolled over to this year. It covers some of the main actions to reform the transport sector. The activities are ambitious, comprehensive and include the adoption and implementation of transport-related legislation, drafting and adoption of sectorial strategies and alignment with the EU *acquis*. The measure also covers the rehabilitation and modernisation of major railway lines and construction of roads. It is encouraging that the government plans awareness campaigns and the drafting of the national programme to improve road safety. The lack of proper maintenance plans is the main reason for slow and unreliable transport services. The measure does not include the development of a multiannual maintenance plan underpinned by sufficient financial resources. The indicators for the measure have been much improved upon since last year, and the inclusion of an indicator on emissions is welcome; however, an indicator on road safety has been removed.

Agriculture

Kosovo's agriculture sector is beset by low productivity and high production costs. Although it remains relatively large, the sector's share of gross value added continues to fall, (it accounts for a significant share of informal employment). Farmers in Kosovo are faced with several constraints, such as high numbers of small farms and high levels of land fragmentation, outdated farm technologies, lack of production diversification, limited capacity to grow and limited technical support and access to finance ([146]). Less than a fifth of Kosovo's arable land is irrigated. Although the government has developed some to address some of these issues (e.g. irrigation systems and organic farming), further investment and action are needed to ensure the measures are implemented and boost the competitiveness of the agricultural sector. Existing support schemes, currently under review, would benefit from a broader approach to developing value chains and integrating them into export markets, instead of direct subsidies for agricultural production and food processing facilities. Other neglected issues are the protection of agricultural land, the environment and less favoured areas (hillsides, rolling land, etc.) that have lower productivity. The Economic and Investment Plan for the Western Balkans has the potential to mobilise much support for the sustainable transformation of Kosovo's agri-food system and rural development.

Kosovo has potential to develop freshwater fish farming and aquaculture. This sector has a potential for a sustainable food production, new job creation, attraction of foreign direct investment and export to the EU and other markets.

Reform measure 14: "Structural changes in the agriculture sector"

The activities outlined under this reform measure focus mainly on implementation of existing support for farmers, investments in irrigation infrastructure and drafting different pieces of legislation. Given the fact that agriculture is considered to be a key sector, the measure fails to address a number of structural obstacles that hinder the development of the sector, such as poor land consolidation, small average farm sizes, land loss to unplanned urban expansion, low productivity and high production costs, low product diversification, outdated technology, limited storage capacity, weak or dysfunctional links between primary producer and processor and between producers and market as well as lack of specialisation. Although Kosovo rightly prioritises irrigation, (a feasibility study and work to implement it are listed as activities in 2023), the credibility of this action is questionable without accompanying measures to improve water quality. There is no mention of EU support under IPA (for example, a EUR 10 million project for irrigation under IPA 2020 managed by the World Bank is not referenced).

Industry

Kosovo's industry is characterised by low added-value and competitiveness. The sector makes a modest contribution to GDP (around 26% in 2021) and employment (around 14%). Manufacturing is dominated by food processing and non-metallic mineral products, accounting for 70.3% of all exports (with metals and rubber and plastics products accounting for 42% of the total). Although manufacturing has the potential to generate quality jobs and raise incomes, high-level and sustained industrial development continues to face structural problems. The sector is dominated by micro, small and medium-sized enterprises with low levels of integration in global value chains, and low shares of innovation. They also attract low levels of foreign direct investment..

([146]) Approximately 93.03% of agricultural holdings, or 100 576, belong to farm size categories of less than 5 ha. (Ministry of Agriculture, Forestry and Rural Development, 2019).

Inter-ministerial coordination in this policy area is weak and the responsible institutions (such as the Kosovo Investment and Enterprise Support Agency, KIESA) lack the capacity to implement plans (OECD, 2021). However, KIESA's performance has improved recently with the organisation of and participation in economic fora and international trade fairs as well as improved direct support for investors. There has been a strong increase in FDI a in 2022 (ca. 6% of GDP). A number of business parks and economic zones have been identified and are promoted as industrial clusters, but most are currently under-utilised and under-funded. Poor cooperation between companies and educational and research institutions and the generally low level of skills in the labour force lead to low production capacities and a lack of product quality and innovation. The government will soon adopt a Strategy for Industrial Development and Business Support containing specific and measurable industrial policy objectives. The strategy is based on an industrial performance analysis, which assessed the economic, social, and environmental performance of Kosovo's manufacturing sector over the past 10 years. The government is preparing new legislation on investment promotion and industrial and business parks. It also plans to restructure KIESA into two separate agencies: an SME and entrepreneurship agency and an investment and export promotion agency. These measures need resources and quality staffing to succeed.

The Economic and Investment Plan, which has productive investments based on circular economy principles at its core, could significantly bolster Kosovar industry's sustainable production and consumption.

Measure 15: "Increasing competitiveness in the production industry"

This measure is rolled over from previous years and focusses on supporting SMEs, improving quality standards and growing foreign direct investment. The planned restructuring of KIESA is welcome although it is not mentioned as one of the activities under this measure and neither is the associated law on sustainable investments. Beyond the restructuring, further action is needed on resources and capacity building to ensure the agency can fulfil its objectives and promote linkages between SMEs and multinationals.

As in previous years, this measure contains a number of direct support measures for businesses to boost production and exports. KIESA support programmes to SMEs should also encourage gender balance and women entrepreneurship. This support should focus on businesses and sectors identified as priorities in the new Industrial strategy. The construction and development of economic zones and industrial parks is included as an activity again, and the budget is similar to last year's ERP. The government also plans legislation to improve the functioning of new and existing industrial parks. However, there is still no feasibility study on industrial zones assessing their return on investment and contribution to economic development. Building these industrial parks should be based on clear and objective criteria and avoid conflicts with state aid legislation.

Services

Despite being the driving force of the economy, Kosovo's services sector suffers from a lack of competitiveness and relies heavily on non-tradeable services. With a share of 72.7% of GDP in 2020 and 79.1% of total formal employment, this sector constitutes the backbone of the private sector. It is mainly composed of non-tradeable activities (accounting for more than two thirds of all sector turnover). Trade in services has been dynamic in recent years, reflected in a sustained service trade surplus, and it has made a significant contribution to Kosovo's current account, driven primarily by the travel and hospitality industries. The export of travel services reached EUR 1.5 billion in 2021 representing 79% of all service exports in 2021. However, most of the travel services provided were for visits by the Kosovo diaspora, which raises concerns as to its long-term growth potential.

ICT services are a promising and rapidly growing sector. Exports of ICT services amounted to around EUR 100 million in 2021 but only make up 5% of total service exports. The development of a competitive tradeable services sector is being held back by an unfavourable business environment, a lack of quality infrastructure and poor access to technology and finance for firms, especially SMEs.

Measure 16: "Increase competitiveness in the sector of trade in services"

The measure is rolled over from last year's ERP and aims to improve the efficiency and competitiveness of tradeable services. The activities planned annually for 2022, 2023 and 2024 are realistic and the sequencing is sound. The single point of contact has already been launched on the e-Kosova portal. It will be important to further develop the single point of contact and integrate additional services. While the funding appears sufficient, it may not be enough if more intensive software development is required. As with other aspects of trade policy, some activities e.g. those related to CEFTA, carry additional political risk and are dependent on external factors. Activities on implementing of the CEFTA additional protocol 6 on trade in services are welcome. However, the lack of human resources in the Ministry of Industry Enterprise and Trade is correctly identified as a high risk to successfully implement these activities.

Measure 17: "Increasing competitiveness in the tourism and hospitality sector"

This measure to develop tourism products in Kosovo's touristic regions has been rolled over from last year's ERP. It is still not sufficiently ambitious to have a significant impact on the economy. The reform of the sector would also require a dedicated strategy and concrete action plan with allocated resources, a timeframe, and ownership. The measure fails to integrate or leverage existing cultural events and festivals. It does consider the impact on the environment and the need for interinstitutional cooperation to alleviate that impact. However, just as last year, it still fails to include other relevant actions, such as abolishing illegal landfills and cleaning waste across the territory, which is a precondition for attracting tourists. The costing of the measure is not properly assessed and does not factor in donor funding including from IPA, such as a EUR 2 million contribution to improving tourist infrastructure in Prizren or a EUR 2 million contribution to a project in Janjevë/Janjevo.

Education and skills

This sector and the reform measures 3 and 4 are analysed in Section 4 above, under key challenge #2.

Employment and the labour market

This sector and the relevant reform measure 5 are analysed in Section 4 above, under key challenge #2.

Social dialogue

Kosovo has yet to tap the potential of social dialogue. The reduction in the high level of informal work in the labour market may improve the ability of workers to exercise their rights. It could also have a positive effect on social dialogue. However, the structure of the labour market hampers the development of fair relationships between employers and employees. A number of business confederations mostly represent the interests of larger employers, while over 90% of registered companies are micro-enterprises with fewer than 10 employees. Although the legal framework is in place, there is little political will to use social dialogue when drafting policies and legislation. The capacity of social partners, in particular trade unions, to influence policy remains limited. A protracted conflict over the composition of the Economic and Social Council is to be solved by amending the law governing the Council, but there is still progress to be made.

Social protection and inclusion

Kosovo's social protection system is not targeted or effective as many households in need remain outside the scheme. Unlike most European countries, the social assistance scheme is financed by state revenue (mainly VAT and direct taxation). However, the scheme is ineffective and unbalanced as most of the revenue goes to pensions, including pensions for war veterans, and war-related schemes. Consequently, very little goes to social services and to labour market policies. As underlined in the World Bank's social protection situational analyses, the system is unsuitable for the country's poverty profile (World Bank, 2022b). In addition, links between the social assistance scheme and social care and employment services are weak or non-existent. This leads to cases being managed in a fragmented manner.

Only about 7% of the total population benefits from the current scheme although the official national poverty rate is closer to 20%. The poverty rate fell significantly in 2021 but is expected to have only decreased marginally in 2022. Continued inflationary pressures could also lead to the poverty rate stagnating (World Bank, 2022a). The situation is particularly bad for minority communities. Higher commodity prices and the energy crisis are expected to increase poverty in Kosovo even more. Therefore, there is a clear need to reform Kosovo's social assistance scheme. The eligibility criteria under the current system are very strict, and this leads to making many poor households ineligible for support.

The government has adopted the reform, and the Assembly recently ratified a World Bank loan (which will fund the reform). The revised design proposes to select beneficiary households based on their poverty status by only considering formal and informal income. This should make the system significantly fairer and better reflect the country's poverty profile. The reform will also create a legal basis to expand the scheme's coverage when poverty dynamics in the country change and more budget is available to finance poverty-targeted programmes. Recent experience also shows the need to invest in how the scheme is delivered, including an integrated data management system (social benefits information is currently housed in multiple management information systems, and there is no social registry).

The reform will depend on parallel reforms of activation measures and better coordination between the social assistance system, care services and employment services, particularly to encourage beneficiaries to participate in reskilling and upskilling to improve their job search efforts. The effective implementation of the youth guarantee depends on the integration of these services. Payment systems must also be modernised to increase transparency and accountability. These reforms are a critical first step to ensuring that the country's vulnerable groups are protected today and in the future.

Measure 19: Improving social services and empowering excluded groups

The measure aims to create a sustainable social protection system that meet the needs of the population, in particular the most vulnerable. It also aims to deliver integrated and targeted social services. A number of laws and bylaws need to be passed before implementation is expected to start in 2024. In addition, the government will continue to support licensed NGOs with grants and subsidies as they have a significant role and involvement in the development and implementation of social policies and services.

Healthcare

The COVID-19 pandemic has put the health system under the spotlight. About 30% of the population living below the poverty line do not have access to healthcare. Health services require out-of-pocket payments, and this significantly affects the budget of low-income households. Essential necessary primary healthcare is unaffordable due to the lack of health insurance risk-pooling. Kosovo's healthcare system is funded by government revenue, which is scarce. The difficulty of access to care is reflected in the infant mortality rate which is about three times the EU average. Among Roma, Ashkali and Egyptian communities, the rate is three times higher than the national rate.

The law on health insurance (2014) gives everyone the right to carry mandatory health insurance. Following that law, the government adopted a national health sector strategy for 2017-2021. The strategy focused on providing better financing and better access for vulnerable people by strengthening primary care. However, the law has not been implemented yet. According to a recent note by the US Department of Commerce, the growing demand for quality healthcare and the lack of government resources to meet these needs create opportunities for US companies to provide many health-related services, including basic and specialised treatments, hospitals, clinics, emergency medical treatment facilities, and high-quality medicines and pharmaceutical products. This note also stresses that the public procurement process in the health sector is complex, time-consuming, and lacks transparency. In 2018, Kosovo allocated 4.6% of GDP to health. This rose to 6.8% in 2020 as a result of donations and loans for the COVID-19 pandemic, but this rate remains below that of other countries in the region. Therefore Kosovo must embrace the implementation of universal health coverage that offers equal access to everyone regardless of their financial situation.

Measure 20: Ensuring sustainable financing in the health system

This measure is carried over from previous years as the implementation was delayed due the COVID-19 pandemic. It will require changing the legal framework and extending/completing the health information system. The full implementation, planned for 2025, should ensure equal access to healthcare. Setting up a national health insurance scheme will then be financed by contributions from all public-sector employees and 65% of private-sector employees. According to the authorities, collecting these contributions is still a challenge. Vulnerable groups will be exempted from paying a contribution.

ANNEX B: OVERVIEW OF THE MAIN INDICATORS PER AREA/SECTOR OF THE ECONOMY

Area/Sector	2016	2017	2018	2019	2020	EU-27 Average (2020 or most recent year)
Energy						
Energy imports dependency (%)	23.6%	30.0%	29.3%	30.5%	29.5%	55.6%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	451.30	409.03	398.07	392.34	413.88	110.35
Share of renewable energy sources (RES) in final energy consumption (%)	24.47%	23.08%	24.62%	24.22%	24.40%	21.7%
Transport						
Railway Network Density (meters of line per km^2 of land area)	30.5 w	30.5 w	30.5 w	30.5 w	30.5w	N/A
Motorization rate (Passenger cars per 1000 inhabitants)	144.0 w	154.6 w	157.2 w	162.0 w	164.4w	N/A
Agriculture						
Share of gross value added (Agriculture, Forestry and Fishing)	10.2%	9.2%	8.1%	9.0%	8.9%	1.8%
Share of employment (Agriculture, Forestry and Fishing)	4.2% w	4.4% w	3.5% w	5.2% w	4.8%w	4.3% (2020)
Utilised agricultural area (% of total land area)	38.2% w	38.2% w	38.5% w	38.6% w	38.6%w	40.6% (2020)
Industry						
Share of gross value added	24.3%	24.1%	24.2%	23.4%	24.1	19.9%
Contribution to employment (% of total employment)	18.0% w	17.4% w	14.3% w	15.1% w	16.3%w	16.1% %

Services						
Share of gross value added	56.4%	56.5%	57.2%	57.6%	57.7%	79.2%
Contribution to employment (% of total employment)	66.3% w	65.3% w	70.3% w	67.1% w	67.9% w	70.9%
Research, Development and Innovation						
R&D intensity of GDP (R&D expenditure as % of GDP)	N/A	N/A	N/A	N/A	N/A	2.26%
R&D expenditure – EUR per inhabitant	N/A	N/A	N/A	N/A	N/A	EUR 734,5
Digital Economy						
Percentage of households who have internet access at home	N/A	89%	93%	93%	96%	92.5% (2022
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	N/A	82.9% w	87.7% w	90.7% w	96% w	90% (2022)
Trade						
Export of goods and services (as % of GDP)	23.8%	27.3%	29.1%	29.3%	21.7%	46.7%
Import of goods and services (as % of GDP)	51.2%	53.1%	57.3%	56.4%	53.9%	42.9%
Trade balance (as % of GDP)	-41.1%	-42.0%	-44.7%	-44.1%	-41.7%	N/A
Education and Skills						
Early leavers from education and training (% of population aged 18-24)	12.7% w	12.2% w	9.6% w	8.2% w	7.8% w	9.9%
Young people neither in employment nor in education and training (NEET) (% of population aged 15-29)	37.5% w	35.1% w	37.4% w	40.0% w	40.4% w	13.7%
Children aged less than 3 years formal child care (% of under 3-years-olds)	N/A	N/A	N/A	N/A	N/A	35.3% (2019)
Individuals who have basic or above basic overall digital skills (% of population 16-74)	N/A	21%	N/A	28%	N/A	56% (2019)

Employment and Labour Market						
Employment Rate (% of population aged 20-64)	32.3% w	34.4% w	33.2% w	34.2% w	32.3% w	71.7%
Unemployment rate (% of labour force aged 15-74)	N/A	N/A	29.4% w	25.5% w	25.8% w	7.1%
Long term unemployment rate (% of labour force aged 15-74)	N/A	N/A	N/A	N/A	N/A	2.5%
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	35.3 pps.	39.4 pps.	38.5 pps.	37.4 pps.	32.8 pps.	11.0 pps.
Disability employment gap (Percentage points difference in employment rates between people with and without a disability)	N/A	N/A	19.7 pps.	N/A	N/A	24.5 pps.
Real gross disposable income of households (Per capita increase, Index = 2008)	N/A	N/A	N/A	N/A	N/A	107.23
Social Protection System						
At-risk-of-poverty or social exclusion rate (AROPE) (% of population)	N/A	N/A	56.7%	N/A	N/A	21.9%
At-risk-of-poverty or social exclusion rate of children (% of population 0-17)	N/A	N/A	N/A	N/A	N/A	24.2%
Impact of social transfers (other than pensions) on poverty reduction	N/A	N/A	5.42%	N/A	N/A	32.68%
Income inequality - quintile share ratio (S80/S20) (Comparison ratio of total income received by the 20% of the population with the highest income to that received by the 20% with the lowest income)	N/A	N/A	15.58	N/A	N/A	5.24
Housing cost overburden (% of population)	N/A	N/A	11.3%	N/A	N/A	9.9%

Healthcare						
Self-reported unmet need for medical care (of people over 16)	N/A	N/A	9.7%	N/A	N/A	1.8%
Out-of-pocket expenditure on healthcare (% of total health expenditure)	N/A	N/A	40.5% [z]	N/A	N/A	15.57% (2018)

w: data supplied by and under the responsibility of the national statistical authority and published on an "as is" basis and without any assurance as regards their quality and adherence to EU statistical methodology.

z: Kosovo – Ministry of Health "National Health Accounts 2018" - https://msh.rks-gov.net/wp-content/uploads/2021/07/ENG-NHA-Report-2018-11-July-2021-Final-with-Annex-1.docx

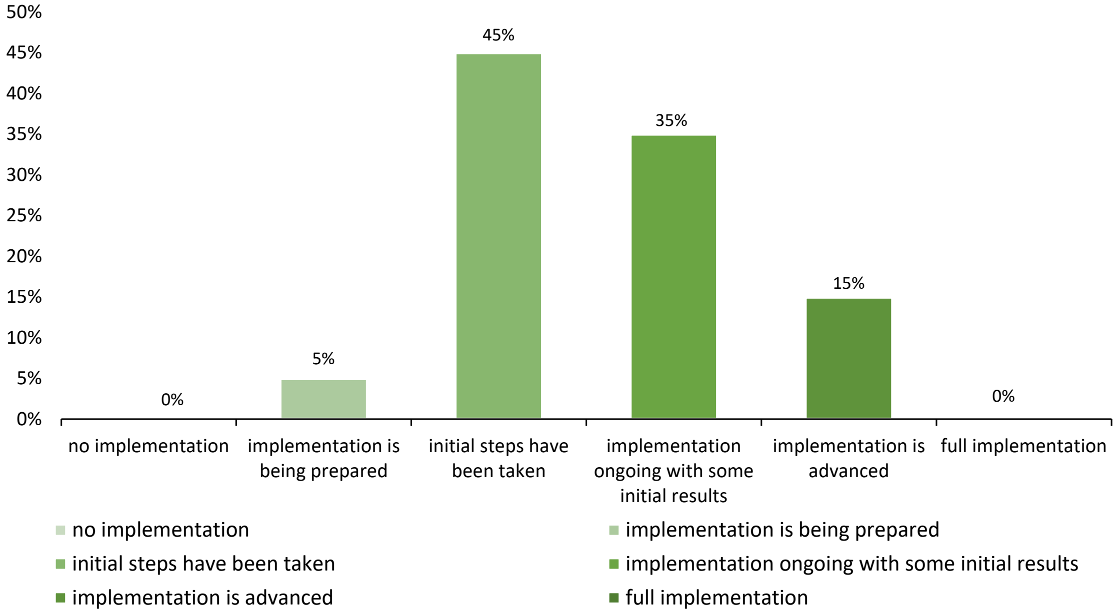
Sources: EUROSTAT and Kosovo Agency of Statistics, unless otherwise indicated.

ANNEX C: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM THE ERP 2022-2024

There was a relatively good progress in the implementation of the measures in 2022, with an average score reported in the ERP of 3.1 out of 5. The reporting on the planned activities provides in general a fair description of the level of implementation.

Implementation is advanced in some measures, such as reform measures 5 (development of policies for EE and RES with a view to the green transition), 6 (energy market reform) and 11 (improving the environment for research, innovation and entrepreneurship). Implementation was low in reform measure 4 (improving of health services) which was removed as a measure in this year's ERP. The variation in levels of implementation across measures is due to some extent to the difference in ambition in the reform measures as well as the specific breakdown into measurable activities.

Graph II.7.2: **Kosovo - Implementation of the structural reform measures of the ERP 2022-2024**



ANNEX D: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government adopted the Economic Reform Programme for 2023-2025 and submitted it to the Commission on 31 January 2023, within the set deadline. It is in line with the previously approved medium-term fiscal strategy and national development strategy, and the forecasts and amendments made in response to the COVID-19 crisis. No components of the ERP are lacking.

Inter-ministerial coordination

The ERP was centrally coordinated, with the Ministry of Finance, Labour and Transfers as National Coordinator in close cooperation with the Strategic Planning Office in the Prime Minister's Office. They were supported by area coordinators from the line ministries. The inter-ministerial coordination process worked well; however, coordination between the Ministry of Finance, Labour and Transfers, the Strategic Planning Office and the National IPA Coordinator was clearly less strong. IPA activities are only minimally or incorrectly reflected in the structural measures.

Stakeholder consultation

The draft ERP was made available online with 2 weeks for stakeholders to provide their feedback, in line with the rules on minimum criteria for public consultation. In-person consultations were held with representatives from civil society organisations, business organisations, international financial institutions and donors by Commission staff dealing with the ERP. Written comments are annexed to the ERP with an indication of whether they have been accepted or rejected, though they include only comments from one civil society organisation and one private consulting firm.

Macroeconomic framework

The baseline scenario projects a robust acceleration of economic activity with output growth above the historical trend over the forecast timeframe, which is optimistic and requires a careful assessment. External assumptions are based on the projections made in the Commission's autumn forecast and the IMF's October 2022 World Economic Outlook. The ERP assessment of macro projections is based on the ERP annex data, which include some corrections made after the ERP was submitted. The programme provides an alternative 'low growth' scenario. This is useful to illustrate the likely impact of some expected developments and risks on Kosovo's economy, such as underspending of capital investment, lower foreign demand, a slowdown in remittances and higher import prices. The forecasts for the labour market and the financial sector are still lacking.

Fiscal framework

The fiscal projections are based on the adopted 2023 budget. For 2023, the ERP forecasts an increased public revenue-to-GDP ratio, while public expenditure is also set to increase from the 2022 level due to a large surge in capital investment. Some of the 2022-2023 fiscal data are not consistent with the main text. The table of the adopted discretionary measures was provided after the programme was submitted. The ERP provides a useful debt sustainability analysis with three negative shock scenarios.

Structural reforms

The structural reform priorities follow the guidance note and cover the new areas, such as public financial management, the green transition and digital transformation. With some exceptions, the reporting on implementation of the policy guidance is sufficient, but additional explanatory information could have been included in those actions where there is only initial or limited implementation. The reporting on implementation of structural reforms is generally sufficient, though there are some discrepancies between the stated stage of implementation and the description of progress.

The programme meets the limit of a maximum 20 reform measures, although there is an overlap between some measures, which are not coordinated sufficiently. The programme slightly exceeds the page limit. Table 9 is missing. Tables 10a and 10b and Table 11 are only partially correct; especially concerning is the fact that IPA funds are not included in the tables. There are some inconsistencies in the way that the implementation of the reforms is rated.

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