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

The Commission's overview & country assessments

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European Commission
Directorate-General for Economic and Financial Affairs

2024 Economic Reform Programmes of Albania, Bosnia and Herzegovina, Georgia, Kosovo*, Moldova, Montenegro, North Macedonia, Serbia and Türkiye:

The Commission's overview and country assessments

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

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INTRODUCTION

Economic governance is a key aspect of the EU enlargement process, mirroring efforts in the EU to strengthen economic policy coordination and multilateral surveillance under the European Semester. The Economic and Financial Dialogue between the EU and the enlargement countries aims to prepare the latter for their future participation in the multilateral surveillance in the EU, also by strengthening their institutional and analytical capacities. The dialogue is based on medium-term Economic and Reform Programmes (ERPs) submitted annually by each candidate country and potential candidate. Since 2015, the dialogue has provided jointly agreed and targeted policy guidance for the partner countries on macro-fiscal and structural reforms. The policy guidance aims to strengthen macroeconomic stability, boost the countries' growth prospects and promote their progress towards meeting the economic accession criteria. In order to avoid duplications and overlaps with the Reform Agendas under the new Growth Plan for Western Balkans ([1]), the 2024 policy guidance for the Western Balkans focuses on macro-fiscal, monetary and financial matters.

In early 2024, Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, Serbia and Türkiye submitted their tenth Economic Reform Programmes covering the period 2024-2026, while Georgia and Moldova presented their first programmes ([2]). Ukraine, while also a candidate country for EU membership, was not asked to submit an ERP to avoid duplications with its overarching Ukraine Plan.

This paper contains the Commission staff's assessments of the ERPs for 2024-2026, 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 2023. The cut-off date for the assessments was 11 April 2024.

Comments would be gratefully received and should be sent to:

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European Commission
B-1049 Brussels

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

([1]) In November 2023, the Commission proposed a Growth Plan for the Western Balkans, whereby Reform Agendas of th Western Balkans will set out specific structural reforms, while additional EU financial support is conditional on their successful implementation.

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

Part I

Horizontal Overview of the 2024 Programmes

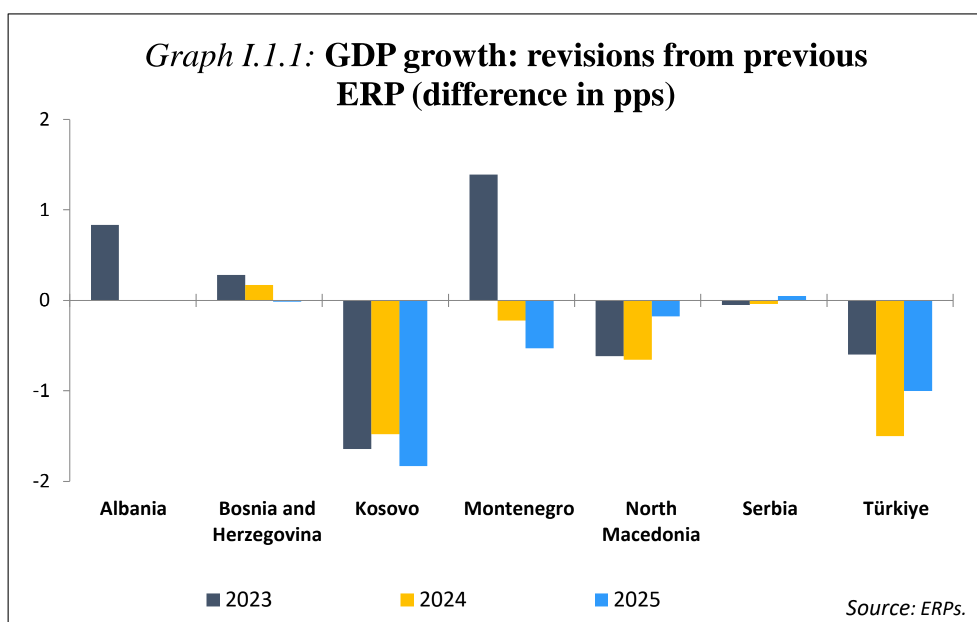
1. HORIZONTAL OVERVIEW OF THE 2024 PROGRAMMES

1.1. INTRODUCTION

Based on the Commission's assessments of the 2024 economic reform programmes (ERPs), this note provides an overview of the economic situation and outlook for the countries of the Western Balkans, Georgia, Moldova and Türkiye, and discusses the main challenges that they are facing. The note serves as a background for the Economic and Financial Dialogue between the EU and the candidate countries and potential candidates taking place in spring 2024.

1.2. MACROECONOMIC AND FISCAL DEVELOPMENTS AND OUTLOOK

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



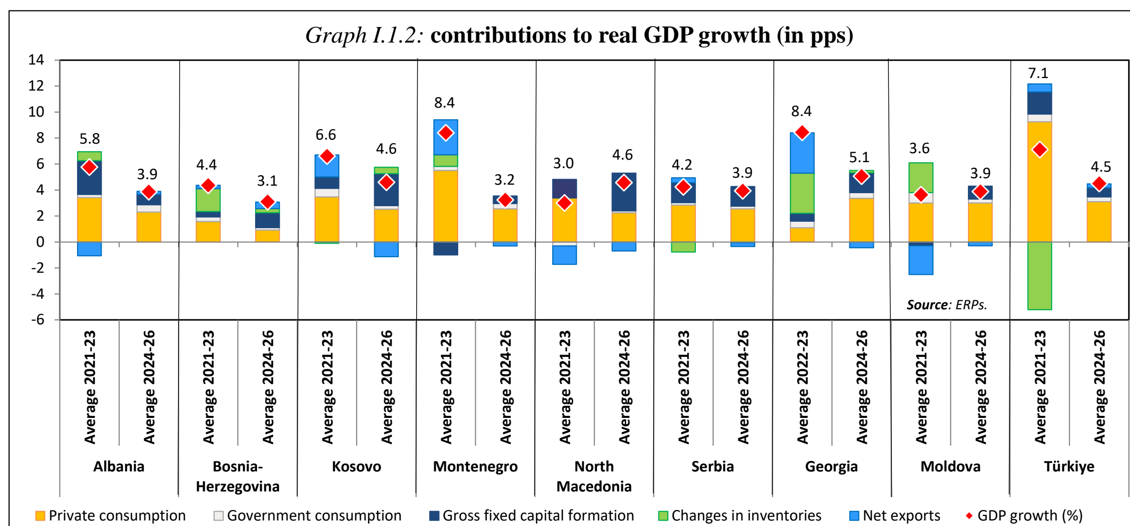
Source: ERPs.

In 2023, most countries of the region ([3]) recorded a slowdown in growth due to tighter financing conditions and weaker external demand. Overall, however, the economies continued to show some resilience in the face of multiple recent shocks. After surging in 2022, consumer price inflation fell significantly in most countries as global commodity prices dropped while central banks with monetary autonomy tightened their policy stance. In Türkiye, inflation remained very high despite some first results brought about by a determined policy shift and much-needed monetary tightening. The main drivers underpinning the region's economic growth in 2023 included a successful tourism season (particularly in Albania, Georgia and Montenegro) alongside consumer spending, which was supported by growing real wages amid falling inflation, and, in some countries, robust foreign direct investment inflows. Unlike most countries, Georgia's and Montenegro's strong growth performance was partly thanks to large inflows of migrants and capital, particularly from Russia. Compared to 2022,

([3]) For this note, the 'region' refers to all ERP partners, i.e. the Western Balkans, Moldova, Georgia and Türkiye. Ukraine is also candidate country for EU membership, but it was not asked to submit an ERP to avoid duplications with its overarching Ukraine Plan. This plan, adopted as part of the Ukraine Facility, includes reforms that strengthen macroeconomic and financial stability. Ukraine participates in the Economic and Financial Dialogue as an observer.

economic growth slowed down in 2023 but remained buoyant in Montenegro, Türkiye, Kosovo, Albania and Georgia, while it picked up in Serbia and Moldova in the second half of the year. By contrast, GDP growth was slower in Bosnia and Herzegovina and North Macedonia, partly due to weak external demand and, in the case of the latter, sluggish investment.

Most ERPs expect GDP growth rates to stabilise or gradually pick up in 2024-2026, while uncertainties and downside risks remain significant. Growth projections have mostly been revised downwards from last year's ERPs (see Graph I.1.1.). Expected average GDP growth rates during the ERP period range from slightly above 3% in Bosnia and Herzegovina and Montenegro to close to 4% in Albania, Serbia and Moldova and at or above 4.5% in North Macedonia, Kosovo, Türkiye and Georgia. Most countries project a slightly accelerating GDP growth profile in 2024-2026. Kosovo's GDP growth is expected to slow slightly in 2026, but from a relatively high rate in 2025 compared to its regional peers. Montenegro significantly outperformed the previous ERP's GDP growth forecast in 2023, but its economic expansion is projected to moderate in 2024-2026 because of slower growth in investment and in household spending. For most countries (except North Macedonia and Moldova), average GDP growth rates over the ERP period are projected to be markedly lower compared to the 3-year 2021-2023 period, which was characterised by a robust post-pandemic recovery (see Graph I.1.2). The main growth drivers in the Western Balkans, Moldova, Georgia and Türkiye are projected to be consumer spending and investment. Investment's contribution to GDP growth in 2024-2026 is expected to be particularly strong in Kosovo (2.5 percentage points (pps)) and North Macedonia (2.9 pps), partly due to high public capital spending, which appears somewhat optimistic unless existing weaknesses in public investment management are tackled quickly. In most countries of the region, net exports are projected to contribute negatively to GDP growth.

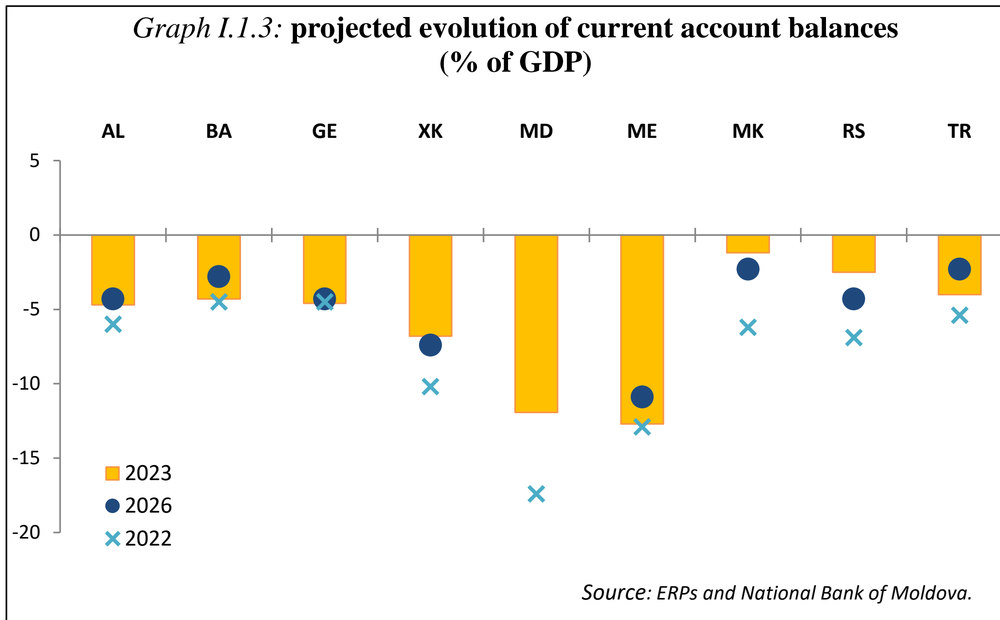


Graph I.1.2: **contributions to real GDP growth (in pps)**

Overall, risks are related to an uncertain global outlook and geopolitical developments, which affect external demand, financing conditions and the further evolution of commodity prices. Such external uncertainties are compounded by homegrown risks, such as: (i) slow implementation of reforms; (ii) a limited fiscal space restricting the response to unexpected adverse shocks to the economy; (iii) slower-than-expected implementation of public infrastructure projects; and (iv) constraints on private investment resulting from higher financing costs and weaknesses in the business climate. Most programmes include risk analyses and alternative growth scenarios, albeit rarely well developed.

In 2023, current account balances improved significantly thanks to lower import prices and, for some countries, stronger revenues from tourism. The improvement was particularly substantial in North Macedonia, Moldova and Serbia, which were the countries hardest hit by the energy crisis in 2022. Most programmes project a further narrowing of external deficits over the ERP

Graph I.1.3: **projected evolution of current account balances (% of GDP)**



Source: *ERPs and National Bank of Moldova.*

period (4) (see Graph I.1.3.) (5). Conversely, in Serbia, North Macedonia and Kosovo, the current account deficit is set to widen slightly over 2024-2026 because of a marked pick-up in domestic demand driving up imports. Inflows of foreign direct investment (FDI) remained robust in most countries in 2023, covering a large part or all of the external deficit. Most ERPs expect this trend to continue. However, whereas some countries benefit from strong inflows into tradable sectors and the resulting increase in export capacities (e.g. Serbia) or from well diversified FDI inflows into various economic sectors (e.g. Georgia), in others (e.g. Montenegro and Kosovo) FDI tends to be concentrated in real estate or other non-tradable activities with little impact on external competitiveness. In Türkiye, policy tightening, along with the envisaged rebalancing of growth, is set to curb external imbalances, but FDI inflows (at 1% of GDP in 2023) remain significantly below the country's potential. In Moldova, FDI inflows continue to suffer because of the effects of Russia's war of aggression against neighbouring Ukraine. Improving the business climate and facilitating exports could help all countries to better benefit from nearshoring trends, and attract more FDI and broaden the export base, underpinning a sustainable expansion, modernisation, and long-term financing of the economy.

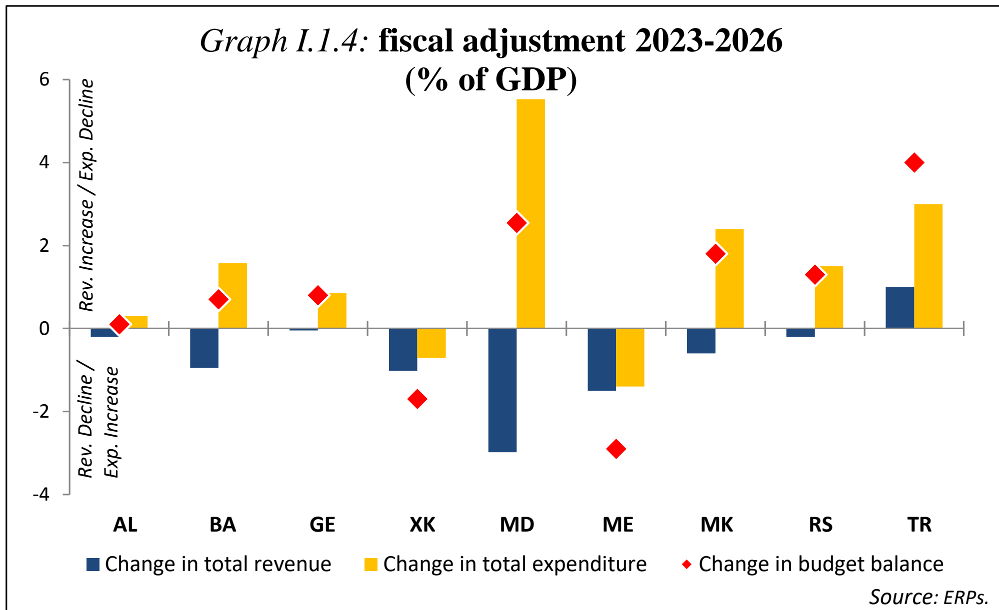
The banking sectors have generally withstood recent shocks quite well. Lending to the private sector has continued to grow at a strong rate in nominal terms in some countries, although real credit growth has remained negative in most cases due to high inflation and tighter financing conditions. Banking systems have maintained solid capital and favourable liquidity positions, and profitability has further improved thanks to wider interest margins and a continued decrease in non-interest costs. Asset quality indicators have remained positive thus far, with the ratio of non-performing loans (NPLs) to total loans not showing a significant increase based on available data. Georgia, Kosovo and Türkiye reported the lowest NPL ratios below 2% (based on the latest available 2023 data), while Albania, Montenegro and Moldova had NPL ratios exceeding 5%. As nominal credit growth has been strong, in some cases it masks an increase in the stock of NPLs, as seen in Albania, Serbia and Türkiye. The ratio of stage 2 loans to total loans, which could indicate a potential accumulation of risks, has increased in North Macedonia and Serbia, and it has ranged from 5% in Georgia to almost 15% in Moldova despite a decline in 2023 (data available up to Q4-2023, with no data available for Albania). Overall, provisioning is generally adequate, although Montenegro currently has the second highest NPL ratio and the lowest NPL coverage ratio among central, eastern, and south-eastern European peers.

(4) Moldova's ERP does not provide projections for the current account balance.

(5) In Graph 3, 4 and 5, the two-letter abbreviations stand for the following partners: AL - Albania, BA - Bosnia and Herzegovina, GE - Georgia, XK - Kosovo, MD - Moldova, ME - Montenegro, MK - North Macedonia, RS - Serbia, and TR - Türkiye.

Budget outcomes varied across the countries in 2023, with fiscal consolidation gaining ground in the Western Balkans. In several countries (Serbia, Montenegro, Albania, Moldova, Georgia and Kosovo), the budget balance outperformed targets and in some cases also improved compared to 2022 thanks to robust revenue growth, less need for energy support, and lower-than-budgeted amounts of capital spending. At the same time, the deficit remained large in Türkiye due to pressing expenditure needs related to post-earthquake reconstruction and pre-election spending and in North Macedonia due to social and capital spending. The government debt-to-GDP ratio continued to fall in most countries due to a favourable snowball effect, as the impact of high nominal GDP growth outweighed rising interest costs. A positive primary balance also helped reduce the debt ratio in Bosnia and Herzegovina, Kosovo and Albania.

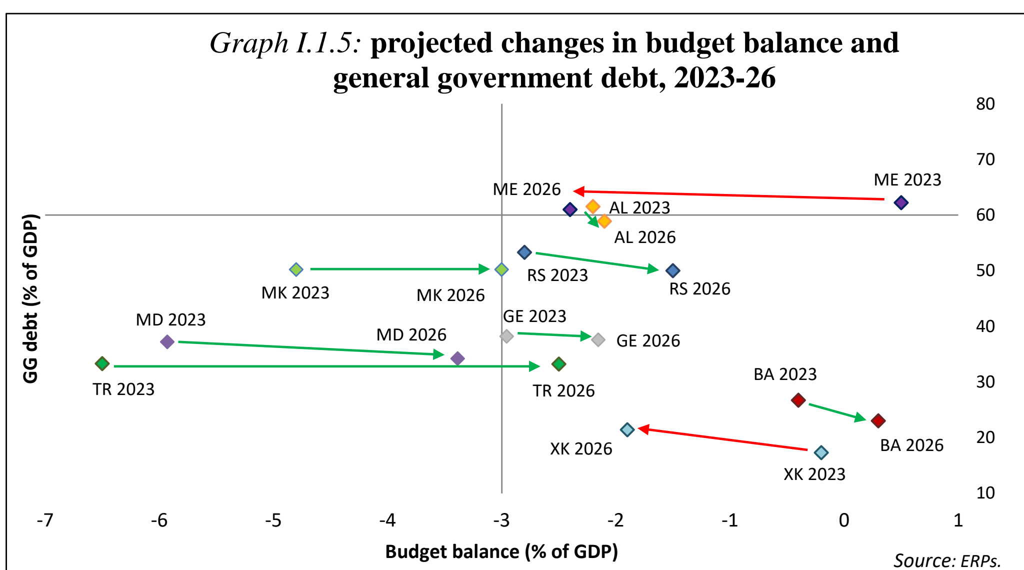
Graph I.1.4: **fiscal adjustment 2023-2026 (% of GDP)**



Source: ERPs.

Most fiscal scenarios project an expenditure-based fiscal consolidation (see Graph I.1.4.)**.** The phasing out of energy support measures and, in the case of Türkiye, the end of post-earthquake reconstruction spending will help lower expenditure. However, interest costs rising further will have the opposite effect. Overall, the fiscal measures to back up the planned expenditure restraint are not always clearly defined. In all the countries assessed except Moldova, the budget deficit is expected to

Graph I.1.5: **projected changes in budget balance and general government debt, 2023-26**



Source: ERPs.

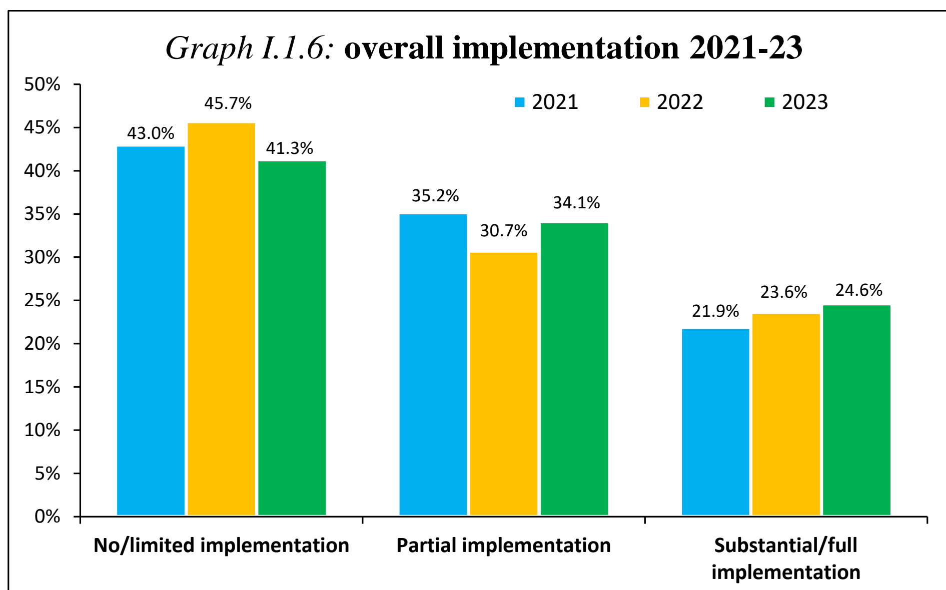
fall below 3% of GDP by 2026 (see Graph I.1.5.). Improvements in the budget balance in 2023-2026 are particularly noticeable in Türkiye, Moldova and North Macedonia. In Moldova, the steep decline in revenue as a percentage of GDP is driven primarily by a projected steep fall in external aid in the form of grants, while real GDP growth is projected to outstrip growth in spending on public sector wages and social benefits. In Kosovo and Montenegro, the budget deficit is projected to increase. In Kosovo, this is driven by the planned substantial rise in public investment after 3 years of fiscal consolidation; however, compliance with the deficit rule is expected to continue. Montenegro also expects its budget balance to deteriorate compared to the exceptionally good outcome in 2023, which was partly thanks to one-off revenues. On the revenue side, the Western Balkan countries expect the revenue ratio to remain at or slightly decrease from the historically high levels achieved in 2023.

Most ERPs project the debt-to-GDP ratio to stabilise or fall in 2024-2026. In most cases, the combination of a moderating but still debt-decreasing snowball effect and an emerging primary surplus (resulting from fiscal consolidation efforts) is driving the decline in the debt ratio. Kosovo's debt ratio is set to increase but remain low at slightly above 20% in 2026, due to, among other things, a narrow domestic investor base and lack of access to international debt markets, which continue to constrain financing options.

1.3. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED IN 2023

Every year since 2015, the Economic and Financial Dialogue has adopted targeted policy guidance (PG) for all partners. The PG represents the participants' shared view on the short-term policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The PG's underlying rationale is similar to that of the country-specific recommendations adopted under the European Semester for EU Member States. The Commission evaluates the implementation of the PG in the following year's ERP assessments ([6])

Graph I.1.6: **overall implementation 2021-23**



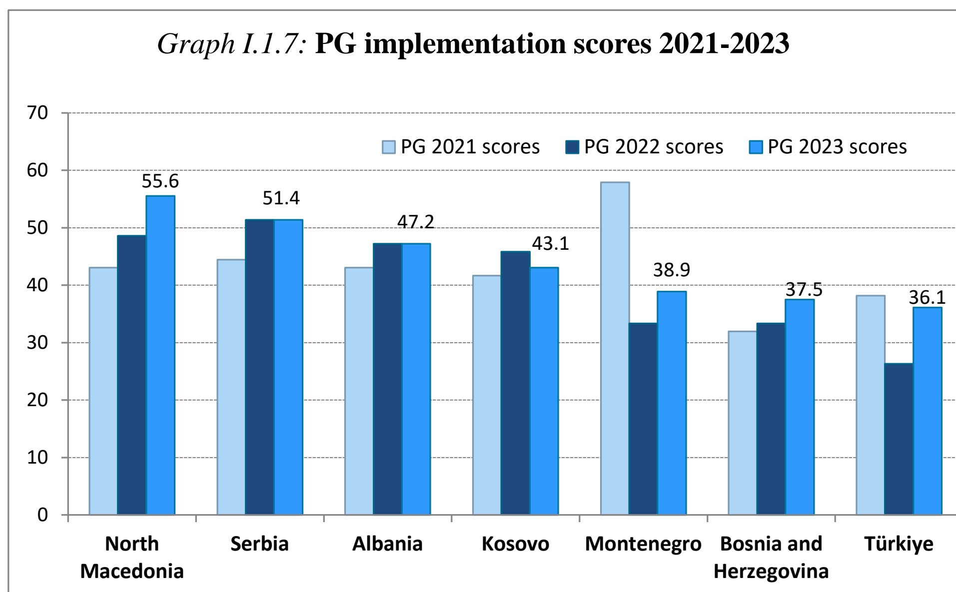
The level of implementation of last year's PG increased somewhat when compared with that for 2022. The average score across the Western Balkans and Türkiye increased from 40.9 out of

([6]) The detailed evaluation of individual PG items can be found in the Commission's ERP assessments. Georgia and Moldova participated in the dialogue for the first time in 2024 and therefore no PG had been adopted for them in 2023.

100 for the implementation of the PG adopted in 2022 to 44.2 in 2023 ([7]). The share of policy recommendations that saw only limited or no implementation fell, while those that have been substantially or fully implemented inched up (see Graph I.1.6.). Still, the former group continued to outweigh the latter by a wide margin, pointing to the need to substantially step up implementation of reforms. The Growth Plan for the Western Balkans, adopted by the Commission on 8 November 2023, aims to incentivise socio-economic reforms and the Western Balkan countries' preparations for EU membership through increased financial assistance and by bringing forward some of the benefits of EU accession. Therefore, the plan is expected to complement and support the policy guidance adopted at the Economic and Financial Dialogue.

Compared with last year, most countries have managed to improve their performance or maintain it at the same level. The improvement was especially strong in Türkiye, reflecting the bold steps it has taken since mid-2023, which have been focused on stabilisation and policy normalisation. However, Türkiye continued to lag behind most of the Western Balkans in terms of the overall country score (see Graph I.1.7.). The implementation score has also improved for North Macedonia, which achieved the best performance, as well as for Montenegro and Bosnia and Herzegovina. Overall, the implementation of the policy guidance adopted in 2023 is assessed as 'partial' ([8]) for all partners except Türkiye, where it remained 'limited' (with a score below 37.5).

Graph I.1.7: **PG implementation scores 2021-2023**



1.4. MAIN CHALLENGES

First, fiscal policy should support the ongoing disinflationary process in 2024, help achieve prudent medium-term fiscal positions and rebuild largely depleted fiscal buffers. The economies of the Western Balkans, Georgia and Türkiye proved resilient in the face of the various

([7]) 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.

([8]) 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.

global challenges, despite a relatively limited fiscal stimulus in many cases. The phasing-out of energy support measures in the context of lower energy prices should help improve budget balances. At the same time, interest costs are expected to rise as maturing public debt is rolled over amid tighter financing conditions, while lower nominal GDP growth will provide less support to debt reduction in the coming years. Careful fiscal planning is even more important in countries with no monetary autonomy and which therefore have 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 to ensure a gradual debt reduction and to rebuild fiscal buffers. In Moldova, which suffered a severe downturn in 2022 and only returned to growth in the second half of 2023, fiscal adjustment will need to be gradual and preserve growth-enhancing spending to support the nascent economic recovery.

Second, continued efforts should also be made to maintain, or in some cases shift, budgets towards a more growth-oriented composition to better support the economic recovery and the green transition. Public investment is expected to be stepped up or kept at a relatively high level in many countries. To effectively maximise the growth-enhancing impact of such investments, greater expenditure efficiency and thorough cost-benefit analysis of investment projects are key. This involves improving investment management, including project planning and selection. Furthermore, partners should prioritise sustainable and inclusive growth by investing in infrastructure, technology and innovation.

Third, it is essential that fiscal consolidation plans are supported by comprehensive medium-term fiscal strategies and well-defined measures. The failure to control current expenditures, particularly on public wages, pensions, and social benefits, has been a recurring issue in many countries and could impede fiscal adjustment efforts. Therefore, it is necessary to strengthen multiannual budgetary planning, establish or increase fair, transparent and sustainable public wages and pension systems, and improve the targeting of social benefits. As a common priority, reforms should involve tax administrations in order to increase the capacity to generate public revenue, broaden the tax base and reassess distorting, ineffective, and costly tax exemptions. Ongoing efforts need to be strengthened to better monitor and address fiscal risks arising from inefficient state-owned enterprises, public guarantees, and public-private partnerships.

Fourth, fiscal governance should be strengthened via credible fiscal rules, independent fiscal institutions, and more binding medium-term budgeting where the administrative capacity exists to do so. There have recently been some encouraging steps across the Western Balkans in these areas, which should be further built upon in the coming years. Strengthening fiscal governance would signal a strong commitment from the authorities to prudent fiscal policies, thereby reducing the country risk premium and sovereign borrowing costs. To improve public debt management, partners should further develop their government security markets, particularly by expanding the range of instruments denominated in local currency (which is envisaged in Georgia and Serbia).

All economies face similar structural challenges and bottlenecks to increase productivity and long-term growth. Most partners struggle with corruption, unpredictability in their legal systems and slow legal procedures. Weaknesses in the regulatory and institutional environment hamper private sector development. Several economies also face problems with still sizeable and unprofitable state-owned enterprises, leading to resource misallocation and unfair competition. The widespread grey economy also undermines competition, hinders the efficient allocation of state and private resources, and reduces tax revenues and funding for social security systems. The green transition is a major challenge for all these countries, with their electricity sectors typically dependent on polluting fossil fuels and outdated energy infrastructure, which have a negative impact on energy security in some countries. A shift towards renewable energy sources, diversification of energy sources and improvements in energy efficiency will be needed to meet targets for greenhouse gas reductions and improve resilience in the face of energy price shocks but will require large investments. Despite positive labour market developments and growth in employment rates in most economies, the activity rates are still low overall and unemployment rates relatively high. Active labour market policies are not sufficiently targeted at population groups most in need. Structural skills mismatches persist, due to under-investment in human capital and weak education systems, including outdated curricula and mismatches between vocational education and training and the needs of the labour market. Low

productivity, in combination with an underdeveloped transport infrastructure and weak private sector, typically results in a narrow and low-value-added export base.

Table I.1.1:
Economic Reform Programmes 2024 – key indicators

	2020	2021	2022	2023e	2024	2025	2026
Real GDP growth (% change)							
Albania	-3.3	8.9	4.9	3.5	3.7	3.9	4.0
Bosnia and Herzegovina	-2.9	7.3	3.8	2.0	2.9	3.0	3.4
Georgia	-6.3	10.6	10.4	6.5	5.2	5.0	5.0
Kosovo	-5.3	10.7	5.2	3.9	4.6	4.8	4.4
Moldova	-8.3	13.9	-5.0	2.0	3.5	4.0	4.2
Montenegro	-15.3	13.0	6.4	5.8	3.8	3.0	2.9
North Macedonia	-4.7	4.5	2.2	2.3	3.4	4.8	5.5
Serbia	-0.9	7.7	2.5	2.5	3.5	4.0	4.3
Türkiye	1.9	11.4	5.5	4.4	4.0	4.5	5.0
Unemployment rate (% LFS)							
Albania	12.2	12.1	11.3	10.6	10.2	9.8	9.5
Bosnia and Herzegovina	15.9	17.4	15.4	13.2	11.9	10.5	9.1
Georgia	18.5	20.6	17.3	16.6	16.2	15.9	15.7
Kosovo	25.9	20.7	12.6	:	:	:	:
Moldova	3.8	3.2	3.2	:	:	:	:
Montenegro	18.4	16.9	14.7	13.2	12.6	12.0	11.6
North Macedonia	16.6	15.6	14.4	12.8	11.9	11.0	10.1
Serbia	9.7	11.0	9.7	9.6	9.3	8.9	8.0
Türkiye	13.1	12.0	10.4	10.1	10.3	9.9	9.3
Current account balance (% of GDP)							
Albania	-8.7	-7.7	-6.0	-4.7	-4.8	-4.5	-4.3
Bosnia and Herzegovina	-2.8	-1.8	-4.5	-4.3	-3.7	-3.0	-2.8
Georgia	-12.5	-10.3	-4.5	-4.6	-4.8	-4.6	-4.3
Kosovo	-7.0	-8.7	-10.2	-6.8	-7.9	-7.9	-7.4
Moldova	-7.7	-12.6	-17.4	:	:	:	:
Montenegro	-26.1	-9.2	-12.9	-12.7	-13.1	-12.0	-10.9
North Macedonia	-2.9	-2.8	-6.2	-1.2	-2.4	-2.4	-2.3
Serbia	-4.1	-4.2	-6.9	-2.5	-3.8	-4.1	-4.3
Türkiye	-4.5	-0.9	-5.4	-4.0	-3.1	-2.6	-2.3
Inflation (CPI annual % change)							
Albania	1.6	2.0	6.7	4.8	3.0	3.0	3.0
Bosnia and Herzegovina	-1.1	2.0	14.0	6.2	3.1	2.2	1.9
Georgia	5.2	9.6	11.9	2.6	2.8	3.0	3.0
Kosovo	0.2	3.3	11.6	5.1	2.7	2.3	2.3
Moldova	3.8	5.1	28.7	13.6	5.0	5.0	5.0
Montenegro	-0.8	2.5	13.0	9.0	5.0	3.4	2.5
North Macedonia	1.2	3.2	14.2	9.5	3.5	2.0	2.0
Serbia	1.6	4.1	11.7	12.3	4.6	3.0	3.0
Türkiye	12.3	19.6	64.3	65.0	33.0	15.2	8.5

e: estimate.
LFS: labour force survey.
Sources: Economic Reform Programme (ERP) 2024 for 2022-2026, CCEQ for 2020 and 2021, national sources for Georgia and Moldova for 2020 and 2021.

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

Table I.1.2:
Economic Reform Programmes 2024 – fiscal indicators

	2020	2021	2022	2023e	2024	2025	2026
Total revenue * (% of GDP)							
Albania	25.9	27.5	26.8	28.0	27.8	27.8	27.8
Bosnia and Herzegovina	41.6	41.0	39.8	41.9	41.9	41.3	40.9
Georgia	27.0	27.1	30.9	31.4	32.6	32.0	31.4
Kosovo	25.4	27.7	27.9	29.1	28.7	28.2	28.1
Moldova	31.4	32.0	33.4	32.9	31.3	30.8	29.9
Montenegro	44.6	44.3	39.2	44.3	44.1	43.3	42.8
North Macedonia	28.4	30.0	32.1	33.7	33.7	33.5	33.1
Serbia	41.0	43.2	43.7	42.5	42.6	42.5	42.3
Türkiye	29.6	28.0	27.8	30.2	31.2	31.2	31.2
Total expenditure * (% of GDP)							
Albania	32.6	32.1	30.4	30.2	30.3	29.8	29.9
Bosnia and Herzegovina	46.8	41.3	38.7	42.2	42.5	41.4	40.7
Georgia	35.9	33.0	33.1	34.4	35.1	34.3	33.5
Kosovo	33.0	28.9	28.4	29.3	31.4	30.9	30.1
Moldova	36.7	33.9	36.6	38.8	36.0	34.6	33.3
Montenegro	55.7	46.2	42.9	43.8	47.5	46.2	45.2
North Macedonia	36.4	35.3	36.5	38.5	37.1	36.5	36.1
Serbia	49.0	47.4	46.9	45.3	44.8	44.0	43.8
Türkiye	32.5	30.3	28.6	36.7	37.2	34.2	33.7
General government balance (% of GDP)							
Albania	-6.7	-4.6	-3.7	-2.2	-2.5	-2.1	-2.1
Bosnia and Herzegovina	-5.2	-0.3	1.0	-0.4	-0.6	-0.1	0.3
Georgia	-8.9	-5.9	-2.2	-3.0	-2.5	-2.3	-2.2
Kosovo	-7.6	-1.2	-0.5	-0.2	-2.7	-2.7	-1.9
Moldova	-5.3	-1.9	-3.2	-5.9	-4.6	-3.8	-3.4
Montenegro	-11.1	-1.9	-3.7	0.5	-3.4	-2.9	-2.4
North Macedonia	-8.0	-5.3	-4.4	-4.8	-3.4	-3.0	-3.0
Serbia	-8.0	-4.1	-3.2	-2.8	-2.2	-1.5	-1.5
Türkiye	-2.9	-2.3	-0.8	-6.5	-6.0	-3.0	-2.5
General government debt (% of GDP)							
Albania	74.3	74.5	64.5	61.5	59.8	59.3	58.9
Bosnia and Herzegovina	36.1	33.9	28.3	26.7	25.6	24.6	23.0
Georgia	59.5	49.0	39.5	38.2	38.0	37.8	37.6
Kosovo	22.4	21.5	20.0	17.3	18.8	20.4	21.4
Moldova	36.6	32.6	35.0	37.2	37.0	35.9	34.2
Montenegro	105.3	82.5	69.3	62.2	61.6	61.3	61.0
North Macedonia	50.8	52.0	50.4	50.2	52.0	50.3	50.2
Serbia	57.0	56.5	55.6	53.3	51.7	50.7	50.0
Türkiye	39.4	40.4	30.8	33.3	35.2	34.6	33.2

e: estimate.
* 2020 and 2021 data from Ministry of Finance.
Sources: Economic Reform Programme (ERP) 2024 for 2022-2026, CCEQ for 2020 and 2021, national sources for Georgia and Moldova for 2020 and 2021.

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

Part II

Country analysis

1. ALBANIA

1.1. EXECUTIVE SUMMARY

Following 2 years of strong economic expansion, Albania's real GDP growth moderated but exceeded expectations in 2023, and the economic reform programme (ERP) projects growth to gather pace in 2024-2026. Helped by exceptional performance in the tourism sector and rising investments, the economy expanded by 3.4% in 2023. The labour market registered positive developments with increases in employment and wages, which supported consumption. Helped by the tourism boom, the current account deficit continued to decrease to historically low levels. The ERP projects economic growth to accelerate from 3.7% in 2024 to 4% in 2026 on the back of increasing domestic demand and rising exports led by a further expansion of tourism. Net exports are expected to contribute positively to GDP growth, which might be somewhat optimistic as rising domestic demand might boost imports more than forecast; while the external environment remains challenging with subdued growth in the EU economy. Inflation declined on the back of external factors and also due to the central bank tightening its policy stance. The ERP expects inflation to already meet the 3% target in 2024. A higher labour force participation rate is expected to be the main driver of labour supply growth, while the unemployment rate is projected to decrease gradually to 9.5% in 2026.

Albania's fiscal position improved in 2023, and the ERP aims to continue realising surpluses in the primary balance in the medium term. In 2023, the budget deficit narrowed to 1.4% of GDP, better than expected on the back of strong revenue growth but also due to lower than planned execution of public investments. The primary balance turned positive. The ERP projects the budget deficit to widen to 2.5% of GDP in 2024 on the back of higher spending on public wages, social insurance and interest costs. However, the primary balance is projected to remain in surplus, in line with the fiscal rule. In 2025-2026, a lower expenditure-to-GDP ratio is projected to lower the budget deficit to just above 2% of GDP and further increase the primary surplus. The government debt ratio fell by more than expected in 2023, reflecting a positive primary balance and favorable snowball effect. It is projected to continue its downward path in future, but at a more moderate pace.

The main challenges facing Albania are the following:

- **While revenues as a share of GDP increased in 2023, the ratio remains low compared to other countries in the region.** After a 1 percentage point (pp.) increase in 2023, the ERP projects public revenues to remain constant at 27.8% of GDP over 2024-2026 and tax revenue to increase marginally. The planned fiscal consolidation is important in the face of elevated financing needs and should be better underpinned by increasing the tax revenue ratio, including by implementing an updated medium-term revenue strategy. A higher tax revenue ratio is crucial for supporting investments in both physical and human capital, and for firmly anchoring the downward trend of public debt. There is also scope for increasing the effectiveness of budget spending by continuing to reform public investment management, including public-private partnerships (PPPs).
- **Fiscal risks continue to stem from arrears and state-owned enterprises (SOEs), particulary in the energy sector.** Arrears continued to accumulate throughout 2023 (1.2% of total expenditure at the end of the year). Reducing their stock and preventing their re-emergence remains a challenge. Contingent liabilities stem from SOEs, PPPs and ongoing court cases. The state-owned energy utilities are reliant on government support either via guarantees or loans, which is a source of fiscal risks. Increased transparency and higher managerial accountability would increase SOEs' fiscal performance and, in turn, reduce their reliance on budget support. While the Ministry of Finance has stepped up fiscal risk monitoring, further progress in this area remains important.

- **Other key challenges are linked to addressing the informal economy, labour shortages and skills, and improving connectivity and energy security.** Informality remains widespread, while the business environment needs further improvements. Informality impacts many sides of the Albanian economy, affecting the business climate and fair competition as well as reducing the tax base and hindering economic growth overall. Given its pervasiveness, tackling informality requires a multifaceted approach. Furthermore, fighting informality and improving the business environment should help stem the tide of emigration. Steady emigration flows over the past few years are shrinking the workforce. While the labour market registered positive developments with increases in employment and wages, the continued brain drain and labour shortages pose issues. Albania has a very high rate of low-skilled adults and high rates of early school leaving. Furthermore, it needs to address the infrastructure gaps and improve connectivity. The energy sector is volatile, with hydro-electricity production dependent on rainfall and reliant on budget support. These challenges are expected to be addressed through key structural reforms identified in the country's reform agenda under the new Growth Plan for the Western Balkans.

Implementation of the policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2023 has been partial. Fiscal consolidation accelerated and a positive primary balance was achieved, as envisaged. Two budget revisions have been undertaken via normative acts, which is not in line with the policy guidance. The end-of-year target for the stock of arrears was achieved (because of budget amendments that reallocated spending for arrears clearance), but throughout 2023 arrears continued to accumulate above the quarterly targets. To increase tax revenues, a new law on income tax was adopted. Albania established a national single project pipeline, but PPPs still need to be integrated into it. Expenditure on education, health and social protection increased in nominal terms while the methodology for data collection and processing on public expenses dedicated to R&D was not finalised. The Bank of Albania continued tightening monetary policy, while the regulation on collecting data from banks on their exposures to the real estate sector has entered into force. The Albanian power exchange ALPEX went live in April 2023, and a new law on renewables was adopted. The piloting of the Youth Guarantee scheme was launched in October 2023 in three regions (Tirana, Shkodra and Vlora). An indexation mechanism of the economic aid scheme still needs to be put in place.

1.2. ECONOMIC OUTLOOK AND RISKS

Albania's economic growth was robust in 2023, exceeding the projections of the previous ERP. The economy grew by 3.3% year-on-year in the first three quarters of 2023, and by an estimated 3.4% in the year as a whole, undepinned by strong domestic demand and exceptional performance by the tourism sector, which reached new heights with over 10 million foreign arrivals in 2023 (which is well above the pre-pandemic level). Consumption, investments and net exports all made positive contributions to growth. Public consumption growth was supported by higher wages in the public sector (due to public sector wage reform). Private consumption grew slower than in the previous year, while investment witnessed a substantial increase, spurred by private investments. Exports have been supported by a surge in service exports, which offset the decline in goods exports. On the production side, services and construction were the main drivers of growth, while the industrial sector suffered somewhat in 2023 due to a mix of factors, including the appreciation of the exchange rate. While the real GDP growth rate moderated in 2023 compared to 2022, it exceeded expectations and the projections of the previous ERP.

The ERP projects GDP growth to accelerate to 3.7% in 2024 and increase to almost 4% in 2025-2026. In the baseline scenario, domestic demand is expected to be the key driver of growth, with positive contributions from private and public consumption as well as investments. Further support for GDP growth is projected to come from net exports, mainly tourism services. Exports of goods and services are forecast to have robust performance, with average real growth of 5.2% per year in 2024-2026, while imports of goods and services are projected to expand at a slower pace (3.7% on average). Investments are expected to continue growing but at slower pace in 2024-2025, before accelerating in 2026. Their GDP growth contribution is projected to average 0.8 percentage

points (pps) per year. From the supply side, all major economic sectors are expected to expand. Employment is expected to rise by an average of 0.3% per year in 2024-2026, gradually reducing the unemployment rate to 9.5% in 2026. A higher labour force participation rate is expected to remain the main driver of labour supply, given the shrinking population (caused by high emigration and low fertility rates). The ERP estimates a zero output gap in 2024 and a slightly negative output gap (-0.1%) in 2025-2026. The plan contains an alternative downside scenario, which assumes that real GDP growth is 1.5 pps lower each year compared to the baseline projections.

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

	2022		2023		2024		2025		2026	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	4.8	**4.9**	3.5	**3.5**	3.1	**3.7**	3.7	**3.9**	n.a.	**4.0**
Contributions:										
- final domestic demand	6.5	**6.5**	4.3	**3.2**	3.3	**3.5**	3.8	**3.6**	n.a.	**4.0**
- change in inventories	1.8	**1.9**	0.0	**0.0**	0.0	**0.0**	0.0	**0.0**	n.a.	**0.0**
- external balance of goods and services	-3.5	**-3.5**	-0.8	**0.2**	-0.2	**0.3**	-0.1	**0.3**	n.a.	**0.1**
Employment (% change)	4.8	**4.8**	2.4	**2.4**	1.8	**0.5**	2.0	**0.3**	n.a.	**0.2**
Unemployment rate (%)	11.3	**11.3**	10.5	**10.6**	10.2	**10.2**	9.9	**9.8**	n.a.	**9.5**
GDP deflator (% change)	9.7	**9.9**	6.2	**4.5**	3.1	**1.5**	2.8	**1.1**	n.a.	**1.1**
CPI inflation (%)	6.7	**6.7**	4.6	**4.8**	3.5	**3.0**	2.9	**3.0**	n.a.	**3.0**
Current account balance (% of GDP)	-6.0	**-6.0**	-4.9	**-4.7**	-5.1	**-4.8**	-4.9	**-4.5**	n.a.	**-4.3**
General government balance (% of GDP)	-3.7	**-3.7**	-2.2	**-2.2**	-2.2	**-2.5**	-2.3	**-2.1**	n.a.	**-2.1**
Government gross debt (% of GDP)	64.6	**64.5**	62.5	**61.5**	61.2	**59.8**	60.9	**59.3**	n.a.	**58.9**

Sources: Economic Reform Programme (ERP) 2024, Commission Autumn 2023 forecast.

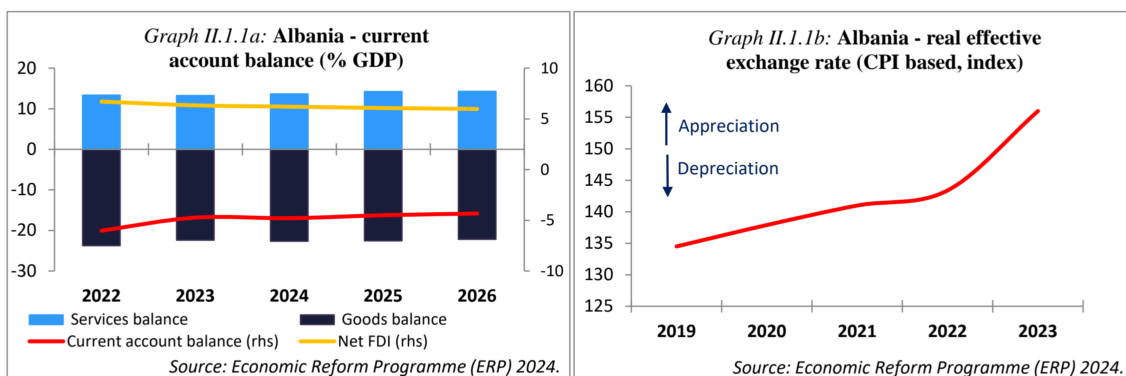
The baseline GDP growth scenario is subject to external and domestic risks, with projections for net exports on the optimistic side. Compared to the previous year, the ERP revises GDP growth downwards by 0.1 pps for 2024, while the estimated growth for 2025 remains unchanged. Nevertheless, the baseline scenario for 2024 is more positive than the Commission's autumn forecast and above international ones. The divergence narrows for 2025, and the estimates are broadly in line. The key difference for both years stems from net exports' contributions to growth, which exceed historical averages in the ERP. In the Commission forecast, net exports are projected to subtract from GDP growth mainly because of decreasing goods exports, which are affected by large currency appreciation, base effects and falling external demand for construction materials. Furthermore, the external environment is challenging, with increased uncertainty amid geopolitical tensions and subdued growth in the EU economy. The ERP baseline scenario also assumes a deceleration in import growth over 2024-2026, which may turn out to be more modest than expected given the projected consumption and investment dynamics. ([9]) This in turn may lead to smaller than expected net exports. On the production side, the ERP expects the contribution of agriculture, forestry and fishing to growth to exceed historical averages (following an insignificant contribution in 2023), although it fails to present the underlying factors. When presenting the downside scenario, the ERP mentions domestic and external risks: negative developments linked to the lending to the economy, eurozone economic performance with subsequent effects on exports of goods and services, remittances, various foreign capital flows, changes in exchange rates and interest rates, and slower implementation of planned structural reforms.

Inflation eased in 2023 and is projected to decline further in 2024-2026. The average annual inflation rate eased from 6.7% in 2022 to 4.8% in 2023. Inflationary pressures have receded on the back of falling energy and food prices in international markets as well as the sizeable appreciation of the domestic currency (10.6% year-on-year in December 2023 against the euro), which helped cushion the impact of foreign price pressures. Domestic inflationary pressures have remained elevated in the

([9]) The ERP does not provide details on the impact of disposable income growth and tourism growth on imports of goods and services.

second half of 2023 as a result of expanding domestic demand, tight labour market and increased production costs due to higher wages, with the latter also boosted by sizeable public sector wage increases. The Bank of Albania continued tightening its monetary policy stance in order to anchor inflation expectations and lower inflation. The main policy rate was raised in 2 steps in 2023: to 3% in March, and further to 3.25% in November 2023. The ERP expects inflation to gradually decline towards the Bank of Albania's target of 3% in 2024. Inflation is projected to remain on a downward path on the back of moderated foreign inflationary pressures, currency appreciation, monetary tightening and a decreasing trend of medium-term inflation expectations. Recent price developments were benign, with inflation already falling below the target in February 2024 (2.6%). However, domestic price pressures may resurface.

External competitiveness and current account



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

Source: Economic Reform Programme (ERP) 2024.

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

Source: Economic Reform Programme (ERP) 2024.

The current account deficit continued to decrease in 2023, and the ERP projects further improvements in the coming years. In the first three quarters of 2023, the current account posted a surplus, outperforming the results of the same period in the previous year. Performance in the fourth quarter was weaker, with the full-year balance turning negative. Nevertheless, reflecting higher inflows from tourism and remittances, the overall 2023 current account deficit is expected to be at a historically low level (4.7% of GDP according to the ERP), continuing the positive trend of recent years. After a small increase in 2024, the current account deficit is projected to follow a downward path from 4.8% of GDP in 2024 to 4.3% of GDP in 2026. This improvement is based on an increasing services surplus led by tourism-related services, and a slight narrowing of the goods trade deficit (as a share of GDP). Overall, the current account developments are more optimistic than in last year's ERP, which assumed higher current account deficits for both 2024 and 2025 (5.6% of GDP and 5.1% of GDP respectively). The difference in the scenarios is driven by this year ERP's higher assumed surpluses in the services balance and narrower deficits in the trade balance (both as a share of GDP).

Net foreign direct investment (FDI) inflows are set to decrease somewhat as a share of GDP, but still fully cover the current account deficit in 2024-2026. Net FDI increased by 6.8% year-on-year in January-September 2023, whereas gross FDI inflows increased by 10.6%. The financial sector was the main contributor to FDI growth in those three quarters. Portfolio investment flows reflected a growth in liabilities of non-residents, namely in the second quarter of 2023 when a Eurobond was issued. As a share of GDP, net FDI decreased from 6.7% in 2022 to 5.9% in 2023, and is expected to gradually decline to 6% of GDP in 2026. Generally, FDI inflows are linked to the construction sector and tourism-related investment projects. As tourism is expected to continue expanding in the medium term, capital inflows are set to remain steady. FDI inflows are projected to cover the current account deficit in 2024-2026. Albania's net international investment position was negative at -45.4% of GDP in 2023, narrowing from -49.5% of GDP in 2022. External debt is estimated to have dropped to about 47.7% of GDP in 2023 on the back of nominal GDP growth and the appreciation of the lek against the euro. The Bank of Albania's risk analysis shows that the external debt ratio is sensitive to currency depreciation and to rising interest rates. These risks are mitigated by ample international reserves, which came to EUR 5.8 billion (or about 28% of GDP) at the end of 2023, covering 7 months of imports of goods and services and over three times the short-term external debt.

Table II.1.2:
Albania - financial sector indicators

	2019	2020	2021	2022	2023
Total assets of the banking system (EUR million)	12 380	13 156	14 980	16 426	19 427
Foreign ownership of banking system (%) *	78.4	69.4	68.8	66.2	64.7**
Credit growth (%, average)	3.0	6.1	6.9	11.2	2.6
Deposit growth (%, average)	2.5	5.8	8.5	8.0	1.9
Loan-to-deposit ratio (end of period)	55.6	54.7	54.8	56.1	56.5
Financial soundness indicators (%, end of period)					
- non-performing loans to total loans	8.4	8.1	5.7	5.0	4.7
- regulatory capital to risk-weighted assets	18.3	18.3	18.0	18.1	19.4
- liquid assets to total assets	15.1	13.6	13.3	11.0	30.1
- return on equity	13.5	10.7	12.9	12.3	17.3
- foreign exchange loans to total loans	50.1	48.5	48.8	49.3	44.2

* foreign equity ownership of total banks' equity.
** September 2023, latest month reporting data.
Sources: Economic Reform Programme (ERP) 2024, IMF, Bank of Albania.

Banking sector capitalisation remains above the regulatory minimum, while profitability improved significantly. At the same time, vulnerabilities are linked to credit risk, the sovereign-bank nexus and cybersecurity risks. At aggregate level, banks had a capital adequacy ratio of 19.4% in December 2023, which is well above the Albanian minimum requirement of 12%. Banks' profitability improved significantly in 2023 driven by higher net interest income. The return on assets came to 2.2% in December 2023, up from 1.4% a year earlier, while the return to equity increased to 17.3% from 12.3%. On the back of rising interest rates and given the high share of variable rate loans (about 75% of the banks' loan portfolio), credit risks need to be closely monitored. As a mitigating factor, the appreciation of the lek supported strong performance in foreign debt repayments, offsetting the effect of interest rate rises. The ratio of non-performing loans to total loans (NPL ratio) declined from 5% in 2022 to 4.7% at the end of 2023 – the lowest level recorded since the beginning of the global financial crisis in 2008. Another source of vulnerability is banks' exposure to sovereign risk given the high share of government securities among their assets. The increase in the stock of loans decelerated in 2023 mainly due to an exchange rate-driven contraction in foreign currency loans. Credit growth in lek accelerated strongly (driven by real estate loans and mortgage loans). Foreign deposits grew in the banking sector, partly reflecting high inflows from tourism and FDI. The Bank of Albania continued to work on strengthening the bank resolution framework. Furthermore, to monitor banks' exposures to the real estate sector, the Bank of Albania approved an act in October 2023 that regulates data reporting from the banking sector ([10]). Overall, within the financial system the banking sector continues to dominate, with almost 91% of total assets.

1.3. PUBLIC FINANCE

Fiscal performance improved in 2023, with the budget deficit falling to 1.4% of GDP. The deficit was lower than in 2022 (3.7% of GDP), reflecting a better performance of government revenues, a higher GDP denominator and a small increase in expenditures. According to budget implementation data, budgetary revenues increased by 12.3% in 2023, driven by strong tax revenue growth (10.6% year-on-year). All tax categories registered increases except national taxes. Profit tax and personal income tax saw exceptional rises of 35.4% and 28.7% respectively, while VAT revenues

([10]) From 2024, banks will report on a quarterly basis on lending for residential housing, and annually on exposures to commercial real estate.

were only slightly above the previous year's level (0.5% increase). This is because the strong appreciation of the lek reduced the VAT calculation base for imported goods, which in turn dampened revenues from VAT on imports. Total expenditures increased by much less than total revenues (3.6%). Spending on wages increased significantly, by 19.2%, on the back of public wage reform ([11]). Interest expenditures jumped by 20.1%, while capital expenditures registered subdued growth of only 6% ([12]). Overall, total revenues as a share of GDP were up from 26.8% in 2022 to 27.8% in 2023. The revenue ratio was slightly lower than what the ERP projected ([13]) (28% in 2023). Total expenditure as a share of GDP was also lower than expected, at 29.2% (down from 30.4% in 2022).

The 2023 fiscal outturn was better than planned in the revised budget, but mainly on the back of lower public investments. In 2023, the government introduced two budget amendments outside of the regular revision process (facilitated through normative acts) that were not triggered by unexpected events. The initial budget revision took place in October 2023. It involved the reallocation of unexecuted capital expenditure funds between programmes and clearing a large part of the arrears stock. The second revision in mid-December introduced a number of changes but kept the budget deficit unchanged from the original target, at 2.4% of GDP ([14]). The fiscal outturn was better than expected, with a budget deficit of 1.4% of GDP and a primary surplus of 0.7% of GDP. Total revenues came to 99% of planned budget revenues, while the execution rate of total spending was 96% of the annual plan. Nevertheless, the overall better performance reflects under-execution in capital expenditures ([15]).

While fiscal consolidation remains a priority, the ERP projects a widening budget deficit in 2024, followed by an improvement in 2025-2026. Following exceptional increases in revenues in the last 2 years, the ERP projects public revenues as a share of GDP to remain constant at 27.8% over 2024-2026, with a gradually increasing tax revenue ratio (0.1-0.2 pps of GDP per year) offset by falling non-tax revenues and grants as a share of GDP. VAT revenues, personal income tax, excise tax and profit tax are key categories of budget revenues, accounting for about 59% of total revenues in 2024-2026. They are all expected to remain stable as a share of GDP over 2024-2026, at 8.7%, 2.7%, 2.6% and 2.2% of GDP respectively. Social and health contributions are set to remain flat at 6.5% of GDP for this period, and at 23% of total revenues. On government spending, the ERP projects total expenditures as a share of GDP to increase marginally to 30.3% in 2024, while in 2025-2026 they are projected to fall to 29.8% and to 29.9% respectively, underpinning the improvement in the budget balance over 2025-2026. In particular, the narrowing of the deficit from 2.5% in 2024 to 2.1% in 2025-2026 is mainly driven by a decrease in capital expenditure (by 0.5 pps of GDP) and lower spending on operations and maintenance as a share of GDP. The primary balance is forecast to be positive in 2024 (in line with the fiscal rule) and increase gradually over 2025-2026. While this path is in line with last year's programme, the primary balance projections are lower than in the previous ERP. The general government debt ratio is expected to decline gradually from 59.8% of GDP in 2024 to 58.9% in 2026.

([11]) Public sector reform aims to increase public sector wages in several phases, starting in 2023. The salary increase policy will cost the state budget ALL 39.1 billion, an effect that will be fully felt from 2025 onwards.

([12]) Capital expenditures represent 17.6% of total expenditures, while current expenditures make up 81% of total expenditures.

([13]) The budget law requires Albania to use a projected nominal GDP not higher than the latest available IMF forecast for fiscal purposes. The ERP expected nominal GDP to be ALL 2311.7 billion in 2023, some 6.2% higher than the original estimate used for the budget preparation (of ALL 2176.1 billion).

([14]) In particular, the amended budget reallocated unspent funds of around 0.9% of GDP (ALL 20 billion). It provided support to vulnerable people; it distributed unconditional grants to municipalities (0.1% of GDP or nominally ALL 2 billion) to pay off arrears and it allocated ALL 250 million to 1144 public employees involved in the EU screening and negotiation process.

([15]) At the end of 2023, the execution rate of capital expenditures was 88%. In November 2023, the execution rate of capital expenditures was even lower at 54%, while current expenditures had an execution rate of 87%. The overall underspending prompted a budget revision in mid-December, which facilitated reallocations.

Table II.1.3:

Albania - composition of the budgetary adjustment (% of GDP)

	2022	2023	2024	2025	2026	Change: 2023-26
Revenues	26.8	28.0	27.8	27.8	27.8	-0.2
- Taxes and social security contributions	22.2	23.0	23.2	23.4	23.5	0.5
- Other (residual)	4.6	5.0	4.6	4.4	4.3	-0.7
Expenditure	30.4	30.2	30.3	29.8	29.9	-0.3
- Primary expenditure*	28.6	28.0	27.6	27.0	26.9	-1.1
of which:						
Gross fixed capital formation	6.2	6.8	6.3	5.8	5.7	-1.1
Consumption	8.3	8.6	8.9	8.7	8.7	0.2
Transfers & subsidies	11.6	11.1	11.6	11.6	11.5	0.4
Other (residual)	2.5	1.5	0.8	0.9	0.9	-0.5
- Interest payments	1.9	2.2	2.7	2.8	3.1	0.9
Budget balance	-3.7	-2.2	-2.5	-2.1	-2.1	0.1
- Cyclically adjusted	-3.8	-2.3	-2.5	-2.0	-2.1	0.2
Primary balance	-1.8	0.0	0.2	0.8	0.9	0.9
- Cyclically adjusted	-2.0	-0.1	0.2	0.8	1.0	1.0
Gross debt level	64.5	61.5	59.8	59.3	58.9	-2.5

* Excluding arrears clearance.

Sources: Economic Reform Programme (ERP) 2024, Commission calculations.

The 2024 budget targeted a primary surplus of 0.2% of GDP, while the revised budget commits Albania to slightly better performance with a 0.4% surplus. The budget plan aims to increase tax revenues (including social contributions) by about 6%, or as a share of GDP by 0.2 pps compared to 2023 budgeted figures. The ERP ([16]) states that the projected revenues from taxes, customs and insurance contributions take into account the effects of economic growth, new fiscal policies as well as the effects of improving the tax and customs administration. This is accompanied by legal changes that aim to increase the level of voluntary compliance of taxpayers with the law. All main categories (except profit tax and property tax) were projected to increase compared to the 2023 budgeted figures: a 5.6% increase in VAT revenues, 7.8% in excise tax, 16.4% in personal income tax, 8% in national taxes and other taxes, 2.5% in customs tax and 9.2% in social and health insurance contributions. The substantial increase in personal income tax revenues is mainly driven by the wage reform in the public sector, the increase in the number of employees and higher average salaries in the private sector. ([17]) Nevertheless, total revenue as a share of GDP was set to remain unchanged compared to the 2023 outcome at 27.8% as the small increase in the tax revenue is offset by a fall in grant revenue compared to 2023 when the one-off EU energy budget support was disbursed. In the budget, total expenditure was planned at 30.3% of GDP in 2024, which is 1.1 pps higher than the 2023 outcome. This rise is driven by personal expenditures that were set to increase by 0.6 pps to 4.9% of GDP. This reflects the second phase of the public sector wage increase planned in July 2024, and driven by interest payments that were projected to reach 2.7% of GDP (from 2.1% of GDP in 2023), including a reserve to mitigate potential risks from interest rate and exchange rate fluctuations. Capital spending was planned at 5.3% of GDP, which is in line with the level of capital expenditure realised in 2023. Overall, the original 2024 budget targeted a deficit of 2.5% of GDP, while the primary balance was set to reach a small surplus of 0.2% of GDP. Nevertheless, the budget was revised in February 2024 via a normative act, increasing the level of ambition with respect to the surplus of the primary

([16]) The ERP figures were in line with the budget plan adopted in December 2023.

([17]) Other relevant factors specified to be taken into account for the projected increase in the personal income tax are: i) increase in income from tax on dividends, tax on leasing, tax on professional services; ii) increase in income from the inclusion in the scheme of taxing income from tourism and accommodation of entities that are not registered and declared as accommodation units.

balance, which is now set to reach 0.4% of GDP, while the revised deficit target is slightly lower at 2.4%. ([18])

BOX II.1.1: THE 2024 BUDGET AND THE REVISED BUDGET

* On 7 December 2023, Parliament adopted the 2024 budget law, targeting a deficit of 2.5% of projected GDP and a positive primary balance of 0.2% of GDP.
* On 21 February 2024, the Council of Ministers approved a normative act amending the 2024 budget. The revised budget targets a slightly lower budget deficit of 2.4% of projected GDP and a slightly higher primary balance surplus of 0.4% of GDP.
* Revenues for 2024 were revised upwards, to about ALL 687 billion or 28.2% of GDP (from 27.8% in the original budget), while total expenditures were also revised upwards but the increase was smaller, to ALL 744 billion or 30.6% of GDP (from 30.3% in the original budget).
* The normative act also included a new State Guarantee Instrument of ALL 4 billion to support the Cut, Make & Trim garment industry, which was affected by exchange rate strengthening. This instrument helps businesses secure the necessary financing from banks via state guarantees.

Table: **Main measures in the budget for 2024**

Revenue measures*	Expenditure measures**
• Taxation on self-employed professionals, excises indexation, increasing of excise duty for cigarettes, gambling law *(overall estimated impact: ALL 7 billion, or 0.3% of GDP)*	• Salary increase for employees in health, education and public administration *(estimated impact: ALL 11 bn, or 0.5% of GDP, permanent measure)*

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

Source: ERP

General government debt fell by more than expected in 2023 and is projected to continue its downward path, but at a much slower pace. On the back of a primary balance surplus and high nominal GDP growth in 2023, the public debt ratio fell by 5.3 pps to 59.2% of GDP in 2023, which is below the ERP projection of 61.5%. Furthermore, general government debt also decreased slightly in nominal terms (from ALL 1378 billion in 2022 to ALL 1369 billion in 2023). Domestic debt accounts for about 54% of the total debt stock, while foreign debt amounts to 46% (September 2023). Assuming a higher initial level at the end of 2023, the ERP projected the public debt ratio to decrease by a cumulative 2.5 pps in 2024-2026, reaching 58.9% of GDP at the end of 2026. Guaranteed debt, which is fully accounted for in the public debt stock, decreased from 2.4% of GDP in 2022 to 1.8% of GDP in 2023.

The public debt maturity structure improved slightly in 2023, but risks linked to refinancing short-term debt and interest rates remain. Short term debt – with maturity of less than 1 year – decreased slightly in 2023 but remains elevated at about 17% of total debt. Furthermore, within the domestic debt stock, the share of debt maturing within 1 year is about 32%, while the share of debt falling due within 5 years is 36%. In this context, the tightening of financing conditions and the shallow domestic market

([18]) The early budget revision was motivated by the need to allocate funds for the newly established ministries, such as the Ministry of Economy, Culture, and Innovation. The upward revision in tax revenues reflects the better-than-expected performance of these revenues up to the point of the revision, leading to higher annual revenue forecast for 2024 compared to the autumn projections underlying the original budget, the macro-fiscal framework, and the ERP.

for government securities pose risks. Meanwhile, foreign debt consists mainly of long-term loans and long-term bonds (5-, 7- and 10-year Eurobonds issued in international markets). While this mitigates refinancing risks, external debt poses exchange rate risk. 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 as a reserve to offset the fiscal impact of exchange rate fluctuations. In June 2023, Albania tapped international markets and issued its sixth Eurobond worth EUR 600 million, with a 5-year maturity, 5.9% coupon and a primary yield of 6.125%. The bond generated strong demand with an order book of over EUR 1.3 billion. The bond's proceeds will be used to cover part of the government's financing needs in 2023 and 2024, which remain elevated. The cost of debt increased on the back of rising interest rates. In particular, the average cost for domestic debt reached 4.62% at the end of September 2023, increasing by 57 basis points compared to the end of 2022. As regards the foreign debt portfolio, due to the increase in international market interest rates, the average cost was expected to be 3.4% in 2023, increasing by 100 basis points compared to the end of 2022.

BOX II.1.2: DEBT DYNAMICS

Albania

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

	2022	**2023**	**2024**	**2025**	**2026**
Gross debt ratio [1]	64.5	61.5	59.8	59.3	58.9
Change in the ratio	-10.0	-3.0	-1.7	-0.5	-0.4
Contributions [2]:					
1. Primary balance	**1.8**	**0.0**	**-0.2**	**-0.8**	**-0.9**
2. 'Snowball effect'	**-7.7**	**-2.5**	**-0.3**	**0.0**	**0.2**
Of which:					
Interest expenditure	1.9	2.2	2.7	2.8	3.1
Growth effect	-3.1	-2.1	-2.2	-2.2	-2.3
Inflation effect	-6.4	-2.7	-0.9	-0.6	-0.6
3. Stock-flow adjustment	**-4.2**	**-0.5**	**-1.2**	**0.3**	**0.4**

[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) 2024, Commission calculations.

The debt ratio fell in 2023, driven by a strong snowball effect due to still high inflation and robust GDP growth. Furthermore, a negative stock flow adjustment related to the use of cash reserves helped reduce the debt stock. In future, primary surpluses are set to support a continued reduction in the debt ratio, while the snowball effect is expected to moderate as inflation abates and interest costs rise. The table is based on the values provided in the ERP. However, due to the much larger than expected debt reduction in 2023, the debt path is expected to shift to a lower level.

Fiscal risks stem from public guarantees to state-owned enterprises (SOEs) such as hydroelectricity providers, from onlending and from arrears. Over 75% of the state guarantee stock belongs to the energy sector. The state-owned energy utilities' dependence on regular government support (either guarantees or loans) is a source of fiscal risks. While public guarantees to SOEs are fully included in the stock of public debt at the date of issuance – an approach that mitigates risks to the budget – this has implications for government debt. ([19]) Budgetary support to energy SOEs increased in 2022 as adverse weather conditions caused a decline in domestic electricity production and import costs surged. Albania's reliance on hydropower exposes it to fluctuations in rainfall and to increasing climate risks for which mitigation measures still need to be developed. The governance system of SOEs has gaps with respect to international standards, reflected also in the weak financial viability of some of

([19]) As such, public debt increases with the issuance of public guarantees.

these companies. ([20]) Better transparency ([21]) and greater managerial accountability would increase the financial performance of SOEs and in turn reduce their reliance on budget support. ([22]) The government also faces fiscal risks from on-lending as a result of gaps in its risk assessment. The recurring accumulation of public sector arrears remains a challenge. Despite reductions in the overall stock, arrears persist, particularly related to investment projects and court cases. Meanwhile, there are also contingent liabilities related to PPPs, but they are not measured in a comprehensive manner and as such are neither properly assessed nor adequately monitored.

BOX II.1.3: SENSITIVITY ANALYSIS

The ERP presents the dynamics of fiscal key indicators over 2024-2026 under three different scenarios: baseline, optimistic and pessimistic.

The alternative scenarios are constructed with varied economic growth assumptions for each year. In particular, the real GDP growth rates that underpin the optimistic and pessimistic scenarios deviate by +0.5 pps and -1.5 pps respectively from the baseline growth scenario of 3.7% in 2024 and its average rate of 3.9% in 2025-2026.

In the optimistic scenario, total revenues as a share of GDP are identical to the baseline scenario. Capital spending as a share of GDP is expected to remain very close to the baseline (0.1-0.2 pps higher than the baseline), while current spending as a share of GDP is gradually being reduced (ultimately 0.5 pps lower than in the baseline in 2026). The fiscal deficit is smaller in the optimistic scenario only in 2025 and 2026. The ERP explains that generally, there is an expectation of a more robust fiscal consolidation in the optimistic scenario and a fiscal deficit relaxation in the pessimistic scenario, reflecting a countercyclical response to different assumed dynamics of the economic cycle.

Nevertheless, in the pessimistic scenario fiscal policy easing, compared to the baseline, would be implemented to the extent that key public finance parameters (such as the debt-to-GDP ratio and primary balance) simultaneously adhere to the fiscal rules in the Organic Budget Law. In the pessimistic scenario, the revenue ratio is assumed to be 0.5 pps below the baseline. Capital spending in 2024-2026 is reduced compared to the baseline by 0.7 percent of GDP on average each year, while current expenditure is about 0.1 pps above the baseline. Interest expenditure (in nominal terms and also as a share of GDP) is assumed to be lower in the pessimistic scenario compared to the other scenarios in 2025-2026. The fiscal deficit is set to be higher (0.1-0.2 pps) than in the baseline scenario, except in 2025 when it is lower.

The public debt ratio is set to decrease in all three scenarios, including in the pessimistic one, although the reduction is marginal (0.1 pps). Furthermore, the primary balance is non-negative in all scenarios.

The government is working on a new public finance management (PFM) strategy, which is expected to be adopted in the first half of 2024. This would be the third PFM strategy, following the 2014-2020 PFM and the one in 2019-2022. According to the ERP, PFM reforms need to be continued in order to increase the effectiveness of budget spending and create a more productive environment for expenditure in the medium- and long term. Nevertheless, in the ERP there are no details on its content and no indication on the starting date for implementation. A first draft of the PFM

([20]) In line with OECD findings. See Competitiveness Outlook 2024 (forthcoming).

([21]) There is limited transparency with respect to the financial performance of SOEs. Furthermore, SOEs benefit from direct subsidies from their line ministries, with limited transparency regarding what activities these subsidies are expected to finance.

([22]) Currently there is no central overview of the state's portfolio of SOEs, with information on their size, employment or financial returns.

strategy document was expected to be finalised in December 2023. In the last stage following consultations, the document is to be approved by the Council of Ministers, which is expected in the first half of 2024. Progress has been made to reform public investment management as the national single project pipeline (NSPP) list has been prepared, updated and approved by the Decision of the Council of Ministers in July 2023. To facilitate medium-term budget planning, a ranking of these projects based on their strategic importance, maturity and financing is yet to be completed. The necessary legal amendments to integrate public-private partnerships into the NSPP and into the regular public investment management cycle are also outstanding. The authorities are working on publishing a fiscal risk statement as a stand-alone document. They also plan to set up a separate department within the Ministry of Finance tasked with fiscal risk monitoring.

The ERP envisages an **incremental increase in the tax revenue ratio over 2025-2026, but better outcomes could be achieved with more decisive revenue-enhancing reforms and a broader tax base.** The medium-term revenue strategy (MTRS), drafted in 2021, has not been officially adopted yet and the authorities have asked the IMF for help in updating the existing plan, also taking into account recent developments such as the growing importance of the tourism sector. Good progress was made in recent years on adopting tax policy measures in line with the MTRS, but some measures, such as a review of the property tax, remain outstanding. However, the main focus of the authorities in the upcoming period will be on improving tax administration, including improved information exchange, the use of IT tools and capacity increase. The initial aim of the MTRS was to increase the tax revenue ratio by 2.5 pps compared to its 2019 level. Of this, 1.5 pps is yet to be achieved according to the authorities' own calculations. Raising more revenue is all the more important as Albania needs to invest more in physical and human capital to accelerate its convergence with EU income levels. However, according to the ERP projections the improvement of the fiscal balance over 2025-2026 is set to be achieved mainly through a reduction of the expenditure ratio driven by a decrease in capital spending and in spending on operation and maintenance as a share of GDP.

ERP medium-term fiscal planning is in line with the fiscal rules. Overall, the assumed fiscal path of a widening deficit in 2024 and an improvement in subsequent years would ensure continuing surpluses in the primary balance and a decreasing debt-to-GDP ratio, in compliance with the fiscal rules set by law. Compliance with the primary balance rule was achieved in 2023, a year ahead of the legal obligation entering into force. The importance of this rule is reflected in the fact that the primary surplus is projected to play an increasing role in ensuring continued debt reduction in 2024-2026.

1.4. MAIN MACRO-RELEVANT STRUCTURAL CHALLENGES

In November 2023, the Commission proposed a New Growth Plan for the Western Balkans ([23]) with the aim of supporting the region's economic convergence and accelerating the accession process. The plan involves a Reform and Growth Facility (EUR 2 billion in grants, EUR 4 billion in loans) that is to be disbursed in 2024-2027 as investment ([24]) and budget support in exchange for implementing reforms that are to be set out in reform agendas prepared by the Western Balkan partners. The New Growth Plan is therefore an important tool to increase reform incentives to boost growth and convergence. In this context, with a view to ensuring an integrated surveillance of Albania's economy, this chapter briefly outlines the main structural challenges facing the country.

The informal economy is sizeable in Albania and the level of informality in employment is also high. Latest studies ([25]) show that the informal economy amounted to 27.2% of GDP in 2019. The International Labour Organization estimates that as much as 56.7% of total employment may be

([23]) https://neighbourhood-enlargement.ec.europa.eu/enlargement-policy/new-growth-plan-western-balkans_en.

([24]) Infrastructure investments need to comply with the EU environmental acquis, national and international nature protection and water management obligations, ensure public participation and consultation, and guarantee high quality environmental impact assessment reports that include cumulative impacts on nature and biodiversity.

([25]) IMF Albania 2022 Article IV Staff Report.

informal in Albania ([26]). At the same time, the Albanian State Statistics Institute estimates that the informal employment accounts for 29.4%, excluding the agricultural sector. ([27]) Informal employment takes different forms such as undeclared work, envelope wages and lower official reported wages with remaining wages paid in cash. Among the economic sectors, agriculture is the sector with the highest level of informal employment, followed by wholesale and retail trade, and then construction. With the expansion of tourism supported by better access to global booking channels, hospitality is a fertile ground for the informal market as there is a large share of accommodation not registered.

Informality impedes fair competition among businesses, reduces the tax base and hinders economic growth. Informality penalises companies that are tax-compliant, reducing fair market competition. The process of fiscalisation as a major reform undertaken by the tax administration has enabled the declaration and real-time tracking of sales and purchase transactions carried out by taxpayers. This process has helped increase the correct declaration by the businesses that make real financial declarations of their economic activity, but informality still remains a challenge, as some businesses will continue with informal invoicing and under-declaration, remaining part of the grey economy. Furthermore, informal activity often occurs due to exclusion factors, where those with lower skills and education in less productive sectors rely on subsistence income, specifically in agriculture and other sectors where enforcement is weak. High informality is reflected in the low tax base and revenue-to-GDP. Compared to other Balkan countries, Albania has been lagging behind in the tax revenue-to-GDP ratio. Low revenues to the state affect the provision of public goods such as infrastructure, education and health. In the ERP, the government included a measure on strengthening the fight against informality. It aims to reduce the compliance gap linked to VAT, reduce undeclared work and under-declaration of wages, and reduce tax fraud. While details are missing on the concrete efforts that are to be undertaken towards these objectives, among the measures that were put forward for 2024 were the integration and use of data from different tax administration systems and the campaign of registration for VAT purposes.

The business environment needs further improvement, including through reforms on the rule of law, better public procurement, digitalisation of cadastre services, better consumer protection and more electronic payments. Progress has been made in improving the business climate. For example, surveys shows that businesses' satisfaction with public services improved in 2021 and 2022, supported by a higher level of digitalisation. A new 'council of enterprises', composed of public and private sector representatives, has been set up to improve consultation of small and medium-sized enterprises (SMEs). To reduce informality and support fair competition, cash limits were introduced for business-to-business transactions. Nevertheless, inefficiencies and delays in dealings with the administration persist. The regulatory framework is excessively complex and subject to changes, while dealing with the tax administration is perceived as burdensome. Irregularities in public procurement procedures are still perceived as an obstacle for businesses. Digitalising the cadastre still needs to be completed and there are discrepancies in the information on property deeds. Businesses in Albania see corruption as the biggest factor in the existence of the hidden economy. Key enablers of a favourable business climate include the strengthening of the implementation of the justice and anticorruption reform measures as they have considerable potential to trigger economic transformation, reducing the informal economy and corruption. Other crucial elements include the adoption of the unified investment law (which is delayed), putting in place adequate consumer protection laws and reducing cash payments.

While the labour market situation has improved, brain drain and labour shortages pose problems. The labour market registered positive developments with increases in employment and wages in 2023. The employment rate for the population aged 15 to 64 was 67.7% in Q3-2023, reflecting an increase compared to 2022. The labour force participation rate continued to increase, peaking at 76.1% in Q3-2023. Nevertheless, the unemployment rate (15-64 years) remained elevated at 11% in Q3-2023 despite improvements, while youth unemployment was 22% in Q3-2023. These

([26]) Based on the Labor Force Survey of 2020– 2021.

([27]) Informality is very high in agriculture and thus estimates are significantly higher when accounting for this sector.

figures are much higher than the EU-27 averages. The gender gap in labour force participation remains significant, despite improvements. Steady emigration flows since 2015 are shrinking the workforce. Since the pandemic, Albania has lost an estimated 20 000 inhabitants per year, and the trend is likely to continue ([28]). This is causing a continual brain drain, particularly in the case of young people that have been leaving for higher-paid jobs in the EU. Businesses have increasing concerns about labour shortages and report that finding skilled labour is challenging, particularly in remote areas of the country.

Albania has a very high rate of low-skilled adults and high rates of early school leaving. There are significant rural-urban and socio-economic differences in access to education, and the early school leaving rate remains the highest among candidate countries and potential candidates after Türkiye, amounting to 17.5% in 2021 (vs 9.6% in the EU in 2022). Participation in adult learning over the past 12 months has been very low compared to the EU. The overall level of digital skills (23.80% in 2021) is the lowest among all candidate countries and far below the EU average (53.92%). Worryingly, about 27% of young people are not in education, employment or training, which is almost double the EU average. The quality of education and training is still low, as illustrated by the latest OECD PISA results in 2022 ([29]): a significant number of students in Albania are not acquiring the basic skills in reading, mathematics and science needed to fully engage in a knowledge-based society after completing compulsory education. In this sense, Albania needs to scale up its efforts to improve student performance, especially among those from disadvantaged families, those living in rural areas, and those belonging to ethnic minorities. Furthermore, reorienting young people to better match market needs would improve the employability of the workforce. The authorities undertook a number of efforts in supporting vocational education and training (VET), but further progress is required. The number of people attending VET schools is still low compared to other countries in the region and in the EU. The main goal and the most complex challenge of the VET system is still to update, expand and adapt the VET offer to the needs of the labour market in order to reduce the skills mismatch. Furthermore, despite efforts the engagement of the private sector in the VET system is still in its infancy.

Risks of poverty and social exclusion are very high, and the capacity of the social protection system to reduce them is low. Albania has the highest rate of poverty and social exclusion (46.2% in 2020) among all EU Member States and candidate countries for which data are available. Although there is a social assistance scheme, the allowances have low adequacy. 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, mainly informal workers, do not have health insurance.

Albania needs to address the infrastructure gaps and improve connectivity. Public investments have been mainly focused on road infrastructure rather than other modes of transport. Nevertheless, work is ongoing to build and rehabilitate railways, including train stations. ([30]) Improving physical transport infrastructure, especially along the main connectivity corridors, remains essential as this will translate into significant improvements on safety and reduced journey times for exported goods. Main interventions will occur in key trans-European transport network (TEN-T) corridors, such as Corridor VIII and the Mediterranean Corridor, which are vital for the transit of goods and passengers between Albania, the EU and other Western Balkan countries. Digital interconnectivity infrastructure is another area of investment, with the government aiming to complete investments for connecting regional networks with European broadband networks.

Albania continues to be hampered by inefficiencies in the energy sector, including insufficient security of supply. While electricity in Albania is produced 100% from renewables, the

([28]) IMF Albania 2022 Article IV Staff Report.

([29]) Albania had the second lowest score of the five Western Balkan economies that participated in the PISA 2022.

([30]) Investment in rail infrastructure increased significantly from 2019 to 2022 but it is still outweighed by investment into road infrastructure.

energy sector is volatile and its hydro-electricity production is dependent on rainfall. The majority of the total net domestic production is generated from the plants owned by the state-owned company KESH, while the other part is generated by independent and priority generation plants. The energy SOEs are dependent on budget support (subsidies, on-lending and guarantees), while some energy infrastructure needs upgrading. Overall, Albania remains a net importer of electricity. Besides better efficiency in energy use, the deployment of solar and wind resources will improve Albania's energy security and reduce its vulnerability to climate change impacts. Furthermore, better governance of energy SOEs would help improve financial performance and strengthen the resilience of the energy system.

1.5. THE POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS PARTNERS, TÜRKIYE, GEORGIA, REPUBLIC OF MOLDOVA AND UKRAINE

The Economic and Financial Dialogue between the EU and the Western Balkans Partners, Türkiye, Georgia, Republic of Moldova and Ukraine

Brussels, 14 May 2024

[…]

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

1. Ensure compliance with the fiscal rules laid down in the Organic Budget Law requiring a non-negative primary balance and a downward path of the public debt-to-GDP ratio, and accelerate the pace of fiscal consolidation in case of better-than-expected economic and revenue performance. Reduce the emergence of new arrears and the overall outstanding stock, ensuring that arrears do not exceed 2% of total expenditure by end-2024. Increase tax revenue as a share of GDP in a growth-friendly way, including by improving tax administration, increasing registrations for VAT, and reducing undeclared work and tax fraud; revise the Medium-Term Revenue Strategy and ensure its implementation.
2. Improve fiscal risk analysis by building capacity in the related new department, establishing a risk management methodology and publishing a comprehensive Fiscal Risk Statement that covers state guarantees, on-lending to public entities and risks stemming from SOEs and PPPs and identifies risk mitigation measures. Increase SOE transparency and accountability by publishing their annual financial performance reports. Facilitate the implementation of the National Single Project Pipeline (NSPP), including by ranking the projects on the list; and advance the integration of PPPs into the NSPP.
3. Ensure a sufficiently tight monetary policy stance as long as necessary to anchor inflation expectations at levels consistent with price stability, underpinned by a thorough assessment of price developments and possible second-round effects and by publishing additional indicators of underlying price pressures. Enhance risk-based supervision in line with best international and European practices, including by further strengthening the reporting framework across the banking system, applying macroprudential measures to mitigate risks and improve data collection to enable a comprehensive assessment of financial sector risks. Continue to promote 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.

ANNEX 1: OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2023

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey 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 guidance is similar to that of the country-specific recommendations usually adopted under the European Semester for EU Member States. Implementation of the guidance is evaluated by the Commission in the following year's ERP assessments.

The following table presents the Commission's assessment of the implementation of the 2023 policy guidance jointly adopted by the EU and the Western Balkans and Turkey at their Economic and Financial Dialogue at ministerial level on 16 May 2023.

Overall: Partial implementation (47.2%) ([31])	
2023 policy guidance (PG)	**Summary assessment**
	There was **partial implementation** of PG 1:
PG 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.	1) **Substantial implementation:** In 2023, the primary balance achieved a positive outcome. Support to vulnerable households and firms was limited compared to 2022 as the energy sector performed better. Furthermore, according to the ERP there were no untargeted subsidies allocated to state-owned electricity enterprises. The public debt as a share of GDP declined to59.2% in 2023, from 64.5% in 2022. In October 2023 the budget was revised through a normative act and not through the regular revision process for budget amendments – this is not in line with the PG. The revision addressed arrears accumulated throughout 2023 and reallocated unexecuted capital expenditure funds. Furthermore, there was another budget revision in December 2023, also via a normative act.
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.	2) **Partial implementation:** The stock of arrears amounted to 1.83% at the end of Q1-2023, 2.67% at the end of Q2-2023, 2.91% in Q3-2023 and 1.16% in Q4-2023. Thus, the annual target of '2.4% of total expenditure at end-2023' was met. While this is progress, the accumulation of arrears throughout 2023 above the set quarterly targets, and their clearance in October and December 2023 via budget amendments, are not in line with the agreed PG. Overall, there seems to be no systematic approach to prevent arrears from

([31]) 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: https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform programmes-commissions-overview-and-country-assessments_en

	building up.
Inform decisions about new state guarantees and on-lending to public entities by a systematic risk assessment.	3) **Limited implementation:** The Ministry of Finance envisages strengthening the analysis and evaluation of the risks and budget impacts stemming from guarantees and on-lending to public entities. In this respect, it intends to collaborate with the World Bank, to receive assistance through the Government Debt and Risk Management Program, for developing a comprehensive framework for providing guarantees and on-lending, underpinned by a formalised assessment methodology focused on the risk management of existing and potential future portfolio. Discussions with the World Bank have been initiated. The Ministry of Finance made legal changes for setting-up a unit specialised in collecting back unpaid obligations of borrowing entities stemming from on-lending operations and guaranteed loans. The unit is expected to be set-up in 2024.
PG 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.	There was **partial implementation** of PG 2. 1) **Partial implementation:** Tax revenues, as a share of GDP increased in 2023. At the beginning of 2023, a new law 'On Income Tax' was discussed and approved in Parliament. It contains a series of measures from the medium-term revenue strategy (MTRS), linked to the field of direct taxes. Furthermore, a new law 'On property tax' was drafted but it is not envisaged to be adopted sometime soon. Overall, in the last years the government made progress in implementing measures from the MTRS and currently it plans to review the strategy.
Complete procedures to fully establish the national single project pipeline (NSPP) and advance the necessary legal amendments to fully integrate PPPs into the NSPP.	2) **Substantial implementation:** In February 2023, the Instruction of the Minister of Finance No. 4 determined the financial limit (threshold) above which projects are eligible to enter the NSPP. Projects classified as non-strategic and have a total value below the threshold are submitted for evaluation and approval only to the Ministry of Finance. These projects are not part of the NSPP list and the procedures followed for these investment projects on identification, preparation and approval are simpler. Projects classified as strategic require in-depth analyses for the processes of identification of the project, preparation, submission of documents and evaluation until the final approval. These projects are submitted for evaluation to the Ministry of Finance and to the State Agency for Strategic Programming and Aid Coordination. For these

	projects, full feasibility studies are required. The final approval of the new investment projects that are to be financed is done by the Ministry of Finance within the framework of the Medium-Term Budgeting Programme. Regarding the form of financing, if private-public partnership (PPP) is an option, a justification should be provided by comparing this option with the financing standards. Regarding the content of the feasibility study, all financing options should be presented and detailed. The NSPP list has been prepared, updated and approved by the Decision of the Council of Ministers on 26.07.2023. The Ministry of Finance and Economy started to work on a new law to replace Law No. 125/2013 'On Concessions and Private Public Partnership PPP'. The development of a methodology for the evaluation of new concessions/PPPs will be part of the new law.
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) **Limited implementation:** In 2023, expenditure on education, and social protection increased in nominal terms. Due to the wage reform, there has been increases in the salaries of employees in public administration. In 2024 the average salaries of teachers and medical staff are foreseen to increase significantly on the back of the second stage of the public wage reform. Nevertheless, the budget on education, health and social protection remains in line with the average levels of previous years. In the 2024 budget, health expenditures as a share of total expenditure comes to 9.3% (higher than 8.6% in 2023, but lower than 9.6% in 2022). Social protection as a share of total expenditure is foreseen to increase to 29% in 2024 from about 28% in 2023, while education increases by 0.4 pps year-on-year to 7.5% in 2024. No progress on data collection on R&D public expenditure. Work is still underway on designing the methodology for data collection and processing on public expenses dedicated to R&D.
PG 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.	There was **partial implementation** of PG 3. 1) **Partial implementation:** The Bank of Albania has not started to publish additional indicators of underlying price pressures yet. It continued to normalise monetary policy but slowed the pace of tightening despite persistent inflationary pressures, rising risks and accelerating credit growth in lek. Nevertheless, it consistently communicated its readiness to tighten further in a data-dependent manner and in line with the fiscal stance and exchange rate developments.

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.	2) **Substantial implementation:** A guideline for reporting in line with European Banking Authority standards is under consultation. The Regulation to improve data collection on the exposures of the banking system to the real estate sector has entered into force. Significant progress was made in the resolution of the bailiff impasse, although problems remain with its operationalisation. The introduction of IFRS 9 standards, planned for 2023, has been postponed.
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.	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:	There was **limited implementation** of PG 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.	1) **Limited implementation:** Further efforts are needed to improve business support services, for SME on the green transition and digitalisation, including e-commerce. Albania has completed an analysis of the green economy, identifying areas such as renewable energy and the Cut, Make & Trim (i.e. clothing) manufacturing as sectors with potential for action on the green economy. More efforts from the institutions and support to the private sector are needed. Uncertainty remains on property titles, hampering investments..
Enhance energy resilience and diversification towards green energy transition to implement the Green Agenda, notably the electricity, energy efficiency and climate acquis.	2) **Partial implementation:** The Albanian power exchange ALPEX established by the transmission system operators of Albania and Kosovo went live on 12 April 2023. The new Renewables Law adopted in March, brings a series of innovations to the electricity sector. A transition to net billing for self-consumed renewables was scheduled to start on 1 January 2024. Progress has been made in the implementation of the national renewable energy action plan through implementation of PV plants (240 MW, Karavasta and Spitalla). Progress has been achieved with the auction on PV plants and wind farms. The government has imposed obligatory measures, requiring a 15% reduction in electricity consumption. Nominated energy managers are responsible for monitoring progress and reporting. There is not yet a dedicated funding mechanism for energy efficiency, and a long-term building renovation strategy has not yet been adopted.
Implement within 2024 the adopted climate and energy targets based on the National Energy and Climate Change Plans, (NECP) as part of the	3) **Limited implementation:** The 2030 climate targets are yet to be defined in national

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.	legislation, but these have been defined in the NECP. The updated NECP, including the new targets, is expected to be enacted by 2024. The Renewable Energy Operator has not yet been established.
PG 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.	There was **partial implementation** of PG 5. 1) **Partial implementation:** Albania adopted the National Strategy for Research, Science and Innovation 2023-2030 in September 2023. In 2023, the National Agency for Science, Research and Innovation opened the first call for joint academia-business projects in the field of innovation and 10 joint projects were awarded. Albania was included for a second consecutive year in the European Innovation Scoreboard as an emerging innovator. However, it experienced a decrease in its score. Albania advanced in drafting the Smart Specialisation Strategy, which is expected to be adopted in the first half of 2024. Despite the efforts that the country is making on innovation, Albania needs to substantially increase funding on science and research. The new Law on Science, which will include Open Science, knowledge valorisation, research infrastructure and facilities, and will support a stronger R&I ecosystem aligned with the European Research Area policy agenda priorities, is still to be adopted. 2) **Substantial implementation:** The National Implementation Plan for the Youth Guarantee Scheme was approved by the Council of Ministers. The piloting of the Youth Guarantee Scheme was launched by October 2023 and its full-scale implementation will take place in three regions – Tirana, Shkodra and Vlora – in 2023-2024. Initial progress states that 120 young people not in education, employment or training have been identified and are receiving services according to their development plan. Public Employment Services (PES) employees were trained in January 2024 through the EU-IPA funded programme. The Youth Guarantee website has been designed but not launched yet. An initial restructuring of the National Agency for Employment and Skills was completed. However, another review and adjustment should be done based on the pilot phase. A further strengthening of the PES offices beyond the pilot regions needs to be implemented to accommodate a service delivery of the Youth Guarantee and 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.	3) **Partial implementation:** The Labour Market Observatory was established and is now operational. It processes and analyses administrative data generated by the General Directorate of Taxes and the National Agency for Employment and Skills, and can display data by occupation, gender and region. Based on the labour market data, the observatory and other instruments such as the tracking of VET graduates/certificates, a new employment promotion programme (ALMP) related to the provision (through outsourcing) of advanced training in the field of ICT (programming) was drafted in 2023. As at Oct 2023, 1 875 unemployed jobseekers had been trained free of charge by public VET centres on the digital curriculum (short-term course with the 5 basic digital competencies according to the EU Digital Competencies Framework 2.0). An inter-institutional working group was established to identify challenges and increase participation in VET programmes, and a regulation was adopted on transferring from universities to vocational education schools and on making the registration process easier. A dedicated website – https://aftesi.al/ – has been created to help all students who wish to receive detailed information about VET in Albania. Further efforts are needed to strengthen cooperation with the private sector.
PG 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.	There was **partial implementation** of PG 6. 1) **Limited implementation:** Limited progress was made in this regard. However, this remains one of the priorities under the National Strategy on Social Protection 2024-2030, which was adopted in March 2024. The annual indexation mechanism of the Economic Aid scheme is part of the measures under the draft National Strategy on Social Protection 2024-2030. 2) **Partial implementation:** The Social Fund budget for 2023 has increased. However, the full absorption/disbursement of the amount from the municipalities remains a concern, particularly the need for clear sectorial instructions. The Ministry of Health and Social Protection, with support from external technical assistance, is currently reviewing the Social Fund. Subject to the results of this evaluation, the Ministry will consider reviewing the Decision of the Council of Ministers on the Social Fund – particularly on the level of contributions from municipalities and the financial sustainability of services. In certain municipalities,

	social service provision is still lacking or is very low.
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.	3) **Substantial implementation:** Progress has been made on implementing the exit strategy for recipients of economic aid. A Joint Order [32] between the Minister of Health and Social Protection and the Minister of Finance and Economy was signed in January 2022 for the referral mechanism for employment and social integration of working-age family members benefiting from the economic aid scheme. The order builds on the referral model initially piloted for 3 months in Elbasan. In 2022, a special tripartite commission was established, composed of the Regional Office for Social Services, the Regional Office for National Agency for Employment Skills and the Department for Social Services in Elbasan. This model has been rolled out to the 12 regions, entailing immediate assistance and support from the Ministry in cooperation with the national agencies (SSS and the National Agency for Employment and Skills). A protocol for referral is now in place, and the regional stakeholders are implementing the profiling of working-age beneficiaries. Social mentoring is part of the individual plans prepared to support the reintegration of economic aid beneficiaries. The reasons for refusing to take on offers of employment or training are also recorded, analysed and addressed through targeted support measures.

[32] Joint Order No. 52 of 26.01.2022.

Annex 2: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government of Albania submitted the 2024-2026 ERP to the Commission on 15 January 2024.

Inter-ministerial coordination

The drafting and preparation of the 2024-2026 ERP was coordinated by the Ministry of Finance and Economy, with contributions from various ministries and agencies.

Stakeholder consultation

The 2024-2026 ERP was discussed at the Investment Council on 15 December 2023, whereby representatives from business associations, development partners and other interested stakeholders were present. The Investment Council is chaired by the Minister of Finance and Economy and supported by its Technical Secretariat.

Macroeconomic framework

The programme presents a clear and concise picture of past economic developments and covers relevant data available at the time of submission. The information provided is coherent, concise and well structured. The macroeconomic framework provides a good basis for policy evaluation and discussions. The ERP does not provide an analysis of labour productivity, skills shortages, migration, brain drain or details on key investment projects or the investment environment. Statistical tables were complete.

Fiscal framework

The fiscal framework is detailed, in line with stated policy objectives and consistent with the ERP macroeconomic framework. The information about discretionary measures planned for 2024 and 2025 is rudimentary and fragmented. There is no analysis on the long-term sustainability of public finances (demographic developments, pensions, health expenditure). The ERP lacks details on expenditure plans, in particular for capital expenditure. Fiscal data do not yet meet Euopean System of Accounts (ESA) 2010 requirements. Soon after the ERP was submitted, the budget for 2024 was revised in February 2024, including the fiscal projections for 2025-2026. The revenue projections were revised upwards and are now closer to the optimistic scenario presented under the sensitivity analysis in the ERP.

Structural reforms

The chapter on structural reforms follows the ERP guidance note. The ERP does not make a clear link between the analysis of the challenges facing the economy, the proposed reforms and the corresponding budget allocations. A dedicated section provides information on the implementation of the policy guidance for 2023. Reporting on the progress of 2023 structural reform measures is generally of good quality. There is also a table reporting on the implementation of the structural reform measures from the previous ERP (2023-2025), but information on implementation is missing for some measures.

2. BOSNIA AND HERZEGOVINA

2.1. EXECUTIVE SUMMARY

After an economic slowdown in 2023, the economic reform programme (ERP) expects GDP growth to rebound in 2024-2026, mainly driven by exports and investments. In 2023, weaker external demand, higher interest rates and still high inflationary pressures resulted in a slowdown in economic growth (estimated at 2% in the programme). The ERP projects GDP growth to accelerate to around 3% in 2024 and 2025 and to 3.4% in 2026, benefiting from rebounding exports and increasing private and public investment. In line with expected international price developments, inflation is projected to fall to around 1.9% by 2026. An expected rebound in foreign demand, especially tourism, and subdued import growth are projected to reduce the current account deficit to 2.8% of GDP by 2026. Foreign direct investment inflows are expected to remain stable at around 2% of GDP. Risks are mainly on the downside due to the programme's optimistic projections for export growth amid a generally bleak global environment surrounded by considerable uncertainty and weak investment. The expected decline in inflation also appears optimistic given recent high wage pressures, partly reflecting labour shortages due to substantial emigration.

The fiscal framework projects expenditure-driven fiscal consolidation, leading to a small budget surplus in 2026. In view of recently adopted permanent expenditure measures, this benign scenario appears optimistic. On the revenue side, a shift in the growth drivers from private consumption to exports and investment is projected to lower the revenue-to-GDP ratio by 1 percentage point in 2024-2026. On the expenditure side, mostly unspecified measures to contain public consumption and 'other' spending, along with lower investment expenditure, are expected to reduce the spending-to-GDP ratio by 1.6 percentage points (pps). However, the ERP's fiscal framework is neither based on adopted budgets nor on a politically approved medium-term strategy. The planned drop in public investment is in contrast to the policy recommendations jointly adopted since 2015. For 2024, the programme expects a slight increase in the deficit to 0.6% of GDP (mainly due to higher social spending). In 2025, lower spending on public investment and collective consumption (by 0.4 pps and 0.3 pps respectively) is projected to almost balance the budget, while additional spending restraint in 2026 is set to result in a slight surplus of 0.3% of GDP. The debt ratio is expected to decline from 26.7% of GDP in 2023 to 23% in 2026, while interest costs are expected to remain at 1% of GDP, benefiting from the low debt level and high share of concessional lending. The reliability of the fiscal framework is reduced by a lack of political support and weak alignment with EU accounting standards, in particular on the definition of the general government. 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 presented does not properly address the challenges the country is facing, in particular in view of 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:

- **A lack of cooperation among the country's stakeholders and highly fragmented competences severely undermine country-level economic governance.** The country's ability to formulate consistent, countrywide short- and medium-term economic and fiscal objectives and strategies is seriously impeded by a high degree of institutional fragmentation, insufficient cooperation among key stakeholders, and excessively politicised decision-making processes. Furthermore, economic analysis and policy formulation suffers from a lack of accurate and timely empirical data.

- **Fiscal policy lacks a growth-enhancing perspective.** Public spending tends to focus on poorly targeted, short-term social transfers, while neglecting medium-term investment needs in areas such as education, infrastructure and the environment. The level of public investment is low in view of the country's needs and its implementation is often 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 affected by a sizeable informal economy and insufficient transparency of taxable income.

- **Other structural challenges are in the rule of law, the business environment and inefficient public enterprises, the green and digital transition, human capital, and fundamental democratic reforms**. A difficult business environment and weaknesses in the country's single economic space are key factors driving poor labour market outcomes, while holding back improvements in competitiveness and living standards. A persistent issue is the lack of political ambition to tackle regulatory burden and corruption. 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 transition. These challenges are expected to be addressed through key structural reforms identified in the country's reform agenda under the new Growth Plan for the Western Balkans.

Implementation of the policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2023 has been partial. Some effort has been made to cushion the impact of external shocks and increase public investment. Limited action has been taken to improve the efficiency of tax collection or the reporting of contingent liabilities. The analytical capacities of governmental institutions have remained limited, including in the field of statistics. With a two-and-a-half year delay, a new central bank governing board has been appointed. Partial progress has been achieved on simplifying business registration, licensing and permitting procedures and on strengthening the coordination mechanisms for employment policies. However, no progress has been made on harmonising them countrywide, nor in developing a system to monitor and forecast the skills needs in the labour market. Work on reforming the governance of state-owned enterprises (SOEs) is still at an early stage. A first draft of a single integrated energy and climate plan for lowering carbon emissions has been prepared. However, only limited progress has been achieved on adopting state-level legislation for electricity and gas and ensuring their harmonisation at entity level. Agreed measures to improve access to early childhood education and care services for children/families from vulnerable backgrounds and in rural areas have been partially implemented.

2.2. ECONOMIC OUTLOOK AND RISKS

After a strong rebound from the pandemic-induced recession, economic activity slowed in 2023, reflecting a deteriorating international environment and the impact of high inflation. Annual output growth slowed from 3.8% in 2022 to 1.6% in 2023 ([33]), which is currently a weaker outcome than the ERP estimate of 2.0%. To some extent, this slowdown reflects a base-year effect after strong post-pandemic growth in 2021 and 2022, but also weaker than expected external demand, while domestic demand has so far performed better than expected. The main drivers of growth in 2023 were private consumption, but also exports and gross investment (including inventories). Furthermore, relatively low interest rates and an expansionary fiscal policy supported economic growth despite a deteriorating international environment. The labour market remained resilient despite the slowing economy. Registered employment growth decelerated from 2.3% in 2022 to 1.4% in 2023, while the unemployment rate – as measured by the labour force survey (LFS) – dropped from 15.4% in 2022 to 13.2% in 2023. Anecdotal evidence points to a significant outflow of migrant workers, leading to a declining labour force. This already leads to labour supply shortages in

([33]) Macroeconomic and fiscal estimates and forecasts covering 2023-26 have been taken from the ERPs themselves; if available, preliminary macroeconomic and fiscal outturn data for 2022 and 2023 have been taken from the relevant national sources (national statistical office, Ministry of Finance, central bank).

some sectors, such as construction but also health services. Youth unemployment (age group 15-24) returned to pre-COVID-19 levels, dropping to a still high rate of 30.1% in 2023. A relativly high inactivity rate among women contributes to an overall rather low activity rate.

Table II.2.1:

Bosnia and Herzegovina - comparison of macroeconomic developments and forecasts

	2022		2023		2024		2025		2026	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	3.9	**3.8**	1.5	**2.0**	2.0	**2.9**	2.3	**3.0**	n.a.	**3.4**
Contributions:										
- final domestic demand	5.3	**1.6**	2.9	**0.9**	2.5	**2.0**	2.7	**2.3**	n.a.	**2.5**
- change in inventories	2.1	**0.5**	-0.3	**0.6**	0.1	**0.4**	0.0	**0.2**	n.a.	**0.4**
- external balance of goods and services	-2.9	**1.7**	-1.4	**0.5**	-0.5	**0.5**	-0.4	**0.5**	n.a.	**0.5**
Employment (% change)	1.0	**1.0**	1.3	**1.5**	1.4	**1.4**	1.0	**1.5**	n.a.	**1.6**
Unemployment rate (%)	:	**15.4**	:	**13.2**	:	**11.9**	:	**10.5**	n.a.	**9.1**
GDP deflator (% change)	12.2	**9.5**	6.5	**4.4**	2.4	**2.6**	2.0	**2.4**	n.a.	**2.1**
CPI inflation (%)	14.0	**14.0**	6.5	**6.2**	3.5	**3.1**	3.0	**2.2**	n.a.	**1.9**
Current account balance (% of GDP)	-4.6	**-4.5**	-4.5	**-4.3**	-4.0	**-3.7**	-3.8	**-3.0**	n.a.	**-2.8**
General government balance (% of GDP)	-0.4	**1.0**	-0.5	**-0.4**	-1.5	**-0.6**	-0.5	**-0.1**	n.a.	**0.3**
Government gross debt (% of GDP)	29.2	**28.3**	26.5	**26.7**	27.0	**25.6**	26.5	**24.6**	n.a.	**23.0**

Sources: Economic Reform Programme (ERP) 2024, Commission Autumn 2023 forecast.

The programme expects largely investment-driven output growth acceleration, from 2.0% in 2023 to 3.4% in 2026. Compared to last year's programme, the baseline scenario expects similar growth dynamics for 2024 and 2025. This brings average output growth during the 3-year programme period to 3.1%, compared to 2.5% expected in the previous programme. This growth performance is higher than the country's main trading partners such as the EU. Key factors in the country's stronger growth performance are exports, increasing by 8.3% a year on average, and investment, which is expected to increase by 5.2% on average, benefiting from increased spending on infrastructure and energy projects. On potential growth, the 2024 ERP estimates a rate of 3.0% over the programme period. This results in slightly negative output gaps in 2024 and 2025, which are projected to close in 2026. The programme presents an alternative macroeconomic scenario, which assumes less dynamic external demand and higher inflation. This would reduce average annual GDP growth compared to the baseline scenario by 0.7 pps to 2.4% on average in 2024-2026, mainly as a result of lower exports and investment and significantly higher inflation in 2024. On internal risks, the programme points to complex decision-making and slow reform implementation as potential downside risks. However, domestic risks in particular are assessed only in a qualitative way. There are no estimates provided on the fiscal impact of this adverse scenario.

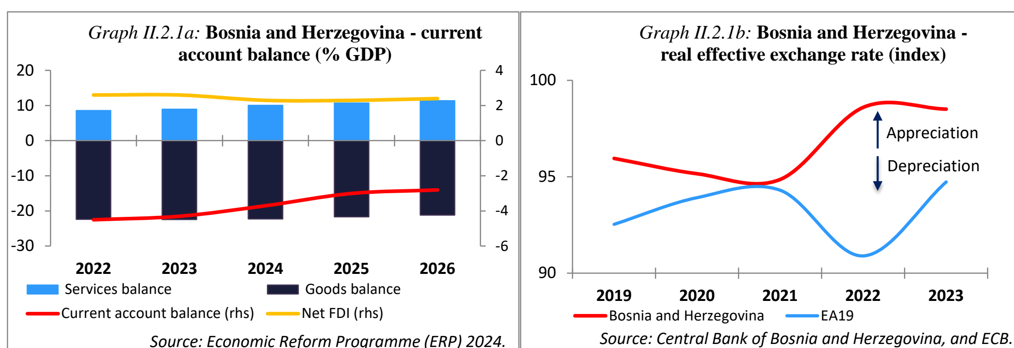
The ERP's overall growth path appears to be on the optimistic side, in particular in view of the currently more pessimistic international outlook. Despite Bosnia and Herzegovina's average growth of about 3% on average over the last 10 years, the programme's macroeconomic growth trajectory of around 3% appears ambitious. In particular, the composition of growth with a strong reliance on external demand and investment appears optimistic, given the country's traditionally strong role of private consumption as a key driver of growth. In view of the programme's assumptions on the external environment, the country's projected export performance suggests significant market share gains, which would have benefited from a more detailed explanation. Given the country's weak track record of reform implementation, the programme appears to be rather optimistic in expecting that structural reforms will translate into higher private and public investment. As in previous years, the macro scenario is more optimistic about public investment than the fiscal framework. For example, in the macroeconomic framework public investment is expected to increase by more than 7% in real terms in 2024-2026. According to the programme's fiscal framework, public investment is expected to decline by around 2.5% in real terms.

The programme expects a swift drop in inflationary pressures. Price pressures started to mount in 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 significantly in 2023, reaching 3.5% in December 2023. On average, consumer price inflation was 6.5% in 2023, compared to 14% in 2022. The programme expects average annual inflation to decline to 3.1% in 2024, easing to 2.2% and 1.9% in 2025 and 2026 respectively. This profile is somewhat more optimistic for 2024 and 2025 compared to the Commission forecast. The ERP expects lower import prices, in particular for energy and food, to be the main factor behind the deceleration in inflation. Unfortunately, it does not elaborate on possible domestic factors for inflation. The absence of an official core inflation series and the late update of the CPI weights is another impediment to assess the country's price dynamics. 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 and increases in mimimum wages not only reflected rapidly rising energy and food prices, but also labour supply bottlenecks due to an increasing scarcity of qualified workers.

The current account balance projection is based on optimistic assumptions about export demand, in particular tourism exports. After a sharp increase – largely driven by import prices – in the current account deficit to 4.5% of GDP in 2022, the programme expects a similar deficit (-4.3% of GDP) for 2023. However, thanks to strengthening export demand and decelerating import prices, the ERP projects a continuous reduction in the deficit, from 3.7% of GDP in 2024 to 2.8% in 2026. This appears optimistic, in view of the country's import elasticities. Furthermore, the programme does not mention the likely negative impact of the introduction of the Carbon Border Adjustment Mechanism (CBAM) on the country's external balances. As in previous years, the programme expects that the deficit in the balance of goods and services will be largely financed by a stable inflow of current transfers, primarily consisting of workers' remittances, accounting for more than 10% of GDP. Foreign direct investment inflows are expected to be between 2¼% and 2½% of GDP, covering the bulk of the current account deficit. This assumption is on the cautious side, given that foreign direct investment inflows were around 3% in 2022 and 2023. After a rather low inflow of greenfield investment in recent years, there seems to be some stronger interest among foreign investors in hydpropower and solar power generation. Furthermore, a number of international financial institutions are supporting investment in the country's transport infrastructure. However, the country's cumbersome business environment, fragmented internal market and political uncertainty so far appear to have impeded a stronger inflow of foreign capital.

The country's external competitiveness deteriorated recently as a result of an appreciation of the real effective exchange rate. However, this largely reflects the strengthening of the euro, to which the domestic currency, the KM is pegged, against the Turkish lira and the Russian rouble. Furthermore, wage increases have been relatively high recently, which could exert upward pressure on the country's export prices. Recent wage increases could also have a negative effect on the country's international price competitiveness.

External competitiveness and current account



The country's banking sector has remained stable so far. Government measures have helped to prevent potential turbulence due to COVID-19 and Russia's full-scale war of aggression. However, the issuance of public guarantees, partly as a result of increased activities of the entities' development banks, has also raised public sector contingent liabilities. The sector's health is regularly supervised by stress test assessments performed by the two entities' banking supervisory agencies. Nevertheless, the Bosnian banking industry remains subject to systemic risk. The legal framework for Systemically Important Banks (SIBs) in Bosnia and Herzegovina is not yet harmonised with international standards. Moreover, the complexity of the institutional set-up contributes to hindering adequate banking supervision. For instance, the Standing Committee for Financial Stability, pivotal for the supervision of the Bosnian financial system, does not convene regular meetings and has not met since March 2022. Nominal credit growth accelerated slightly in 2023, reaching 4.6% by the end of December 2023, while in real terms credit growth remained mostly negative in this period. This partly also reflects the tightening of credit conditions in recent years. Deposit growth accelerated to 7.2% by the end of the year, leading to an increase in deposits as a share of GDP and pointing to an improving liquidity situation among households and businesses. The non-performing loans (NPL) ratio decreased further to 43.8% at the end of 2023, and the ratio of foreign-denominated loans to total loans also continued to decline. However, in some smaller, domestically owned banks, NPL ratios appear to be significantly higher. The country's two supervisory agencies extended measures to contain the increase in domestic lending rates, which helped to preserve the households' repayment capacity. However, such an intervention introduces distortions to the financial market's allocation mechanism and should remain temporary. In view of the country's fragmented financial supervision, a countrywide financial safety net would strengthen the country's shock resilience.

Table II.2.2:
Bosnia and Herzegovina - financial sector indicators

	2019	2020	2021	2022	2023
Total assets of the banking system (EUR million)	16 621	16 824	18 121	19 137	19 932*
Foreign ownership of banking system (%)	84.7	83.1	82.2	74.2	74.3*
Credit growth (average)	5.7	1.1	1.7	4.2	4.6
Deposit growth ** (average)	9.3	5.6	10.1	5.9	7.2
Loan-to-deposit ratio *** (end of period)	89	83	77	76	75
Financial soundness indicators (%, end of period)					
- non-performing loans to total loans	7.4	6.1	5.8	4.5	3.8
- regulatory capital to risk-weighted assets	18.0	19.2	19.6	19.6	19.7
- liquid assets to total assets	29.2	28.6	30.7	30.5	29.0
- return on equity	9.1	5.6	9.6	12.0	15.0
- foreign exchange loans to total loans	53.9	53.9	50.2	43.3	37.6

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

2.3. PUBLIC FINANCE

As in 2022, the budgetary performance in 2023 benefited from stronger than anticipated revenue growth. This allowed a signficant increase in (primarily current) spending, while still meeting the 2023 ERP's initial fiscal target. Based on provisional data, the programme estimates that total revenue rose by 12.1% in 2023, compared to an 8% anticipated increase in the previous programme. Total spending is projected to have increased by 16.1%, compared with last year's 8.7% estimate. The 2024 programme therefore estimates a budgetary surplus of 0.4% of GDP, which is in line with the last year's target. Official fiscal data for 2023, prepared by the central bank, is expected by November 2024 . The main factor behind the better than expected revenue performance is broad-based: social contributions, benefiting from higher wages and increased employment, rose by 14.3% and contributed 5.1 pps to the 12% revenue increase. Indirect taxes rose by 8.3% against a nominal GDP increase of 6.5%. Profit taxes benefited from high energy prices, leading to significant profits in the electricity producing industry. On the spending side, the main elements were strong increases in social transfers (+20.3%) and collective consumption (+14.4%), accounting for some 70% of the total spending increase. Capital spending was 18.1% higher than in 2023. This led to an increase in public investment from 3.5% of GDP in 2021 to 3.9% in 2023. However, due to the rather low level of investment, this increase contributed only 1.8 pps to the overall spending increase of 16.1%. Compared to the initial budget plans for 2023, the main deviation on the revenue side was higher than expected income from social contributions, which were 5% higher than expected. On the spending side, the main unplanned expenditure increases were social transfers, which were 7.4% higher than initially planned, while capital spending was 13% lower than initially budgeted. Overall, the reasons for the fiscal deviations are structural, but also due to ad hoc decisions. The cautious revenue estimates are a structural feature of the country's budgetary process, while the inflation-driven excess revenues were largely unexpected. On the spending side, the additional spending is largely due to discretionary decisions in response to unexpected events, such as high energy prices or the availability of unplanned revenues.

BOX II.2.1: BOSNIA AND HERZEGOVINA'S FISCAL ARCHITECTURE

Bosnia and Herzegovina's public finances consist of four independent budgetary institutions made up by two 'entities' (the *Federation* and *Republika Srpska)*, accounting in 2022 for 58% and 34% of total fiscal spending, the *Brčko District*, accounting for 1.7% of total spending, and the country-level institutions, accounting for 6.5% of total spending.

There are no countrywide fiscal rules in place. Only one of the four budgetary entities has adopted a deficit and debt rule. However, according to the country's fiscal council law there is a countrywide fiscal coordination body, the Fiscal Council, although it is neither independent nor has any authority to influence policy decisions of the four budgetary institutions. This coordinating body is tasked with preparing, in coordination with the four fiscal institutions, an agreed Global Fiscal Framework. This provides a 3-year medium-term revenue and expenditure framework with coordinated fiscal objectives. However, in practice it is often finalised only once the two largest fiscal institutions – the two entities – have completed their budgetary planning process.

As a result, the country's overall fiscal strategy can be described as the sum of the often-diverging fiscal policies of the two key budgetary spenders, i.e., the *Federation entity* and the *Republika Srpska entity*. In recent years, *Republika Srpska entity* has often applied a significantly more expansionary fiscal stance. As a result, their public debt levels differ considerably.

Three out of the four budgetary institutions, accounting for 95% of total spending, pursue independent fiscal policies. The fourth budget institution primarily covers the administrative expenses of the country's state-level institutions, such as the Council of Ministers, state-level ministries or the country's foreign representations.

The budgets for the central governments of *Republika Srpska* entity and *Brčko District* were adopted in December 2023, while the budget for the *Federation entity* followed on 25 January. The budget for the country-wide institutions still is not adopted. The Global Fiscal Framework was adopted on 25 January. Unfortunately, information on all these budgets has not been included in the ERP.

Due to the late adoption of the country's medium-term fiscal strategy (the Global Fiscal Framework), the programme presents only projections for 2024-2026 based on historic trends and basic assumptions. On the revenue side, the programme expects a gradual decline in the revenue-to-GDP ratio (from a preliminary 41.9% in 2023 to 40.9% in 2026), mainly as a result of a declining share of private consumption in GDP. Due to indirect tax revenue increasing at a rate below nominal GDP growth, the share of tax revenue in GDP is expected to decline by 0.6 pps between 2023 and 2026. The share of income from social contributions is expected to increase by 0.1 pps, reflecting the effects of measures taken in 2023. On the expenditure side, the ERP expects a 1.6 pps decline in the spending ratio mainly driven by low growth in public consumption and 'other' expenditure, with these two spending categories each decreasing by 0.6 pps. The growth in public investment spending is projected to remain below nominal GDP growth, with a 0.4 pps fall in investment in 2023-2026 to just 3.6% of GDP. Relatively low investment spending is not in line with the country's needs and also conflicts with the policy guidance jointly agreed since 2015. Based on these assumptions, the ERP expects a moderate deficit in 2024 (0.6% of GDP), a largely balanced budget in 2025 and a slight surplus (0.3% of GDP) in 2026. The general government deficits in 2024 and 2025 are largely the result of deficits in *Republika Srpska*, while the *Federation's* budget is expected to be in surplus. The *Republika Srpska* entity indicates that part of the deficits are expected to be financed by concessional lending from international financial institutions (IFIs). However, in the past this source of financing often did not materialise. The programme's fiscal stance (the change in the cyclically adjusted primary balance) targets a slight fiscal impulse of 0.2% in 2024 and slight negative fiscal impulses in 2025 and 2026, when the economy is projected to be at its potential output level or slightly above.

The programme projects a slight increase in the general government deficit to 0.6% of GDP (+0.2 pps) for 2024 mainly as a result of higher social transfers, while the main revenue and spending positions have been kept largely unchanged as a percentage of GDP. However, this is just a programme estimate – when the ERP was drafted, only one of the four main budget

users, Republika Srpska's central government, covering about one quarter of the country's total spending, had adopted its 2024 budget,. The programme expects total revenues to increase by 5.7%, while expenditures are projected to increase by 6.3% mainly due to higher spending on social transfers (+8.8%) and collective consumption (+5.4%). Capital spending is expected to increase by 7%, increasing public investment spending as a share of GDP only slightly from 3.9% in 2023 to 4.0% in 2024. Significant savings on 'other expenses' (-0.2 pps of GDP) are projected, which unfortunately are not described in further detail. Overall, this benign fiscal scenario appears optimistic in view of recently adopted permanent expenditure measures.

Table II.2.3:

Bosnia and Herzegovina - composition of the budgetary adjustment (% of GDP)

	2022	2023	2024	2025	2026	Change: 2023-26
Revenues	39.8	41.9	41.9	41.3	40.9	-1.0
- Taxes and social security contributions	35.9	37.7	38.0	37.7	37.4	-0.2
- Other (residual)	3.9	4.2	3.9	3.6	3.5	-0.7
Expenditure	38.7	42.2	42.5	41.4	40.7	-1.6
- Primary expenditure	38.1	41.3	41.5	40.4	39.7	-1.6
of which:						
Gross fixed capital formation	3.5	3.9	4.0	3.6	3.6	-0.3
Consumption	16.5	17.7	17.7	17.4	17.1	-0.6
Transfers & subsidies	16.0	18.0	18.4	18.2	17.9	-0.2
Other (residual)	2.1	1.6	1.4	1.3	1.1	-0.6
- Interest payments	0.6	0.9	1.0	1.0	1.0	0.0
Budget balance	1.0	-0.4	-0.6	-0.1	0.3	0.6
- Cyclically adjusted	0.7	-0.4	-0.6	-0.1	0.2	0.5
Primary balance	1.6	0.6	0.4	0.9	1.2	0.7
- Cyclically adjusted	1.3	0.6	0.4	0.9	1.1	0.6
Gross debt level	28.3	26.7	25.6	24.6	23.0	-3.6

Sources: Economic Reform Programme (ERP) 2024, Commission calculations.

The relatively low debt level suggests that there is fiscal space to support stronger investment and growth. The programme expects a continuous and stable decline in the debt ratio for 2024-2026, from 26.7% of GDP in 2023 to 23% in 2026. The main debt-reducing factors are primary surpluses with a 2.5 pps cumulative debt-reducing impact in 2024-2026. Real GDP growth and inflation lead to a further debt reduction of 2.2 pps and 1.7 pps respectively. Interest costs are estimated to amount to 1% of GDP per year, increasing the debt ratio by 3 pps over the 3-year programme period. Due to tightening financial conditions, the implicit interest rate registered a significant increase from 2.1% in 2022 to 3.5% in 2023. The ERP calculations imply a moderate further increase in the implicit interest rate to 4% in 2024 and to 4.1% in 2025 and 2026.

Overall, the country's debt level is relatively low and benefits from low financing costs thanks to a high share of IFI funding, with the World Bank, the European Investment Bank and the European Bank for Reconstruction and Development accounting for 27.2%, 23.7% and 11.7% of total external public debt respectively in 2023. IMF debt sustainability analyses and stress tests point to an overall sustainable public debt situation, with only a moderate risk in the event of a banking sector crisis.

BOX II.2.2: DEBT DYNAMICS

Bosnia and Herzegovina

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

	2022	2023	2024	2025	2026
Gross debt ratio [1]	28.3	26.7	25.6	24.6	23.0
Change in the ratio	-3.7	-1.7	-1.0	-1.0	-1.6
Contributions [2]:					
1. Primary balance	**-1.6**	**-0.6**	**-0.4**	**-0.9**	**-1.2**
2. 'Snowball effect'	**-3.1**	**-0.8**	**-0.4**	**-0.3**	**-0.3**
Of which:					
Interest expenditure	0.6	0.9	1.0	1.0	1.0
Growth effect	-1.1	-0.5	-0.7	-0.7	-0.8
Inflation effect	-2.7	-1.2	-0.7	-0.6	-0.5
3. Stock-flow adjustment	**1.1**	**-0.3**	**-0.2**	**0.2**	**-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) 2024, Commission calculations.

Risks to the programme's fiscal scenario appear to be tilted towards higher than planned deficits and a shift of spending towards social transfers. While the country has a track record of cautious revenue assumptions, there is a risk that upcoming municipal elections could lead to further increases in public consumption and social transfers. In addition, recently adopted permanent (social) expenditure measures risk either resulting in significantly higher deficits during the programme period, or requiring substantial spending cuts in other areas. Furthermore, economic growth could be lower than expected, resulting in lower than anticipated revenue growth. As in previous years, there is a risk that planned investment increases will not materialise due to weak implementation capacities or the priorisation of available funds to finance additional social transfers.

BOX II.2.3: SENSITIVITY ANALYSIS

The ERP's sensitivity analysis refers the programme's alternative scenario and its assumption of higher inflation. This leads to largely unchanged GDP nominal growth rates, which should limit the impact of lower growth on tax revenues. Unfortunately, the programme does not elaborate on the possible effects of lower growth and higher inflation on the spending side, for example the additional costs of unemployment benefits or a higher public wage bill due to higher wage increases.

Overall, the sensitivity analysis appears to be incomplete and is on the optimistic side. Although the annex tables contain data on contingent liabilities, there is no analysis of this topic. The level of contingent liabilities is expected to drop from 3.5% of GDP in 2023 to 2.9% in 2024. This appears to be rather low. No fallback fiscal positions are mentioned. There is also no data on long-term projections on contingent liabilities and future health and pension expenditures.

The quality of public finances and budget planning remains low. There is no countrywide coordination of lower-level fiscal policies. The country's public finances continue to be plagued by a

lack of medium-term planning and a strong focus on social transfers. In addition, the fiscal situation of publicly owned companies, many of which continue to rely on state support, is far from transparent. The programme does not present sufficient plans to improve the spending structure. As in previous years, it also lacks a sustained pro-growth focus. This approach is not in line with the policy guidance jointly adopted in the last 7 years, which called for higher investment spending and a more growth-oriented fiscal policy.

The country's fiscal framework continues to suffer from weak coordination of a highly fragmented fiscal system, lengthy decision procedures and low-quality fiscal data. There is neither a countrywide fiscal rule nor an independent fiscal council in the sense of the EU *acquis*. There is currently no credible or effective *ex ante* medium-term fiscal framework – in contrast to existing legislation, a countrywide fiscal framework is only adopted once the main fiscal entities have adopted their own budgets. Budget planning is often based on outdated information and tends to underestimate revenue performance, leading to supplementary budgets adopted in the second half of the year to adjust spending on updated revenue estimates. Due to frequent delays in the budget adoption process, spending in the first few months of the year is often based on the previous year's spending, which poses substantial problems during times of high inflation. The availability, quality and timeliness of fiscal data is rather poor, the result of a highly fragmented fiscal set-up and regulations, weak compliance with existing standards and insufficent cooperation among the numerous stakeholders. There is a significant degree of non-alignment with EU public sector accounting standards, particularly for publicly owned enterprises, which seriously impedes the assessment of the country's actual fiscal position. As a result, both the deficit and debt ratio could be significantly different than reported. The central bank implements an EU-supported project to improve the accounting of historic general government data. The programme mentions intentions in one of the three regional governments to improve their risk assessment, although it fails to provide sufficient details.

2.4. MAIN MACRO-RELEVANT STRUCTURAL CHALLENGES

In November 2023, the Commission proposed a New Growth Plan for the Western Balkans ([34]) with the aim of supporting the region's economic convergence and accelerating the accession process. The plan involves a Reform and Growth Facility (EUR 2 billion in grants, EUR 4 billion in loans) that is to be disbursed in 2024-2027 as investment ([35]) and budget support in exchange for implementing reforms that are to be set out in reform agendas prepared by the Western Balkan partners. The New Growth Plan is therefore an important tool to increase reform incentives to boost growth and convergence. In this context, with a view to ensuring an integrated surveillance of Bosnia and Herzegovina's economy, this chapter briefly outlines the main structural challenges facing the country.

A slow pace of catching-up with EU living standards points to significant structural weaknesses. Bosnia and Herzegovina has a small open economy. GDP growth averaged 3% over the last decade, which is low when taking into account the country's relatively low GDP per capita of about one third of the EU-27 average. The main underlying reason for the country's moderate growth performance is the slow speed of structural reforms.

Economic governance is weak and highly politicised, with frequent delays in overdue structural reforms due to political stalemate and disputes, often related to the fragmented distribution of competences. Bosnia and Herzegovina's short-and medium-term track record in adopting and implementing overdue structural economic reforms remains poor, in particular on

([34]) https://neighbourhood-enlargement.ec.europa.eu/enlargement-policy/new-growth-plan-western-balkans_en.

([35]) Infrastructure investments need to comply with the EU environmental acquis, national and international nature protection and water management obligations, ensure public participation and consultation, and guarantee high quality environmental impact assessment reports that include cumulative impacts on nature and biodiversity.

countrywide measures. The main reasons for this are a lack of political commitment and insufficient cooperation among key stakeholders, together with highly politicised decision-making processes and institutional fragmentation. Implementation of the policy guidance jointly adopted each year at the Economic and Financial Dialogue with the EU remains limited and lags behind its peers.

Political leaders and judicial institutions are failing to tackle widespread corruption. Transparency International ranks Bosnia and Herzegovina 108th out of 180 countries in its 2023 Corruption Perception Index, making it the worst performer in the Western Balkans. Just 14% of businesses surveyed in Bosnia and Herzegovina say that the fight against corruption there is effective – a lower proportion than any other country in the region – and a higher proportion of businesses than in any other Western Balkans country had to make irregular payments. Important measures in this respect would be to develop comprehensive anti-corruption strategies and action plans for the state level, the two entities and the Brcko district, to amend (at the state-level and the RS entity) or adopt (at the level of the Federation entity) whistleblower protection laws in line with international standards, to ensure the registration and disclosure of the beneficial ownership of legal entities and to strengthen the capacity to effectively investigate, prosecute and adjudicate high-level corruption cases.

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. Businesses that wish to operate across the entire economy still face technical and administrative obstacles and frequently need to obtain the same licences 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 licences, 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 Western Balkans country to cite the lack of a fully digitised process for applications and approvals of licences as a major obstacle, with 76% of businesses indicating it to be at least a 'moderate' obstacle, compared with a regional average of 49% (Balkan Business Barometer 2022). Public sector spending is not coordinated on a country level and is routinely driven by short-term considerations, often focusing on upcoming elections. Overall, the public sector, in particular many of the still substantial public enterprises, are oversized and inefficient and pose substantial fiscal risks for the already constrained public finances.

The overall quality of education remains inadequate despite sizeable spending. According to data from 2021, public spending on education accounted for some 4% of GDP. When adding private spending and support by foreign donors, the overall amount is nearly 5% of GDP. However, the education system fails to provide Bosnia and Herzegovina's labour force with the skills and knowledge necessary for smooth integration into the labour market. Inadequate education is an important factor behind the particularly high youth unemployment rate (30.1% in 2023), more than twice the country's overall unemployment rate. Insufficient coordination among the numerous stakeholders results in a lack of common standards for various levels of education and differences in the quality of teacher training and performance evaluation. Insufficient coordination is a problem that exists not only between the entities but also within the Federation entity among the various cantons. Teaching curricula continue to be outdated and are still not sufficiently aligned with the country's needs. There has been little change in levels of educational attainment in recent years. 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 and also lack sufficient providers. This is to some extent a supply issue, but also a structural problem, reflecting a weak training system and a lack of coordination with the private sector and public employment services. Participation in early childhood education and care is significantly lower than in the EU and elsewhere in the region. Furthermore, access to Early Childhood Development (ECD) centers is insufficient. The illiteracy rate continues to be around 3%, largely as a result of a relatively high illiteracy rate among women. Bosnia and Herzegovina's irregular and inconsistent participation in international assessments, such as the Programme for International Student Assessment (PISA) or the Trends in International Mathematics and Science Study (TIMSS) prevents the country's from better understanding educational trends and challenges.

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 web page 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 the different levels of 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. 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.

Moving away from coal-based electricity and improving energy efficiency requires legislation and investments. Bosnia and Herzegovina has one of the most energy-intensive output generation processes in the Western Balkans and remains heavily reliant on lignite coal. The level of emissions from coal-fired power plants is therefore a major concern. A reliable and secure energy supply is still impeded by the lack of a single regulatory framework to attract investment in a low-carbon energy sector. Adopting laws on renewable energy and energy efficiency should be a priority, together with state-level legislation on electricity and natural gas with which the entities must comply. Bosnia and Herzegovina should also design and implement a comprehensive building renovation strategy to improve energy efficiency. Furthermore, there is a need to prepare for the planned phased implementation of the EU Carbon Border Adjustment Mechanism (CBAM) entering into force in 2026. Lack of progress in these areas contributes to the poor business environment and will prolong the move to decarbonisation, the transition to renewables and improved energy efficiency that the current energy crisis has made even more urgent.

2.5. THE POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS PARTNERS, TÜRKIYE, GEORGIA, REPUBLIC OF MOLDOVA AND UKRAINE

The Economic and Financial Dialogue between the EU and the Western Balkans Partners, Türkiye, Georgia, Republic of Moldova and Ukraine

Brussels, 14 May 2024

[...]

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

1. Adopt the Global Fiscal Framework in time so that it provides effective guidance for the budget preparations of all budgetary entities (i.e., the BiH Institutions, the Federation entity, the RS entity and the Brcko district) and ensure the timely adoption of the budgets of all entities. Increase the share of government capital spending in GDP by adopting measures improving public investment management and allowing for an accelerated implementation of those investment projects that have been subject to a clear positive cost-benefit assessment. In order to strengthen the efficiency of tax collection, improve the effective exchange of taxpayer information between 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. Include in the forthcoming ERP 2025-2027 (i) a first assessment of fiscal risks and contingent liabilities related to publicly owned enterprises, and (ii) concrete policy measures to manage such risks and contain the emergence of new contingent liabilities. With a view to improving the quality of data aggregation and reporting, strengthen the analytical capacities of all institutions responsible for fiscal accounting and planning, 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, in particular by agreeing on the national account sectorisation, and increase efforts to improve the coverage and timeliness of all statistics.
3. Continue to thoroughly assess 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. Continue to safeguard the integrity of the currency board arrangement and the independence of the central bank. Enhance risk-based supervision in line with best international and European practices, phase out the temporary measures potentially affecting market mechanisms in setting interest rates, initiate the setting up of a single resolution fund and improving data collection to enable a comprehensive assessment of financial sector risks.

ANNEX 1: OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2023

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey 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 guidance is similar to that of the country-specific recommendations usually adopted under the European Semester for EU Member States. Implementation of the guidance is evaluated by the Commission in the following year's ERP assessments.

The following table presents the Commission's assessment of the implementation of the 2023 policy *guidance* jointly adopted by the EU and the Western Balkans and Turkey at their Economic and Financial Dialogue at ministerial level on 16 May 2023.

Overall: Partial implementation (37.5%) ([36])	
2023 policy guidance (PG)	**Summary assessment**
PG 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.	There was **limited implementation** of PG 1: 1) **Partial implementation:** Funds from the EU Energy Support Package, amounting to about 0.3% of GDP, have been distributed by all governmental levels for households and energy efficiency measures (for households and micro-, small and medium-sized enterprises). However, a lot of the available fiscal space was actually used for permanent increases of wages and pensions while the targeting of social support measures has been rather limited. Furthermore, instead of using this opportunity for establishing a more permanent system of improved social targeting, the chosen approach was more of a one-time nature.
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.	2) **Limited implementation:** According to the ERP, capital spending have increased in 2023, from 3.5% to 3.9% of GDP, but this is not yet confirmed by budget execution data. According to adopted entity budgets, public investment spending is set to decline in 2024. Steps to improve public investment management have remained limited.
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	3) **Limited implementation**: No progress was made on improving the efficiency of tax collection or improving data exchange between the four tax administrations in Bosnia and Herzegovina in 2023. As in the previous year, there were also no steps taken to clarify the constitutional competence for establishing a central (i.e. countrywide) registry of bank accounts

([36]) 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.

individuals, in line with the EU acquis	of private individuals
PG 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.	There was **limited implementation** of PG 2: 1) **Partial implementation**: In the RS, the first report on fiscal risks of public companies for 2022 was completed in the third quarter of 2023. The report addresses the fiscal risks of 20 public enterprises of special interest.T All hospitals in FBiH are now regularly reporting on arrears to the FBiH MoHs, and the joint commission with representatives from MoF, MoH and PMs office is overseeing the implementation of the Law on financial consolidation and restructuring in health sector in FBiH. In RS around 15 primary health centers were included into the Treasury, and their arrears cleared. The RS Government has invited the remaining primary health centers to be included into the Treasury system. This means that all arrears in primary health centers will be cleared by end 2025, and hence more financial discipline introduced.
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.	2) **Limited implementation:** Comprehensive technical assistance, financed by the EU, has been provided to all stakeholders. However, the practical impact on the quality of fiscal accounting and the ERP has remained limited, and the ERP was again submitted with a signficant delay. The capacity of the BiH MoFT dealing with theERP-related fiscal accounting has been slightly increased.
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) **Limited implementation:** The country still needs to prepare and agree on a master plan for national accounts and on the classification of regions equivalent to NUTS classification. The labour force survey is produced regularly. Progress was made in the government finance statistics, however efforts should be continued to expand data availability and increase quality. Central Bank staff are working closely with a statistics twinning project, and important improvements are being made. Substantial efforts are still needed to improve coverage and timeliness of all statistical data, and priority should be given in the areas of national accounts, excessive deficit procedure and government finance statistics.

PG 3:	There was **partial implementation** of PG 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.	1) **Partial implementation:** While the central bank kept monitoring carefully the evolution of price dynamics, the limitations due to data availability remain. The statistical office does not publish a core inflation series and the weights of the CPI are outdated and published with unusually long lags. This complicates and constrains a proper assessment of price developments.
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.	2) **Limited implementation:** The reporting and risk management frameworks were gradually enhanced, inter alia by improving the legislation governing credit risk management and classification of exposures. The bank resolution framework is still not fully operational and needs to be strengthened further. While the two banking agencies have continued to co-operate smoothly following harmonised approaches, there is still a lack of a single resolution fund. In addition, the remaining obstacles of an effective non-performing loans (NPL) resolution framework have not been addressed, such as facilitating out-of-court restructurings and amending the tax treatment of NPL sales to specialised companies.
Safeguard the integrity of the currency board arrangement and the independence of the central bank, in particular appoint Governing Board members without further delay.	3) **Full implementation**: The central bank continued to ensure full convertibility of the domestic currency by backing monetary liabilities with net foreign exchange reserves. In addition, after two and a half years of uncertainty, a new governing board of the central bank has been formed, including the appointment of a new governor.
	There was **limited implementation** of PG 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.	1) **Limited implementation**: Engagement with work related to the second cluster, i.e., progress with aligning with internal market acquis, has been limited. Electronic registration of businesses is functioning in the Republika Srpska and in Brčko District, whilst in the Federation digitalisation of court documents has been finalised and pilot projects in Sarajevo, Mostar and Travnik registration courts have been established, although electronic registration is still not working. As a result, the registers are not fully functional or have not been connected, and a way of coordination has not been established. Efforts are still needed to harmonise company law at country level. Administrative procedures have yet to be simplified, and some initiatives are taken in both entities on the issuance of e-construction permits (pilot project in Banja Luka and Gradiska in the RS entity and facilitation of inspections in Ze-Do Canon).

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.	2) **No implementation:** There were some discussions, but these were interrupted and then restarted. But there are no concrete drafts of the law, and a working group has not been formed to draft the law, 3) **Partial implementation**. Oversight units in both entities have been set up, in the General Secretariat and the Ministry of Finance. In the RS entity, units have allocated human resources, while in the Federation entity the recruitment process is still ongoing. No countrywide register exists. The register in the Federation entity is accurate and publicly available and incudes major key performance indicators and organisational information. In the RS entity, the registry is outdated (from 2015) with very limited information. There is some progress on contingent liabilities, with a first report on fiscal risks in the RS.
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	There was **partial implementation** of PG 5: 1) **Partial implementation:** The first draft of the national energy and climate plan (NECP) was submitted to the Energy Community secretariat (ENCS) in mid-2023. The country is currently in the process of addressing the comments on the plan. The aim is of adopting it by 30 June 2024 (which is the legal deadline for the adoption). 2) **Limited implementation:** A working group for drafting a new law on electricity and gas was established in October 2023. The authorities are currently preparing a first draft of the law. 3) **Partial implementation:** All authorities are currently finalising the building renovation strategies.

	There was **limited implementation** of 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.	1) **Partial implementation:** The institutions have coordinated their joint work, depending on the political outlet, and have established an inter-ministerial task force to develop the Youth Guarantee (YG) Implementation Plan. The drafting process is still ongoing, as there have been serious delays in the Federation entity due to late nomination of their YG coordinator and political stalemate caused by elections. The Republika Srpska entity and Brčko District have advanced significantly. They have already prepared their draft action plans (to form an integral part of the overall YG Implementation Plan for Bosnia and Herzegovina) and are now waiting for the Federation entity to catch up with them and work on the comprehensive plan.
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.	2) **No implementation:** No progress
Improve access to early childhood education and care services towards children/families with vulnerable backgrounds and in rural areas.	3) **Partial implementation:** Bosnia and Herzegovina has announced measures to address the issue of deinstitutionalisation through the draft roadmap. It aims to end institutional care, improve the system through a set of measures to plan the transformation, downsizing and/or closure of residential institutions, while establishing diverse other childcare services regulated by rights-based and outcome-oriented standards. These measures are promising, but have not been implemented yet. Implementation should be monitored. The planned measures should be addressed in the coming period also under the EU-funded programme to support independent living/community living of people with disabilities and/or children without parental care. The activities pertaining to the development of tools for early detection, intervention and support for children and adults at risk of social exclusion aim to ensure the inclusion of children with disabilities. It ensures their optimal development thanks to the reform of the assessment, referral and monitoring system. The child and the entire family are also offered timely and coordinated support from local and other institutions. The implementation of this activity will ensure that all children have equal development conditions and system support. The measure also encompasses the ongoing training of professional bodies and coordinators from the social protection, education and

	health sectors, as well as the establishment of an electronic database on children with disabilities. This database will serve, among other things, to gather data on the needs for the establishment of social services in real time.

ANNEX 2: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Council of Ministers adopted and submitted the 2024-2026 ERP on 28 February 2024, i.e. 7 weeks 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. Bosnia and Herzegovina needs to strengthen its coordination capacity on economic policy, build consistent political support for the ERP and increase its visibility and coherence.

The macroeconomic framework is based on rather old data. The fiscal framework contains neither details on adopted budgets nor a politically approved medium-term fiscal scenario. Instead, the fiscal outlook is based on historic trends and assumptions.

Inter-ministerial coordination

The preparation of the ERP was centrally coordinated by the Directorate for Economic Planning. The Council of Ministers adopted the activity plan - which empowered the Directorate to coordinate the drafting process - only on 9 November 2023.

Stakeholder consultation

No countrywide stakeholder consultation took place.

Macroeconomic framework

The description of recent macroeconomic performance suffers from a lack of up-to-date data. The macroeconomic framework 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. This is partly a reflection of the country's insufficient administrative capacity and lack of cooperation among the various stakeholders.

Fiscal framework

The programme continues to lack a consistent, complete and sufficiently detailed presentation of the country's fiscal policy for 2024 and its budgetary plans for 2025-2026. This seriously impedes the 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 is not yet in line with the European System of Accounts (ESA 2010). The submission of the fiscal notification is still in an experimental phase.

3. GEORGIA

3.1. EXECUTIVE SUMMARY

Following robust GDP growth of 7.5% in 2023, the Economic Reform Programme (ERP) expects growth to remain solid at around 5% over 2024-2026, close to potential output growth. Investment and consumption (both private and public) were the main growth drivers in 2023. On the supply side, growth in 2023 was driven by services and construction, while manufacturing declined reflecting weaker global demand. The exceptionally strong growth performance in 2021-2023 was partly due to temporary factors related to post-pandemic recovery and the unusually large inflows of skilled migrants and money transferred from Russia following Russia's full-scale invasion against Ukraine. Many of these migrants work remotely for foreign companies and brought part of their savings with them. Their arrival triggered the creation of new businesses, particularly in the IT sector, stimulated domestic consumption and wage growth, but also led to currency appreciation and a spike in the rental market. However, the number of migrants appears to have peaked in 2023 and has already started to drop. The risk of their sudden reversal appears limited, considering that a significant share of the migrants are expected to stay in Georgia. While wage growth remained strong at the end of 2023, given the skills shortages in the labour market, the inflows of funds have not fuelled significant macroeconomic imbalances, also thanks to the prudent policy response of the authorities.

Looking ahead, economic growth is set to be supported by the expected easing of monetary policy, low inflation, increasing wages and a continuous inflow of remittances. Consumption and investment are expected to remain the main growth drivers in 2024-2026, while the contribution of net exports is expected to remain negative. Supported by the projected economic expansion, labour market outcomes are set to continue improving, albeit slowly and from a weak initial position. Inflation moderated to below 1% in late 2023, due to the tightening of monetary policy, falling global commodity prices and the appreciation of the Georgian currency. Price growth is expected to stabilise around the central bank's target of 3% from the second half of 2024 onwards as the downward pressures on prices ease. The current account deficit is benefiting from an expansion of incoming tourism and is much lower than before the pandemic. The ERP envisages it stabilising at below 5% of GDP over the programme period, but the external balance remains vulnerable due to a weak export base, which is highly sensitive to swings in global demand, and the large money transfers from abroad. The economic scenario in the ERP seems plausible overall but is subject to a high degree of uncertainty, linked specifically to the geopolitical risks affecting the large tourism sector and further dampening global growth.

The ERP's fiscal scenario projects a gradual decrease in the general government deficit and public debt-to-GDP ratios, with both projected to stay well below the respective targets set by the national fiscal rules. Similar to 2022, the general government deficit [37] in 2023 (2.2% of GDP) turned out to be significantly lower than the 3% of GDP planned for in the budget. This reflected stronger-than-projected tax revenue growth thanks to the booming economy and one-off factors linked to increases in fees charged by general government entities. Public debt eased slightly to 38.2% of GDP at the end of 2023 on the back of high nominal GDP growth and remains well below the 60% of GDP national threshold and also below the safety limit of 40% of GDP imposed by the authorities to avoid exceeding the above threshold if there are external shocks. The ERP envisages revenues peaking in 2024 on the back of mostly permanent tax measures with a decrease afterwards largely due to other revenues being lower. At the same time, the expenditure ratio is set to rise in 2024 as a result of an indexation of wages and social expenditure reflecting past inflation, ongoing reforms of health care and social protection, and higher interest cost. A gradual decrease in public expenditure is projected in

[37] The general government deficit in 2023 has been updated after the adoption of the ERP and amounted to 2.2% of GDP. The deficit is defined in the ERP in the same way as in Georgia's budget laws.

the following two years largely due to lower investments, as key infrastructure projects are reaching completion. Investment is nonetheless expected to remain well above the EU average, reflecting Georgia's large investment needs, especially in transport and energy infrastructure. The general government deficit and the public debt ratios are projected to moderate slightly in the medium term, allowing for a gradual build-up of buffers against the national deficit ceiling of 3% of GDP. This is prudent given the heightened global uncertainty and tight international financing environment, which could result in lower external demand and therefore affect Georgia's economic and fiscal performance. The fiscal policy stance is expected to move from a broadly neutral setting in 2024 to a counter-cyclical stance in 2025, with a small negative fiscal impulse. The authorities continue to improve the already sound fiscal governance framework, while reducing the very high share of foreign currency debt.

The main challenges facing Georgia are the following:

- **In a medium-term perspective, Georgia faces the challenge of ensuring sufficient financing for priority outlays such as social protection, education and healthcare, along with investments in infrastructure and R&D to underpin productivity growth and reduce the significant regional disparities.** Given the constitutional restrictions on increasing the main taxes, the authorities are pursuing a strategy of broadening the tax base through identifying and quantifying tax expenditures, where in 2024 they plan to publish an analysis of the large agricultural sector and implementation is expected to start under the 2025 budget. The authorities are also preparing a medium-term revenue strategy to identify and address the impact of longer-term challenges posed by the demographic and climate developments on public finances.
- **In the area of public finance management, there is room to make further improvements.** Efforts to make public investment more efficient hinge crucially on the capacity and expertise in the relevant line ministries in charge of public investment projects, which remains limited. Therefore, the authorities plan to introduce a new electronic tool that would allow for closer monitoring of public investments at all stages and help prepare the required analyses. On public debt, the main challenges relate to the high share of foreign currency denominated debt and the relatively small market for local currency debt. To address these, the ERP presents steps to continue issuing benchmark bonds and boosting the capacity of primary dealers. These efforts are anchored in a broader strategy to develop the local capital market. As regards state-owned enterprises, the authorities adopted the public corporation reform strategy in December 2022. The implementation of this strategy and the adoption of the law on public corporations have been delayed. However, the authorities are making progress on improving the fiscal oversight over state-owned enterprises included in the general government sector by gradually bringing their cash management under the Single Treasury Account.
- **Georgia's competitiveness is hampered as its economy and exports are dominated by low value added sectors, with low productivity in agriculture, high informality and shortcomings in economic governance.** Georgia's value chains are still dominated by low-value sectors and the country's export base remains narrow. Agriculture, a key sector in terms of employment, faces major competitiveness challenges, such as those related to land registry and land management, low productivity and fragmentation. Long-overdue reforms in irrigation are starting while land management reform is well-advanced. However, the share of the informal economy remains considerable, especially in the agricultural sector. Addressing informality requires a comprehensive, government-wide approach that encompasses tax, labour, social and financial policies. The governance and institutional environment in Georgia is favourable overall to economic development, yet some challenges persist, particularly as regards the political independence of institutions and the fight against high-level corruption. These points are also included in the nine steps set out in the Commission Communication on EU Enlargement of 8 November 2023 as well as in Chapters 23 and 24 of the annual country report on

enlargement ([38]). No strategic vision on fighting corruption is in place. Access to finance has improved in recent years, and is better than in peer economies, but many SMEs still consider this a major obstacle, e.g. in the agricultural sector. Non-effective enforcement of regulations on food safety is another reason for Georgia's weak exports to the EU.

- **Georgia faces numerous challenges in the area of connectivity linked to energy security, as well as market opening and integration, infrastructure in the maritime, road and railway sectors and in the digital area.** It relies heavily on fossil fuel imports. The rich renewable electricity production is to be further diversified and ramped up. The unbundling and opening of the electricity market need to be finalised. While energy intensity has dropped, further energy efficiency measures would bring significant gains, especially in buildings. There is not yet a national carbon pricing or emission trading scheme. The quality of road transport is yet to be improved. Continued investments, in particular to promote the extended trans-European transport network, railway links, ports, road infrastructure maintenance, rolling rail stock and intermodal and logistic capacities as well implementation of the railway strategy are needed. Access to digital infrastructure has improved, but some regions lag behind and there is no overarching digital strategy.
- **Georgia also faces challenges in the areas of labour market, social protection and healthcare.** The labour market is characterised by high unemployment and low employment rates, especially for women and young people. The mismatch between workers' skills and labour market needs is affecting people's income and employment opportunities, and the country's ability to boost productivity. Vocational education and training are provided in both public and private institutions, but there is only a modest level of enrolment and drop-out rates are high. Poverty rates are decreasing but inequalities persist and social safety nets are very limited. Access to healthcare services is gradually improving, but out-of-pocket expenditures remain high.

This first ERP submitted by Georgia since it became an EU candidate country in December 2023 is overall of high quality. This reflects the Georgian authorities' strong technical expertise in public finance management and strategic planning. The Commission welcomes the fact that Georgia chose to also present its structural policy plans in the ERP, which was not compulsory considering this was the first submission under very tight deadlines and the life cycle of strategy preparation could not be fully taken into account (such as an inclusive consultation process or a breakdown of measures per year). The ERP very much builds on the existing strategic government documents, such as the Development Strategy of Georgia – Vision 2030, medium-term budgetary planning as well as numerous sectoral strategies and action plans, ensuring the strong alignment and coherence of Georgian policy planning.

3.2. ECONOMIC OUTLOOK AND RISKS

In 2023, Georgia's GDP growth was robust reaching 7.5% ([39]), driven by consumption and investment, although it slowed down from the two-digit expansion recorded in 2021 and 2022. Investment and consumption (both private and government) became main growth drivers last year. They were stimulated by improved business confidence, rising wages and falling inflation, as well as the impetus provided by the spending of migrants from Russia. The contribution of net exports turned negative in 2023 as, despite growing revenues from tourism, lower external demand (amid weak global growth) led to a decrease in domestic exports, while imports increased. On the supply side, the value added in services and construction increased significantly, driven by high domestic demand, while manufacturing declined. The strong economic activity led to improvements in the labour market

([38]) The European Council decided to grant the status of candidate country to Georgia on 15 December 2023, on the understanding that these steps are taken.

([39]) The preliminary GDP growth estimate for 2023 published by the statistical office in February 2024 was 7%, subsequently revised to 7.5%, while the estimate reported in the ERP was 6.5% (see Table 1).

although it remains rather weak. The unemployment rate decreased by 0.9 percentage points (pps) year-on-year to 16.4% in 2023. Labour market participation increased but remains at a low level. Following a moderate rise in previous years, the average level of wages increased strongly in 2023, by some 15% in real terms and faster than labour productivity, which grew by 4.5%. According to the central bank, strong wage dynamics were caused by the good financial results of Georgian companies, which enabled salary rises that could compensate for rising living costs, especially housing rents in the main cities partially driven by the inflow of migrants. In combination with faster-than-expected disinflation, high nominal wage dynamics brought real wage growth into double digits last year.

The ERP forecasts a still robust economic growth of around 5% on average over 2024-2026. The drivers of growth are expected to change over the forecast period. In 2024, investment is expected to bring the strongest contribution to growth, while private consumption is set to be the main growth driver afterwards once base effects subside. Net exports are expected to make a negative contribution to growth. On the production side, the output of industry and construction is expected to grow at 7-8% on average, faster than services which were the most dynamic part of the economy in recent years. In 2023, the output gap estimated in the ERP was positive at 1.4% of GDP, implying that the actual output exceeded the potential one last year. It is expected to gradually close in the coming years. Supported by the projected steady economic expansion, the number of people employed is expected to grow each year by 1.2% on average. The unemployment rate is projected to continue falling, by 0.3 pps annually, to an average 15.7% in 2026. Despite these improvements, labour market outcomes are expected to remain challenging, given the existing skills mismatches, regional disparities and a large informal sector. Wage dynamics are expected to slow down from the two-digit real growth in 2023 to 5.5% on average in real terms in 2024-2026, which would be slightly higher than average productivity growth in that period (4%).

The macroeconomic scenario presented in the ERP appears plausible, although it is subject to significant uncertainty. However, the composition of growth may turn out differently. In particular, the expected substantial slowdown in the growth of private consumption in 2024, followed by its acceleration in the following years, seems rather unlikely to materialise given the envisaged continuous, although slower, wage growth and credit dynamics. Likewise, the expected sharp deceleration in private investment from 2025 does not appear fully plausible in light of high investment needs and expected gradual reduction of interest rates. The ERP rightly underlines that the economic outlook is subject to a high degree of uncertainty and identifies several main risk factors. Most of them relate to the external environment, including the impact of Russia’s war of aggression against Ukraine and Georgia’s economic links with Russia which, in contrast to most countries in the EU and its neighbourhood, have had a positive impact on the economy thus far. Among these risks, the ERP mentions and briefly analyses the potential impact of a decrease in remittances, a decline in foreign tourism, a slowdown in global economic growth and trade turnover, as well as regional political and economic risks. As regards domestic risks, the ERP only mentions renewed price pressure leading to a tighter-than-expected monetary policy, while other uncertainties, for instance a possibility of continued high wage growth weighing on competitiveness, or political risks, are not analysed. The risks presented in the ERP are translated into two alternative scenarios, one negative and one positive. In the negative scenario, GDP growth in 2024-2026 would be almost 3 pps lower on average than in the baseline. In this case, the budget deficit would be higher by a half of a percentage point at the end of the programme period but would still comply with the 3% of GDP fiscal rule.

Table II.3.1:
Georgia - macroeconomic developments

	2022	2023	2024	2025	2026
Real GDP (% change)	**10.4**	**6.5**	**5.2**	**5.0**	**5.0**
Contributions:					
- final domestic demand	**-7.2**	**11.6**	**5.4**	**5.4**	**5.2**
- change in inventories	**9.0**	**-2.8**	**0.5**	**-0.1**	**0.1**
- external balance of goods and services	**8.6**	**-2.3**	**-0.7**	**-0.3**	**-0.4**
Employment (% change)	**5.4**	**2.0**	**1.5**	**1.1**	**1.0**
Unemployment rate (%)	**17.3**	**16.6**	**16.2**	**15.9**	**15.7**
GDP deflator (% change)	**9.1**	**3.1**	**3.0**	**3.0**	**3.0**
CPI inflation (%)	**11.9**	**2.6**	**2.8**	**3.0**	**3.0**
Current account balance (% of GDP)	**-4.5**	**-4.6**	**-4.8**	**-4.6**	**-4.3**
General government balance (% of GDP)	**-2.2**	**-3.0**	**-2.5**	**-2.3**	**-2.2**
Government gross debt (% of GDP)	**39.5**	**38.2**	**38.0**	**37.8**	**37.6**

Source: Economic Reform Programme (ERP) 2024.

Consumer price inflation fell below 1% year-on-year in the second half of 2023 but is expected to pick up and then stabilise at around the 3% target from the second quarter of 2024. The sharp decrease in inflation (from 9.8% in December 2022 to 0.6% in June 2023 and further to 0% in January 2024) can be attributed to several factors: tight monetary policy of the National Bank of Georgia, falling global commodity prices (especially for energy and food) and the impact of the appreciation of the Georgian currency, the lari. The central bank started to gradually loosen its tight monetary policy stance in May 2023, lowering the policy rate five times by 275 basis points in total, to 8.25% in March 2024. The central bank expects continuing price pressures stemming from services, partly related to wage growth, which is set to push inflation back to the target in coming months. The demand-side pressures are expected to gradually drop due to the dampening impact of monetary policy and inflation is forecast to converge towards the 3% target during 2024. Monetary policy is expected to ease rather gradually, as reducing policy rates would spur further lending and add to the pressures from high-wage growth. This scenario appears plausible overall. Nevertheless, the central bank underlines that there are inflationary risks related to the geopolitical situation and other risk factors. In particular, the central bank intends to tighten its monetary policy in case of rapid outflows of foreign currency if Russian migrants, who came to Georgia after Russia's invasion of Ukraine, leave the country after the end of the war.

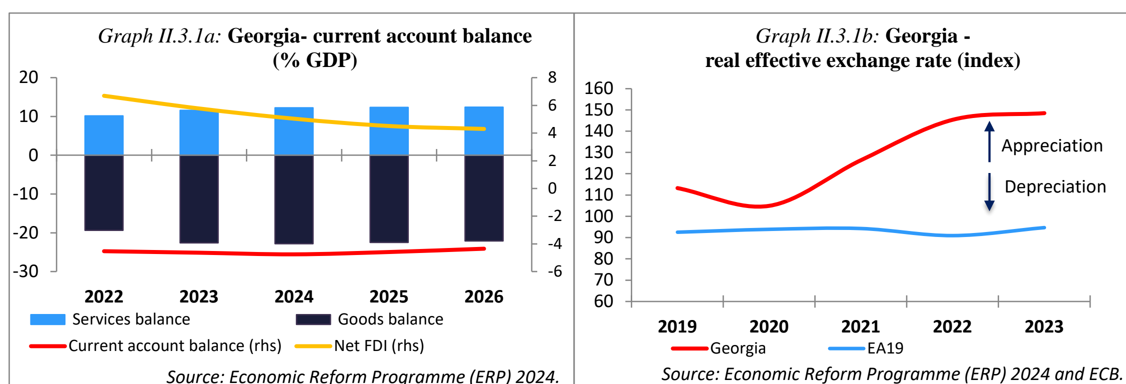
The current account deficit is much lower than before the pandemic and the ERP envisages it stabilising below 5% of GDP, but the external balance and position remains highly vulnerable to swings in global demand and geopolitical factors. One of the main vulnerabilities concerns merchandise trade, which reflects a narrow and low value added export base. In 2023, the trade in goods deteriorated to a deficit of 21% of GDP. Domestic exports (i.e. excluding re-exports) of goods decreased last year, due to a stronger lari as well as reduced external demand and lower prices for commodities such as metals and fertilisers, which constitute a substantial share of Georgia's exports. At the same time re-exports, mainly of cars, increased ([40]). On the other hand, exports of services, especially tourism and IT services, grew dynamically, leading to a surplus in the services balance of 11% of GDP. The ERP forecasts an almost equal increase in exports and imports of both goods and services by 9% a year on average, which may underestimate the growth potential of the services sector, especially tourism and IT, while the value of exports depends on external demand and is difficult to forecast. Since the start of Russia's war of aggression against Ukraine, Georgia recorded a high inflow of money transfers from abroad (15% of GDP in 2023). These transfers include both the traditionally substantial remittances from Georgians working abroad and financial inflows related to migrants from Russia, many of whom work remotely for foreign companies. The ERP's baseline scenario envisages these transfers continuing to grow, especially the traditional remittances, but

([40]) In 2023, re-exports represented 54% of Georgia's exports, with cars accounting for over a half of this percentage.

transfers related to migrants may diminish rapidly if the geopolitical situation changes. Many components of the current account are subject to downside risks identified in the ERP's negative scenario, but the programme does not quantify the impact of this scenario on the current account balance and its components.

Foreign direct investment (FDI) inflows, traditionally very high, are gradually decreasing as a share of GDP, while international reserves remained broadly stable. FDI inflows are expected to decrease from 5.5% of GDP in 2023 to 4.1% in 2026, which would almost fully finance the expected current account deficit. However, among the FDI components, reinvested profits, stimulated by tax benefits ([41]), play an increasing role, more important than that of greenfield investment. Georgia has a strongly negative net international investment position and a relatively high external debt, although both have decreased considerably in the last two years due to the appreciation of the lari (to -99% and 79% of GDP, respectively, as of September 2023). The ERP envisages a stabilisation of external debt in EUR terms in the coming years, which would lead to its gradual decrease as a share of GDP, given the projected positive nominal GDP growth. Despite the large financial inflows to Georgia, the level of gross official foreign reserves remained almost unchanged in 2023 and amounted to USD 5 billion at the end of the year, corresponding to almost 100% of the IMF's Assessing Reserve Adequacy metrics. Gross reserves reached their peak in August 2023 and have decreased since then reflecting, among other factors, the interventions of the central bank to stabilise the currency in view of the regulatory uncertainty over the application of international sanctions. The ERP envisages official reserves increasing to over USD 7 billion in 2026, which seems on the high side.

External competitiveness and current account



The Georgian banking sector remains sound overall. According to data from the National Bank of Georgia, the banking system's capital adequacy ratio stood at a comfortable 22.6% at the end of 2023 and most lenders remained very profitable (reaching an aggregate 24.7% return on equity). The asset quality of the sector as a whole remains strong, with the ratio of non-performing loans to total loans remaining broadly unchanged at a low 1.8%. The high dollarisation of both assets and liabilities remains a structural weakness of the banking system, although overall it has decreased over recent years. The share of loans in foreign currencies decreased substantially as the central bank raised the reserve requirements for foreign currency loans in 2022 and raised the floor for foreign currency lending to unhedged borrowers in 2023, although it increased somewhat in 2023, amounting to 41.6% by the end of the year. The level of dollarisation for deposits is higher but quickly fell to 51% by the end of 2023 from 56% a year earlier. Access to finance has improved in recent years but is still considered a major obstacle by many SMEs. The size of financial intermediation, measured by the ratio of loans to the private sector to GDP, was 64% at the end of 2023, against 90% of GDP in the EU, while being higher than in peer enlargement countries. Credit growth accelerated from 12.1% at the end of 2022 to 17.2% at the end of 2023 (excluding the effect of exchange-rate fluctuations) for both corporate and retail loans, while being stronger for the latter. The central bank expects some decrease

([41]) Since 2017, Georgia has adopted the Estonian corporation tax model, under which corporate taxes are only levied when dividends are distributed, creating strong incentives to reinvest earnings.

in demand for business loans during the programme period, while demand for consumer loans is expected to remain dynamic, spurred by new regulatory changes facilitating access to them and by high demand for housing, including from foreigners.

Table II.3.2:
Georgia - financial sector indicators

	2019	2020	2021	2022	2023
Total assets of the banking system (EUR million)	14 646	14 144	17 264	24 336	26 901
Foreign ownership of banking system (%)	86.6	86.6	86.2	87.4	
Credit growth (average)	16.2	9	18.2	12.1	17.2
Deposit growth * (average)	9.3	20.8	12.2	29.6	12.4
Loan-to-deposit ratio (end of period)	1.2	1.1	1.2	1	1
Financial soundness indicators (%, end of period)					
- non-performing loans to total loans	1.9	2.3	1.9	1.5	1.8
- regulatory capital to risk-weighted assets	19.5	17.6	19.6	20.3	22.6
- liquid assets to total assets	19.2	20.4	20.2	22.8	22.4
- return on equity	17.7	1.8	30.4	24.6	24.7
- foreign exchange loans to total loans	55.1	55.3	50.6	40.4	41.6

* Total deposit growth.
Sources: Central Bank of Georgia.

The capital market is still underdeveloped, and the authorities plan to develop it. The capitalisation and liquidity of the Georgian Stock Exchange are limited, with a total market capitalisation of GEL 5.2 billion (6.5% of GDP) by the end of February 2024. Development of the domestic capital market in line with the 2023-2028 capital market development strategy is considered as a priority by the authorities and it has been included among the six selected structural reforms in the ERP. The envisaged reform has two main goals. The first is increasing the quantity and types of securities on the market, with a focus on government securities in local currency. The second is the deepening of the investor base, including the reform of insurance and the private pension system to add new institutional investors to the market.

3.3. PUBLIC FINANCE

The fiscal deficit amounted to 2.2% of GDP in 2023, the same as a year earlier. The outcome is 0.8 percentage point better than planned for 2023. In October 2023, the government revised the budget in line with the better than expected revenue growth amid robust economic activity and the identification of additional financing needs. The budget deficit ceiling was raised to 3.0% of GDP (previously 2.9%). This reflected a largely unchanged nominal budget deficit target and a slight downward projection for the nominal GDP due to a lower deflator. The projected tax proceeds were revised up by GEL 520 million (0.7% of GDP). On the expenditure side, an additional increase of GEL 250 million (0.3% of GDP) was factored in for pensions and social assistance for children. Additional funding was provided for reconstruction following the damage caused by summer floods and for other priority areas. According to figures for the execution of the 2023 budget, general government proceeds increased by 16.2% on the year, well outpacing the average inflation. Apart from the buoyant economic activity, revenue growth was supported by increases in fees for state services as well as by merging the corporate income tax (15%) with the dividends tax (5%). Expenditures rose by 15.0% year-on-year in 2023, fuelled by a rise in current spending and still strong growth of capital outlays.

The ERP envisages a moderate pace of fiscal consolidation leading to a headline deficit of 2.2% of GDP in 2026. The programme's key objective, as stated by the authorities, is directing investment towards developing infrastructure and providing employment to the population, as well as financing priority areas such as pensions, social security, healthcare, education and agriculture. Another objective is ensuring that the budget deficit and the general government debt stay within the limits set

by the fiscal rules so that fiscal policy contributes to the country's economic stability. According to the programme, the revenue ratio is projected to increase sharply in 2024 (by 1.2 pps when compared with the 2023 budget plan), thanks to the robust and revenue-conducive economic activity and discretionary measures, in particular increases in the revenues related to the gambling tax and the profit tax in the banking sector, before receding gradually to 31.4% of GDP in 2026. Personal income tax revenues are projected to remain close to 8% of GDP during the programme period, which is a significant increase compared to the 2010-2019 levels. A similar shift, although of a slightly lower magnitude, is expected for corporate tax revenues, reflecting expectations for higher company profitability. VAT revenues are expected to remain the key revenue item with a share of around 10.7% of GDP in 2024-2026, which is similar to that share before the COVID-19 pandemic. At the same time, the share of the non-tax revenues in the economy is projected to decline considerably in the next few years. Overall, tax proceeds are projected to be more than 3 pps higher than their pre-2020 levels throughout the period covered by the ERP.

Expenditures are projected to peak at 35.0% of GDP in 2024 before retreating to 33.5% in 2026, a figure that is still substantially higher than the 2010-2019 levels. The decline during the programme period will be almost entirely explained by a reduced share of capital outlays, as major infrastructure projects, particularly the construction of the East-West highway, are nearing completion. Still, capital expenditure is set to remain rather high, approaching 7% of GDP in 2026, reflecting the country's significant investment needs and the government's focus on these. The ERP also envisages a gradual rise in the spending ratio for wages and social benefits as well as for interest payments. This reflects a policy of increasing public-sector salaries to bring them closer to those in the private sector, and of increasing pensions in line with the indexation scheme that was introduced in 2021. Expenditures for subsidies are projected to ease slightly but will remain high from a historical perspective at 2.4% of GDP in 2026. The ERP envisages a slightly positive (pro-cyclical) fiscal impulse in 2024 as the cyclically-adjusted budget deficit is expected to increase over the year. It would be followed by counter-cyclical policies in 2025 and 2026, which could help the authorities to build further fiscal buffers.

Table II.3.3:

Georgia - composition of the budgetary adjustment (% of GDP)

	2022	2023	2024	2025	2026	Change: 2023-26
Revenues	30.9	31.4	32.6	32.0	31.4	0.5
- Taxes and social security contributions	25.1	25.6	26.7	26.6	26.3	1.2
- Other (residual)	5.8	5.9	5.8	5.4	5.1	-0.6
Expenditure	33.1	34.4	35.1	34.3	33.5	0.5
- Primary expenditure	32.6	33.6	33.8	32.7	31.9	-0.7
of which:						
Gross fixed capital formation	9.0	8.8	8.5	7.8	7.0	-2.0
Consumption	10.2	10.7	11.0	10.9	10.9	0.6
Transfers & subsidies	11.1	11.5	11.7	11.7	11.6	0.5
Other (residual)	2.3	2.6	2.6	2.4	2.4	0.1
- Interest payments	1.1	1.5	1.8	1.8	1.9	0.8
Budget balance	-1.6	-2.3	-2.2	-2.2	-2.2	-0.6
- Cyclically adjusted						
Primary balance	-0.8	-1.1	-0.6	-0.5	-0.3	0.5
- Cyclically adjusted						
Gross debt level	39.5	38.2	38.0	37.8	37.6	-1.9

Sources: Economic Reform Programme (ERP) 2024, Commission calculations.

The 2024 budget, which was passed by the Parliament on 15 December 2023, envisages a general government deficit of 2.5% of GDP. The budget is based on the assumption that there will be real GDP growth of 5.2% and a GDP deflator of 3.0% in 2024. The authorities expect the revenue-to-GDP ratio to increase significantly to 32.6% due to further growth of tax proceeds, in particular personal income tax. This could be attributed to the considerable wage growth throughout 2023, which

is likely to be sustained in 2024 due to the hike in public-sector wages and the still robust economic activity that exerts upward pressure on private sector wages. On discretionary measures, the authorities expect to mobilise an additional GEL 400 million (0.5% of GDP) in revenues in 2024 through changes related to the gambling sector (an increase of the gross gambling revenue rate and a higher withdrawal fee). In addition, a methodological change in the way the loss reserve for the banking sector is calculated is expected to bring additional and one-off revenue of GEL 170 million (0.22% of GDP). The ERP assumes an increase of 0.6 pps in the spending ratio in 2024 that would be driven by higher expenditure on interest payments, wages and social benefits. At the same time, the share of capital spending in GDP is to decline as some of the large-scale public investment projects are being finalised. Overall, both revenues and spending are projected to grow at double-digit rates in real terms in 2024, similar to the pattern in the previous year.

The ERP projects a very gradual decrease in the general government debt ratio to levels that appear appropriate to safeguard debt sustainability. Public debt is expected to remain slightly below 40% of GDP, a level which the authorities consider 'safe', that is providing enough fiscal space for fiscal stimulus in case of a shock. Therefore, public debt is projected to stay well below the 60%-of-GDP ceiling set in Georgia's fiscal rule over the course of the programme ([42]). Georgia has access to both the domestic and international financial markets. At the end of 2023, the average maturity of the public debt is favourable, as the country traditionally relies on long-term concessional funding from international financing institutions, which constitutes close to 70% of the total liabilities. Public debt is prone to significant exchange-rate risks due to the high reliance on external financing. As of the end of November 2023, 72.6% of the debt was denominated in foreign currency. This ratio has decreased in recent years (from around 80% at the end of 2021), mainly due to the sharp appreciation of the local currency but also due to the authorities' efforts to increase the share of domestic financing, a key objective of Georgia's debt management strategy. Developing the investor base in the local capital market is also among the structural reforms identified by the authorities in the ERP. To this end, they plan to further boost the capacity of primary dealers and increase the share of non-resident investors in government bonds and securities. Work is also ongoing on developing a methodology to establish an optimal interest rate structure for the government debt portfolio. While the ERP does not elaborate on the country's financing needs, it notes that debt servicing costs are relatively low –– traditionally around 5-6% of total spending (with an increase to 6.7% in 2023). Given the high reliance on institutional lenders, upholding good governance standards and maintaining a positive track record in complying with policy conditions agreed with international institutions is critical as an anchor for foreign investments and ensuring access to financial market.

([42]) The definition of public debt under Georgia's fiscal rule includes the general government gross debt and liabilities incurred under public-private partnership (PPP) contracts. At the end of 2023, PPP liabilities amounted to 0.1% of GDP.

BOX II.3.1: DEBT DYNAMICS

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

	2022	2023	2024	2025	2026
Gross debt ratio [1]	39.5	38.2	38.0	37.8	37.6
Change in the ratio	-10.2	-1.3	-0.1	-0.2	-0.2
Contributions [2]:					
1. Primary balance	1.2	1.4	0.7	0.5	0.3
2. 'Snowball effect'	**-7.0**	**-1.9**	**-1.1**	**-1.0**	**-0.9**
Of which:					
Interest expenditure	1.1	1.5	1.8	1.8	1.9
Growth effect	-4.3	-2.3	-1.8	-1.8	-1.7
Inflation effect	-3.8	-1.1	-1.1	-1.1	-1.0
3. Stock-flow adjustment	**-4.4**	**-0.8**	**0.2**	**0.3**	**0.4**

[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) 2024, Commission calculations.

The debt trajectory in the ERP is based on an expected annual growth rate of slightly above 8% for the nominal GDP, broadly in line with historical patterns. Furthermore, the ERP incorporates the technical assumption of a stable exchange rate over the programme period. Long-term interest rates are projected to hover around 5%. In 2022, Georgia's debt-to-GDP ratio declined sharply due to robust real growth, high inflation and strong appreciation of the local currency, which explains the large stock-flow adjustment in the year. This was followed by a much lower decrease of the debt ratio in 2023, reflecting the ongoing real growth of the economy and the inflation effect, which was somewhat countered by the primary budget deficit and interest payments. The stock-flow adjustment also helped reduce the debt ratio in 2023.

The ERP projects that the debt ratio will inch down marginally in the medium term, supported by a gradual narrowing of the primary deficit. While the 'snow-ball' effect is expected to continue to lead to a lower debt ratio, the magnitude is expected to diminish in 2024-2026 due to a rise in the projected interest expenditures. Unlike in 2022 and 2023, the stock-flow adjustment is expected to lead to the debt ratio slightly increasing by the end of 2026. As mentioned above, the exchange rate, which historically has been an important factor behind Georgia's public debt-to-GDP dynamics due to the high share of foreign currency debt, is assumed to remain stable under the ERP.

Risks to the fiscal scenario are moderate. They relate mainly to the growth path of the economy but also the high volatility to external shocks. For example, debt levels decreased by some 20 pps between 2020 and 2023, driven by the high nominal GDP growth and the significant appreciation of the local currency that ensued during the post-COVID-19 recovery period and intensified following Russia's invasion of Ukraine due to the massive inflows of funds. On the downside, lower-than-projected GDP growth due to negative external shocks could impact revenues, leading to a higher fiscal deficit and public debt ratio. Tighter financing conditions could also have a detrimental impact on the budget and public debt, including its refinancing. A significant risk stems from the possibility that some of the Russian citizens who settled in Georgia following the Russia's invasion of Ukraine could exit the country together with the associated capital outflows. There are also risks related to the structure of the Georgian economy, due in particular to the high share of tourism in the economy. As regards public debt, the high foreign-exchange exposure remains a key risk. However, it is somewhat mitigated by the ongoing progress made by the authorities on reducing the share of external borrowing. Most of the above-mentioned risks are recognised and well elaborated in the ERP.

An area that could merit a more detailed analysis is the possible capital outflows associated with a potential exit of Russian citizens and businesses that entered the country as of 2022.

On the upside, Georgia's macroeconomic forecasts have a track record of being rather conservative. This usually results in higher nominal growth than initially projected. Accelerating structural reforms that would anchor and speed up the country's path towards EU membership could boost the economy. The authorities have a sound track record in implementing prudent fiscal policies despite the numerous external shocks the country faced in the last decade. Georgia had been compliant with its fiscal rules until 2020. Due to the economic shock from the COVID-19 pandemic and the government's response in the form of significant support for both households and businesses, the budget deficit significantly exceeded the corresponding 3%-of-GDP ceiling in 2020 and 2021, while the public debt ratio marginally surpassed the 60% target by the end of 2021. Following this temporary shock, compliance with the fiscal rules was restored in 2022. While the ERP does not provide information about contingency risks due to possible financial rescue operations, state guarantees, and accumulation of debt of SOEs, it highlights the low (0.1% of GDP) exposure to public-private partnerships liabilities.

BOX II.3.2: SENSITIVITY ANALYSIS

The sensitivity analysis in the ERP explores the impact of changes in key macroeconomic indicators on the budget deficit in 2024. In a scenario in which both growth and inflation significantly exceed the baseline (real GDP growth of 9.7%, consumer price inflation of 6.2%), the general government deficit would be lowered by 1.1% of GDP, with the bigger part (0.9% of GDP) related to the higher level of economic activity that is expected to boost revenues. Conversely, a negative shock (3.8% GDP contraction and a deflation of 0.6%) would widen the 2024 deficit by 2 pps, leading to a breach of the country's 3%-of-GDP fiscal rule on the budget deficit. Again, the drop in economic output would be the driving factor in this case – it is estimated to lower revenues by 1.7% of GDP. The sensitivity analysis also includes scenarios that involve an interest and an exchange-rate shock. In both cases, the expected budgetary impact is relatively small.

On public debt, the ERP refers to the debt sustainability analysis carried out annually by the authorities and included in the budget documentation. This analysis tests various shocks – real interest rate, real GDP growth, primary deficit, nominal exchange-rate shock, a combined shock and a contingent liability shock. In almost all cases, the public debt ratio initially increases before resuming a downward trend. The biggest increase (of more than 10 pps) is witnessed in the scenario of a currency shock (30% depreciation of the local currency). This reflects the very high share of general government debt in foreign currency (around 73% of the total at the end of 2023).

Georgia has a high share of spending on economic affairs and on public order, while spending on social expenditure and healthcare, and to a lesser extent general public services, is very low. Benefiting from higher-than-expected revenues in 2022 and 2023, the authorities have allocated additional funding to support social inclusion and capital expenditures. While maintaining a gradual fiscal consolidation, the ERP envisages increased financing for human capital and social security in the medium term. As a result, the share of spending on education is projected to record its biggest increase by 2026, to 4.5% from a low base of 3.7% of GDP in 2023 (EU: 5.0% of GDP in 2021). This reflects plans to rehabilitate education facilities and construct new ones as well as increase the salaries in the sector. Spending on social security (namely increasing pensions in line with the 2021 indexation rules as well as disability pensions) and on healthcare is also set to grow at a high rate, from a relatively low base of less than 10% of GDP for both (EU: around 27% of GDP in 2022). The programme also provides for a gradual increase in the expenditure for environmental protection. At the same time, the share of capital outlays is to gradually decline but will remain at a high level from a historical perspective. The ERP further assumes a significant rise in expenditures for public-sector salaries to ensure that they do not fall below 80% of private sector wages. Regarding revenues,

the main source continues to be VAT proceeds, followed by personal income tax revenues. The authorities do not collect social security contributions and provide a flat-rate pension (one rate to people below 70 and another to people aged 70 and above). There is rather limited space for revenue adjustments given the current very strict fiscal rules that require a referendum for any tax increases (save for excise taxes; see more below). In view of these constraints, the authorities are pursuing a strategy of broadening the tax bases through identifying and quantifying tax expenditures. Following an estimate of VAT and income tax expenditures, they are now focusing on a sectoral analysis, where implementation is expected to start with the large agricultural sector.

Georgia has a well-developed fiscal framework and the ERP plans continued reforms to further strengthen it and improve monitoring of fiscal risks. As part of the public finance management (PFM) reform, the authorities introduced a new public investment management (PIM) methodology as well as indexation rules for public-sector salaries and pensions. To step up monitoring of fiscal risks, the authorities included part of state-owned enterprises (the non-commercial ones, classified as part of the general government and not as public corporations) in the budget as of 2023 and started assessing fiscal risks related to climate change and population ageing. Some of the PFM reforms presented in the ERP include, among others, the approval of a medium-term revenue strategy (MTRS) and further work on fully incorporating the non-commercial SOEs into the general government statistics. The MTRS is expected to identify and address the impact of longer-term challenges posed by the demographic and climate developments on public finances, which is important for strengthening Georgia's fiscal sustainability. As regards SOEs, the authorities adopted the public corporation reform strategy in December 2022. The strategy's implementation and the approval of the law on public corporations has been delayed amid lack of consensus on the content of the law and on the issue which entity should carry out the ownership function. However, the authorities are making progress on improving the fiscal oversight over state-owned enterprises included in the general government sector, by gradually bringing their cash management under the Single Treasury Account. In the area of PIM, Georgia introduced an updated methodology for assessing investment projects in February 2023. One of the main challenges for its application relates to the capacity of line ministries' staff to carry out good quality cost-benefit analysis of projects. An electronic PIM system is planned to be introduced and integrated into the electronic budget management system.

The fiscal path as set out in the ERP complies with the national fiscal rules on budget deficit and public debt. These rules are regulated by the Organic Law 'Economic Liberty Act' from 2011, which sets a ceiling for the consolidated budget deficit at 3% of GDP and for the state debt at 60% of GDP. The 'revenue rule' allows for the adoption of a new tax or an increase in tax rates (except excise) only after a referendum ([43]). The authorities have a strong track record in complying with the fiscal rules despite recurrent adverse external shocks. They activated the escape clauses ([44]) to the rules with the COVID-19 pandemic in 2020 but managed to comply with the requirements again in 2022, partly due to the exceptional factors that have characterised Georgia's growth performance since 2021. Georgia's fiscal accounting is based on the government finance statistics manual from 2014 developed by the IMF. The authorities plan to align with the ESA 2010 in the future. However, the ERP does not provide a tentative timeline or corresponding steps to be taken to achieve this objective. The Parliamentary Budget Office (PBO), which provides budget analysis and macro-fiscal projections, is considered by the authorities as Georgia's independent fiscal institution. A self-assessment in line with the OECD Principles for Independent Fiscal Institutions carried out by the PBO in 2022 indicated several areas for improvement, including the PBO's official mandate, legal guarantees of independence and autonomy, the strengthening of skills in quantitative analysis, and the need to add an advisory council.

([43]) This rule is valid until 2030.

([44]) The escape clause ensures fiscal policy flexibility in case of economic recession or emergency situations. It also sets the timeline (3 years) within which the parameters need to return within the general limits.

3.4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

Strong economic growth has resulted in Georgia being upgraded to an upper-middle income country, while overall productivity is improving due to a structural shift to a service economy. Real GDP per capita grew by an average of 4.7% during the last 10 years (2014-2023), making Georgia one of the fastest growing economies in the region. In the same period, the poverty rate declined from 23.5% to 15.6%, but inequality remains high. Capital accumulation and total factor productivity has driven Georgia's growth since the 2010s, as the economy diversified towards services and to some extent manufacturing. The structure of gross output is as follows: 20% manufacturing, 13% wholesale and retail, 12% construction, 7% transportation and storage, 6% real estate, 6% agriculture, and 36% other sectors, mostly services. Following a severe contraction caused by the pandemic in 2020, the recovery was faster than in other Eastern neighbourhood countries, helped by tourism, exports, and remittances.

The Commission has conducted an independent analysis of Georgia's economy and identified the main structural challenges to competitiveness and inclusive growth, drawing on Georgia's own ERP and other sources. The analysis highlights several structural challenges across many sectors. The three most significant challenges are:

- addressing key factors behind low competitiveness, in particular those linked to the dominance of low value added sectors in the economy, low productivity in agriculture, informality, and shortcomings in economic governance;

- enhancing connectivity, especially by strengthening the energy system, further developing transport infrastructure and furthering digital reforms;

- addressing weaknesses in Georgian labour market including by improving the quality and relevance of education and professional skills development, and strengthening the social protection system and healthcare services.

Tackling corruption, reducing political polarisation, advancing 'de-oligarchisation', strengthening the rule of law, undertaking judicial reforms and boosting the capacity and independence of public institutions is essential to promote competitiveness. The delays and lack of transparency in court proceedings impact on business decisions, while lack of independence of public institutions may impact the credibility of policies, including macroeconomic management. Addressing these fundamental concerns is a prerequisite for the successful transformation of the Georgian economy. These points also form part of the nine steps set out in the Commission Communication on EU Enlargement of 8 November 2023 as well as in Chapters 23 and 24 of the annual country report on enlargement ([45]). The European Council decided to grant the status of candidate country to Georgia on 15 December 2023, on the understanding that these steps are taken.

While the Georgian economy continues to experience several obstacles to inclusive growth and competitiveness, properly targeted reforms on the three key structural challenges offer the biggest potential for economic resilience, inclusive growth and competitiveness. The Commission welcomes that Georgia has broadly identified the same three key structural challenges in Chapter V of its ERP. However, there are some differences in understanding over the prioritisation and substance of reforms, especially for the key structural challenge on competitiveness and on social policy and human capital.

Key challenge #1: Addressing key factors behind low competitiveness linked to a dominance of low value added sectors in the economy and exports, low productivity in agriculture, informality and shortcomings in economic governance

While Georgia has managed to attract significant foreign direct investment over recent years, the country's value chains are still dominated by low-value sectors. The stock of FDI in

([45]) 2023 Georgia Enlargement Report: https://op.europa.eu/s/zhxt.

Georgia, at 106% of GDP, is higher than in the other Eastern neighbourhood countries and is significantly above the EU average (68%). Foreign investments are well diversified and are mostly in energy, financial services, real estate, manufacturing, and trade. Georgia's industrial production is dominated by low value-added sectors, especially commodities (predominantly metals) and food processing. Georgia's export base remains narrow and Georgian exports to the EU mostly consist of mineral products, chemical products and textiles ([46]).

Agriculture, a key sector for employment, faces major competitiveness challenges, including low productivity and fragmentation. The share of people working in agriculture is disproportionately high, compared with the sector's contribution to value added, even if this has decreased in recent years. This suggests continued low productivity in the sector which still relies on small-scale farming with an untapped potential to move up the value chain in food processing. Employment in agriculture amounted to around 18% of total employment in 2022, thus including the informal rural household workforce this makes the sector the biggest employer in the country. The small size of farms, limited business and investment opportunities, weak land markets (grappling with unclear and unregistered ownership and lack of strategic management of state land) and fragmented supply chain logistics, due also to Georgia's geographic location, contribute to these outcomes.

These challenges are recognised in Georgia's agricultural policy, which is governed by the 2021-2027 strategy for agriculture and rural development. The Ministry of Environmental Protection and Agriculture is responsible for implementing the strategy. Also, as part of addressing the important needs in terms of land reform, the National Agency for Sustainable Land Management and Land Use Monitoring was established in 2020. It aims to conduct an inventory of land resources and develop a land information system.

Adding to the potential of its agricultural sector, Georgia has rich water resources, but they are unequally distributed while irrigation systems are outdated and need to be significantly overhauled. The availability of renewable freshwater per capita is consistently the highest among the EU's eastern neighbouring countries but Georgia's climate diversity requires better distribution and management of water resources. Ongoing major reforms on the management of water used for irrigation are driven by a tariff revision introducing the principle of cost recovery to reduce the government subsidies and to follow the tariff recommendations from the Georgian National Energy and Water Supply Regulatory Commission. Yet the tariff setting methodology still needs improvement, while implementation timeline is to be defined. The law on water resources management was adopted in 2023 but will only enter into force in 2026. Furthermore, there are ongoing pilot projects to help implement this tariff reform based on the existing recommendations from the Georgian National Energy and Water Supply Regulatory Commission. By the end of 2025, the new tariffs are expected to be implemented to promote sustainable water use in agriculture and ensure the long-term solvency of the Georgian Amelioration Estate Company. Soil deterioration is recognised by the ERP as another major challenge with several pieces of legislation outlined for finalisation and adoption, which then require swift implementation to help address the growing problem.

The share of the informal economy remains considerable. **The ERP notes the significance of informal employment but does not address explicitly challenges linked to the informal economy.** The informal economy estimates vary greatly, but its level remains sizeable despite likely decreasing due to strong economic growth in recent years. Around one third of workers are employed informally, many of them in agriculture or in seasonal jobs. Informality in Georgia is closely linked to: the country's economic structure with agriculture, construction, and tourism being dominant sectors, a very large amount of self-employment, a lack of unemployment benefits, a high reliance on remittances and a high share of cash payments coupled with a low level of public services and social protection. It is also linked to the high share of the population living of subsistence farming. Informality significantly reduces the country's tax revenues, exacerbates poor working conditions, cements inequality and distorts competition.

([46]) European Commission: https://policy.trade.ec.europa.eu/eu-trade-relationships-country-andregion/countriesandregions/georgia_en.

Addressing informality requires a comprehensive, government-wide approach that encompasses tax, labour, social and financial policies. Georgia is undertaking several steps to tackle informal employment through the re-established labour inspectorate, revenue measures, and strengthened links between social and employment services. However, no comprehensive strategy to fight informality exists. In the short term, a systemic approach is needed to better understand and measure the informal economy consistently with best international practices and methodology. This also requires an inter-agency working group to be set up that involves relevant government stakeholders, with the aim of drafting a strategy and action plan to address this complex issue using a whole-of-government approach.

The SME policy environment in Georgia is generally considered to be conducive to investment and supportive for business development, but firm-level productivity and export growth has been underwhelming. Georgia ranks among the world's best performers according to international indices on doing business and openness to FDI. Opening a business in Georgia can be done swiftly, with little red tape. As documented in the 2024 edition of the SME Policy Index for Eastern Partner countries published by the OECD and EBRD, since 2020, Georgia's performance has further improved in ten out of twelve SME Policy Index dimensions. Particular progress has been made with regards to the institutional and policy framework, SME internationalisation, and monitoring and evaluation of SME support services. There is also a level playing field between domestic and foreign investors. Insolvency proceedings have improved since 2021. A strategy for SMEs development over 2021-2025 is being implemented. Georgia has also made progress towards the systematic application of regulatory impact assessments, even if the methodology for SME-specific impact assessment tests has still not been adopted. Women entrepreneurship policies were strengthened, including with the state concept on the economic empowerment of women. Trade openness has constantly been increasing since the 1990s. The government agency 'Enterprise Georgia' has an export assistance programme to promote the growth of export-oriented SMEs. On the other hand, studies indicate that total factor productivity growth at firm level has been stagnant, which indicates low innovativeness and low competition in many sectors. Firm capabilities such as digitalisation, ability to innovate and adopt technology, and managerial quality are quite low. Georgia's merchandise export basket remains unsophisticated and dominated by primary products and resource-based manufactures, which grew significantly in share and now account for more than 60% of the total (excluding re-exports). Integration into global value chains continues to be very limited.

Non-effective enforcement of regulations on food safety remain one of the key reasons for Georgia's weak export performance towards the EU. Necessary certification for EU markets and high transport cost are key challenges for Georgian exports to the EU. Some 60% of DCFTA-related legislation has already been adopted, but many local producers are not ready to implement these provisions. In addition, due to a weak surveillance system, the competent authorities cannot deliver the full necessary level of assurances which hampers Georgian exports in several agricultural products. Enhancing implementation of already aligned legislation by strengthening surveillance capacity and diagnostic resources of regional and local services as well as providing assistance to companies in the application of food safety standards would help to address this weakness.

Access to finance has improved in recent years but is still considered as a major obstacle by many SMEs including in the agricultural sector. The size of financial intermediation, measured by the ratio of loans to non-financial sector and households to GDP, reached 64% at the end of 2023, one of the highest in the region but below the 90% of GDP in the EU. Overall, access to bank loans continues to be a major obstacle for many small and medium enterprises, for instance due to substantial collateral requirements and the large informal sector, while non-bank sources of finance are largely absent. To overcome this obstacle, the authorities have some programs to facilitate access to finance for the private sector through credit guarantees, subsidising interest rates subsidies on bank loans, and other instruments. Yet, start-up funding remains limited, and would require the development of new solutions, including crowding-in private investment. The implementation of the reform to ease the use of movable collateral for secured transactions would also be an important step to facilitate SMEs' access to finance. As a new measure aimed at stimulating lending to very small companies, the Parliament approved a law on micro-banks which entered into force in July 2023 and targets especially the agricultural sector.

The governance and institutional environment in Georgia are favourable overall to economic development, although some challenges persist. Georgia scored well on regulatory quality (close to EU average) and government effectiveness, as measured by the 2022 World Bank's Worldwide Governance Indicators. However, challenges persist as regards judicial reform, the adverse impact of political polarisation on business confidence, and a large degree of political control over public institutions and their limited transparency. While Georgia has a comparatively low level of perceived corruption, some challenges related to the business environment remain. Georgia was ranked 49th out of 180 countries in the 2023 Transparency International corruption perception index. Stalled judicial reform and inefficiencies in the court system are also considered as weaknesses in terms of protecting property rights, and therefore pose obstacles to Georgia's investment climate. Further efforts are needed to tackle high-level corruption, in particular, to address the challenge of large-scale vested interests and their influence in the political, judicial and economic spheres. Therefore, it will be important to move ahead with implementing the nine steps outlined in the Commission Communication on EU Enlargement of 8 November 2023.

The most recent anti-corruption strategy and action plan covered the period of 2019-2020 and no strategic vision has been adopted since. Georgia lacks a comprehensive and strategic approach to continuing its anti-corruption efforts. In the context of the ERP and in line with recommendations made in the annual country report on enlargement, it seems warranted for Georgia to, among other things, develop and adopt an anti-corruption risk assessment, strategy and action plan, ensuring they are comprehensively implemented through realistic timelines, adequate funding and monitoring mechanisms.

Reform measure 1: Domestic capital market development, is focused on two major directions, (i) increasing the type, quantity, and availability of securities (increase in supply); and (ii) developing a domestic investor base. While this is an important reform, it is further analysed under the fiscal framework part of the ERP.

Reform measure 2: Improved food security though upgraded irrigation and drainage systems outlines the reform of agriculture and rural development, focusing on finalisation of a unified land information system based on numeric technologies. A first version of the information system including the land registry will be released in 2024, while the full system should be finalised in 2025. There are plans to introduce a satellite monitoring system and create land use and land cover data, accompanied by necessary legal changes. The ERP sets out that the land management monitoring system will cover 70% of the country's territory by 2027, with full coverage expected by 2030. A monitoring and control system for soil will be introduced, together with modern provisions on soil protection and pasture management.

Strengthening land management information and irrigation systems is one of the critical building blocks for making Georgia's agricultural sector more competitive. This reform is crucial not only for securing investments in the agri-value chains but also ensuring the traceability of agricultural products and strengthening right-based management systems for common natural resources.

Key challenge #2: Enhancing connectivity in particular by strengthened energy system, further development of transport infrastructure and digital reforms.

Georgia relies heavily on imports of fossil fuels. Domestic energy production covers about one fifth of Georgia's energy demand, and mostly comes from hydropower and bioenergy. All natural gas, hard coal, and most oil products are imported. According to the International Energy Agency (IEA), the final energy mix is relatively diverse compared with other countries in the region. In 2022, natural gas accounted for 42% of country's energy consumption followed by oil products (27%) and electricity (22%). The remainder was covered by renewables (5%) and coal (4%). Net imports in total energy supply rose from 47% in 2002 to 81.4% in 2020 to meet rising energy demand. About 80% of natural gas is imported from Azerbaijan, while almost a half of oil products are imported from Russia, which is not in line with EU energy security policy, which prioritises a phase-down in imports of fossil fuels from Russia. Measures ensuring emergency gas and oil storage and capacities for gas cross-border connections need to be finalised, while access to the global liquefied natural gas market has been

strengthened. Georgia is currently finalising its first National Energy and Climate Plan, which would provide it with an overarching strategy until 2030 to address energy security and transition and a roadmap to achieve its climate change mitigation objectives.

Renewable policy is mostly based on hydroelectric plants. As of 2021, the share of renewable energy in electricity production was a highly impressive 81%, provided by hydropower and one wind farm. Further fast and large-scale development of renewables is hampered by structural factors. However, it is necessary to take full advantage of the deployment of the planned Black Sea electric cable. Permitting procedures should be simplified and streamlined to enable faster deployment. The electricity market still needs to be fully liberalised. Institutionally, the energy sector is considered stable and reliable and has been largely unbundled since the mid-1990s. Since 2023, the government has had two private auctions for renewables.

While energy intensity has dropped, buildings consume more than 30% of total energy. As energy efficiency in buildings is low, Georgia has prioritised access to finance for energy-efficient renovation and support to innovative new practices. In 2020, Georgia adopted laws on energy efficiency and on the energy performance of buildings, which will introduce energy audits and energy performance certificates. Since then, 15 by-laws have been passed, with strengthened energy-efficiency requirements for new buildings in place since July 2023 and following a transition period for major reconstructions. Further by-laws are being finalised, and their implementation is strengthened.

The European Commission would consider that it is time to make progress on the implementation of a national carbon pricing or emission trading scheme. With the implementation of the EU's Carbon Border Adjustment Mechanism (CBAM) planned for 2026, which will directly impact Georgia's substantial exports to Europe, especially those related to fertilisers and steel, the Ministry of Environmental Protection and Agriculture is preparing legislation (to be approved in 2024) to introduce a monitoring, reporting and verification system as a first step. Its objective is to strengthen the private sector's capacity in this regard in 2025.

The quality of road transport remains suboptimal. In 2021, the total length of the road network was about 21 000 kilometres, but only the few express roads or motorways are in good condition. Poor transport infrastructure caused by inadequate maintenance and trucks with excessive load hampers internal and external connectivity and impacts road safety. The government's action on road infrastructure is focused on constructing the missing part of the East-West Highway (part of the European route E60), with one of the sections completed in late 2023.

Continued investments are needed, in particular to promote the extended trans-European transport network, railway links, ports, road infrastructure maintenance, rolling rail stock and inter-modal and logistic capacities as well as to implement the railway strategy. These will have to be paired with further measures to attract private sector participation, institutional capacities and operational effectiveness and soft measures, in particular to improve road safety. In addition, active engagement within the Transport Community, in which Georgia is currently an observing participant, remains essential and offers Georgia the chance to further align itself with transport *acquis* and more closely integrate its transport market with the EU. In early 2024, Georgia established the regional observatory on road safety in Tbilisi.

Access to digital infrastructure has improved substantially, but some regions lag behind. According to Eurostat, 88.4% of Georgian households have internet access as of 2022. However, high-speed and affordable internet for some rural, remote, and high mountainous areas remains a challenge. Digital connectivity is largely supported by bilateral programmes and by the Log-in Georgia project supported by the EIB and the World Bank as well by EU's Economic and Investment Plan ([47]) Flagships. In 2023, Georgia adopted a law on infrastructure sharing to provide incentives for more investment in the roll-out of broadband connectivity in rural areas. Broadband affordability is a still a

([47]) More on the Economic and Investment Plan in the Joint Staff Working Document on Recovery, resilience and reform: swd_2021_186_f1_joint_staff_working_paper_en_v2_p1_1356457_0.pdf (europa.eu).

challenge and internet speed in firms needs to be improved. According to the International Telecommunication Union, 69% of Georgia's population lack basic skills to use the internet.

Georgia lacks an overarching digital strategy. The ERP outlines the challenges in strengthening the digital economy considering the digital gap between urban and rural areas, high service prices, lack of digital skills and the absence of an institutional coordination mechanism and of a comprehensive vision. It also underlines the opportunity offered by the Black Sea submarine digital cable to be developed under the EU economic and investment plan. The ERP then highlights the priority of investing in broadband infrastructure to bridge the urban-rural gaps, assessing the private sector's need to service this, and explore the potential of infrastructure sharing as a driver for more public-private investment in the field. This will also allow for the creation of data centres and potential investment in cutting-edge technology such as high-performance computing and cloud services. The ERP also highlights the opportunities to boost digital skills among the SME workforce, digitally empower women, young people and vulnerable people, as well as promote entrepreneurship in the field, as a lever for economic diversification and to unlock Georgia's untapped potential in digital innovation. Digitalisation policies are included in several policy documents, like the National Broadband Development Strategy 2020-2025, Georgia's Development Strategy: Vision 2030 and the government programme for 2021-2024 'Towards Building a European State'. However, affordability of fixed broadband lines remains an issue. The 2021-2024 cybersecurity strategy is partially aligned with the EU *acquis* on the use of electronic identities and qualified electronic trust services (e-IDAS). Digital skills are covered by various policy documents and initiatives. From early 2024, the government has renewed work on the digital health strategy. To fully benefit from the planned Black Sea digital cable, an overarching strategy and coordinated efforts from line ministries and agencies are needed.

Reform measure 3: Renewable energy and energy efficiency recalls the priority to establish Georgia as an electricity hub. It also underlines the importance of investments in the modernisation of infrastructure, energy production and networks to address the country's own foreseeable growth in demand as well as to promote the necessary ecosystem to fully benefit from the direct access to the European electricity market that would be provided by the Black Sea electricity cable. While extensive investments are planned and necessary to ensure the extension and reliability of the networks, this will also require further integration into the EU energy market, significant steps in alignment with the EU *acquis* and synchronisation with its network. In particular, it will be important to open the market as set out in its commitment with the Energy Community but also further move ahead in unbundling its transmission system operators in electricity and gas.

On energy production, the ERP rightly highlights the opportunities offered by further developing renewable energy sources. The government could already auction 1 500 MW of production, with 800 MW underway or completed. The objective is to reach 6 000 MW of installed capacity by 2030 – nearly doubling it compared to 2021. However, with the bulk already concentrated in hydropower, it will be important to increase the share of solar and wind to reduce the impact of seasonality that affects some hydro power plants and the possible impact of climate change as well as mitigate environmental and social impacts. Infrastructure investments need to comply with the EU environmental acquis, national and international nature protection and water management obligations, ensure public participation and consultation, and guarantee high quality environmental impact assessment reports that include cumulative impacts on nature and biodiversity.

With energy intensity dropping but buildings still consuming more than 30% of total energy, energy efficiency remains a priority including in the ERP. Hundreds of energy auditors are being trained to help implement this reform and discussions are ongoing on how to further strengthen access to finance in this regard.

Reform measure 4: Enhanced connectivity, recognises the importance of strengthening Georgia's logistics and inter-modal transport capacities, especially as they relate to the shift from road to railway and ports. According to the government, in 2023, the number of containers shipped increased by 40%, to reach 700 000 TEUs ([48]). This measure outlines the extensive investments carried out and planned in

([48]) Twenty-foot equivalent units.

infrastructure both for national and local roads as well as the extended Trans-European Transport Networks (TEN-T) connectivity, via the East-West Highway, with EU support. In terms of maritime connection, it highlights the planned deep seaport of Anaklia, as well as the increase of ferry services across the Black Sea. Georgia also outlines measures that have been taken to strengthen institutional capacities and agencies in the railway and road transportation sectors.

To ensure a resilient digital transformation that leaves no one behind and seize the full opportunity offered by the Black Sea digital cable, a broad and strategic vision effectively coordinated by a clearly identified state institution is important to broaden the potential of the digital economy, roll out e-governance effectively, strengthen the skills base and ensure compliance with EU digital and cybersecurity standards. Because of its strategic location in the South-Caucasus region, Georgia would also benefit from being further aligned with the EU standards related to digitalisation of transport corridors, as a means to boost trade and become further integrated into the Digital Single Market. The government's plan to develop and adopt a national digital strategy, mirroring the EU Digital Compass would be a further step in aligning Georgia with EU standards in the context of the accession process and ensure a coordinated approach to mainstream initiatives supported by different donors, the private sector and international financial institutions.

Key challenge #3: Addressing weaknesses in Georgian labour market including by improving the quality and relevance of education and professional skills development, and strengthening the social protection system and healthcare services.

The Georgian labour market has several structural weaknesses. The unemployment rate stood at 16.4% in 2023, although this is, down from 17.3% in 2022, and 20.6% in 2021. In addition, the employment rate is structurally low at only %. 54%. This is partly due to high informal employment (28.4% of non-agricultural employment, of which 33.4% for men and 22.5% for women), and a high share of population involved in subsistence farming. The employment rate is particularly low for women (43.5% compared to 62.2% for men) while the share of young people neither in employment nor in education or training (NEETs) of 30.7% is particularly high (for 15-29 years old; the EU average is 11.7%). The unequal participation of women in the labour market, compared to men, leads to human capital being underused and, according to the World Bank, an opportunity loss of economic output equivalent to 11.3% of GDP. Self-employment is high (one third of total number of employed people) but decreasing steadily. Still, almost 4 out of 5 employed people in rural areas are self-employed, mostly in agriculture. Involvement of social partners in developing and implementing labour market measures is crucial for their success.

Overall, there is a need to increase labour market participation and training for under-represented groups, **such as NEETs, women, and people with disabilities, including those in remote areas**. Further enhancing pre-primary education and establishing institutionalised childcare systems would be a way of both supporting women's labour force participation and improving education outcomes. Georgia drafted the 2024-2028 National Strategy of Labour and Employment Policy, which sets out specific goals and objectives in the areas of labour and employment, specifically covering enforcement of labour standards through labour inspections, social dialogue, labour market integration of vulnerable groups, labour migration, education, gender equality, social protection and entrepreneurial-economic policy. The timely adoption and implementation of the strategy remains key.

Despite the high level of unemployment and inactivity, companies struggle to find the skills they need in the labour market. The low quality of education and insufficient matching of skills development with labour market needs is affecting people's income and employment opportunities, and the country's ability to boost productivity. Georgia carried out significant reforms in the education sector in the mid-2000s. Public spending on education has reached 3.3% of GDP in 2022 (4.7% in EU) and early school leaving is in line with the EU average. Nonetheless, outcomes point to weaknesses in the system. With education systems worldwide being significantly disrupted by the COVID-19 pandemic, Georgia's performance in the 2022 PISA assessment was slightly better in relative terms (its performance in science improved by a single point and its rate of decline in maths and reading was below the average decline rate). However, Georgia is still among the bottom 25 countries in terms of ranking in all three domains (mathematics, reading and sciences), and regional disparities remain high.

This would suggest the need to carry out a comprehensive assessment of reforms needed to improve the quality of the education outcomes.

Vocational education and training (VET) are provided in both public and private institutions, but enrolments are modest and drop-out rates are high. Georgia aims to promote private-sector involvement in work-based learning and dual education. Creating partnerships with businesses is a guiding principle in Georgia's technical and VET reform. In 2021, the Vocational Skills Agency was established by the Ministry of Education and Science and Georgian Chamber of Commerce and Industry to promote interaction and partnership with private sector. Two new strategies, the 2022-2027 VET strategy and career management services strategy for all formal education levels, are expected to be approved in 2024. However, the transition from vocational education programmes into the labour market remains a big challenge, relating to the quality of VET, alignment with labour market needs, lack of human and financial resources, and development of key competences.

Poverty rates are decreasing, but inequalities persist, and social safety nets are very limited. The poverty rate dropped from 20% before the COVID-19 pandemic to around 15% in 2023, but the Gini coefficient stands at 0.34, suggesting significant and persistent inequalities, particularly between urban and rural populations. In recent years, the government has taken steps towards implementing significant social protection reforms. Among other measures, the government introduced a Targeted Social Assistance Programme in 2006 and targeted child allowances in 2015. Overall, spending on social protection (5.7% of GDP in 2022) remains below the average spending in Europe and Central Asia. The country has a very low minimum wage in place and the social allowance for extremely poor people is also low (at most EUR 100 per family per month). The universal pension was increased in 2023, but still it only provides relatively small benefits. Georgia has no unemployment insurance and employees pay very little in social contributions. In the private sector, there is no obligation for firms to provide paid maternity leave. The government on the other hand provides a one-off state allowance of maternity/child adoption benefits, which was increased from approximately EUR 340 to EUR 680 in 2023. In a further initiative providing parental support, secondary school teachers can now receive 100% of their salary during maternity leave. Adopting a comprehensive and sustainable social protection system, including unemployment and minimum income benefits, is included in the recommendations addressed to Georgia in the 2023 Enlargement Package.

The universal healthcare system is mostly provided by private providers, with high out-of-pocket expenditure. Public spending on healthcare is above many low- and middle-income countries in the Europe and Central Asia region, but below the EU average and low in absolute terms. 86% of hospitals are owned by for-profit private entities, while the rest, mostly specialised hospitals, are operated by public institutions. Out-of-pocket expenditures are high and are still the largest source of health financing for the general population (51% vs 16% in the EU). Universal healthcare coverage has been implemented in Georgia for the past decade, with around 82% of the population being covered. The universal health coverage programme primarily focuses on protecting poor households (i.e. those with an annual income threshold of approximately EUR 13 600) with an expanded benefits package, and the rest of the population with a basic set of publicly funded benefits. Outpatient care is increasing but remains low. In 2022, the country adopted the National Healthcare Strategy of Georgia 2022-2030 and its action plan in 2022, with an overall goal to improve the health status of the population through universal access to healthcare services and equitable distribution of financial burdens.

Reform measure 5: Improved Healthcare of the Population aims to improve the health status of the population, through universal access to health services, improved quality of the services, and equal sharing of the financial burden. The government is working to improve the effectiveness of social spending through stronger intersectoral dialogue and an improved institutional framework. This includes the protection of all citizens from social and financial risks and to ensure wider coverage of the health services. Georgia is planning to introduce modern reimbursement methods in the field of specialised healthcare services (e.g. result-oriented payment). The reform measure also aims to reduce out-of-pocket costs and improve access to high-quality, efficient, and safe medicinal products. This reform measure is relevant and contributes to the broader goal of establishing a comprehensive social protection system. Recent initiatives, such as the introduction of Diagnostic Related Groups to improve

health provider payment mechanisms and External Reference Pricing, have provided improvements in the quality of outpatient care and brought significant savings.

Reform measure 6: Education includes three broad actions for the 2024-2026 period: (i) ensure a high-quality, supportive and development-oriented care and educational process by all early and preschool care and education institutions; (ii) provide a highly effective, relevant and student-centred learning experience for every student in secondary school, enabling the student to fully develop academic, personal, social and learning competencies; and (iii) provide vocational education services in response to current demands and challenges. While all these measures are relevant to improve the quality and relevance of education and professional skills development, translating the reforms into specific measures to be achieved in the following years is needed along with ensuring improved alignment between the high degree of enrolment in the higher education sector with the actual labour market needs. Georgia needs to upgrade its education system to build strong foundational and transferable skills from early ages and to ensure market-relevance of its tertiary education.

3.5. THE POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS PARTNERS, TÜRKIYE, GEORGIA, REPUBLIC OF MOLDOVA AND UKRAINE

The Economic and Financial Dialogue between the EU and the Western Balkans Partners, Türkiye, Georgia, Republic of Moldova and Ukraine

Brussels, 14 May 2024

[...]

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

1. Ensure that the 2024 budget deficit is within the target set in the budget law, and implement the medium-term plan to reduce the deficit with a view to building fiscal buffers. In order to improve efficiency of the tax policy, publish the tax expenditure analysis of the agricultural sector and prepare concrete budgetary recommendations to implement its findings, and continue work on analysing the economic and fiscal impact of all tax expenditures. Adopt and publish the medium- term revenue strategy and make progress on its implementation.

2. With a view to improving the quality of the assessment of public investment projects, further enhance staff skills in preparing these assessments and introduce an electronic system for the management of public investments. In line with the public debt management strategy, continue efforts to develop the government security market, in particular by expanding the range of instruments denominated in local currency as an important step towards further development of capital markets. In order to improve the monitoring framework and cash management, continue the process of improving fiscal oversight over state-owned enterprises (classified as general government units) by bringing the accounts of the largest enterprises under the Single Treasury Account.

3. Ensure a sufficiently tight monetary policy stance as long as necessary to anchor inflation expectations at levels consistent with price stability, underpinned by a thorough assessment of potential second-round effects. Ensure the independence of the central bank, including by adhering to proper appointment procedures and sound central bank governance. Continue to enhance risk-based supervision in line with best international and European practices, as well as to promote the use of the domestic currency and to limit unhedged lending.

4. With a view to strengthening competitiveness and exports in the agricultural sector, finalise the architecture of the land information system and make progress on extending its coverage. Advance with the irrigation sector reform including the revision of water tariffs. With a view to addressing the informal economy in a holistic, government-wide manner, encompassing tax, labour, social and financial policies, undertake steps towards preparing a policy plan, by establishing a dedicated inter- ministerial Working Group and elaborating sectoral and risk assessment.

5. Adopt a legal framework for supporting Energy efficiency and Renewable Energy roll out, improve the security of energy supply by finalising and adopting legislation on establishing strategic oil reserves, continue to liberalise the energy market by finalising and adopting

legislation on unbundling of transmission system operators in electricity and ensuring electricity market opening by launching intra-day and day-ahead markets and preparing for the balancing market. To support the country's climate commitments, adopt the Integrated National Energy Climate Action Plan and develop draft legislation to introduce the Monitoring, Reporting and Verification system thus approximating national legislation to the EU legal acts. To support the country's transit potential, continue reforms and ensure implementation of investments in transport infrastructure (ports, railways, road transport), build capacities within relevant transport agencies including through active cooperation with donors. To strengthen digitalisation and productivity of the economy, adopt an overarching digital strategy and enhance coordination among digitalisation governance agencies and relevant ministries.

6. To improve labour market outcomes and social inclusion, adopt and ensure an effective implementation of the Labour and Employment Policy strategy, paying special attention to internally displaced persons and under-represented groups, such as women, people with disabilities, and NEETs, including in remote areas. To strengthen Georgia's human capital and reduce skills mismatches in the labour market, conduct and finalise - with the support of the European Training Foundation - a diagnostic of the education system, including vocational education and training. To reduce regional disparities and social inequalities including through strengthened equity, access and efficiency of health care and the social safety net, extend universal health coverage further.

ANNEX: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Economic Reform Programme 2024-2026 was endorsed by the Government of Georgia ([49]) and submitted to the Commission on 15 January 2024. The ERP includes both a presentation of the macro-fiscal framework and of a selected number of structural reforms that the authorities consider focusing on in the next few years. Given the significant time constraints in preparing the programme, the ERP was based on documents and processes already in place in the Georgia's fiscal governance and policy planning. The chapter on structural reforms, which was submitted on a voluntary basis, covers selected measures from the Government Strategic Document, 'Vision 2030 – Development Strategy of Georgia'. Both the macro-fiscal framework and the structural reform part broadly reflect the key components requested by the Commission.

Inter-ministerial coordination

The ERP is coordinated by the Ministry of Finance, which worked closely with the other public institutions in preparing the ERP. The authorities noted that the date for submitting the ERP to the Commission was suboptimal given the absence of final budgetary and national accounts figures for the past year and the winter holiday period that posed a significant challenge to the authorities in submitting the programme in good time.

Stakeholder consultation

Given the time constraints, independent experts were not consulted on the ERP. There was also no public consultation on the programme either. However, the government documents and strategies that were used as a backbone for preparing the ERP underwent such consultations.

Macroeconomic framework

The macroeconomic part of the ERP was prepared on the basis of Georgia's medium-term fiscal framework for 2024-2027 (called 'Basic Data and Directions') ([50]), which was submitted to the Parliament as part of the 2024 budget package and the 2024 State Budget approved by the Parliament on 15 December 2023. It describes the past economic developments based on the available data and includes an updated medium-term macro-fiscal framework. The programme presents a clear and concise picture of past and expected main future economic developments. The presented framework is coherent and consistent, although it does not provide a detailed explanation of the factors behind the figures presented. It describes both an alternative positive and negative macroeconomic scenario, although in a very succinct manner.

Fiscal framework

The major policy documents underpinning the fiscal framework are listed. The link between the fiscal framework and specific priorities is well presented. The programme contains references to obligations under the EU-Georgia Association Agreement, though does not yet make reference to recommendations from the first enlargement country report published in November 2023.

While the ERP covers all components required by the Commission, the estimated fiscal impact of the key revenue and expenditure measures is not elaborated upon sufficiently. The programme would benefit from a more detailed analysis of budget implementation in 2023 (compared both to the previous year and the 2023 budget plan) as well as a more comprehensive explanation of the key factors expected to influence the fiscal outcomes in 2024-2026. The ERP does not mention any one-off expenditure measures to be implemented in 2024. Georgia's fiscal reporting does not follow ESA 2010 standards, and therefore does not meet the Commission's fiscal notification requirements. The authorities mention in their programme plans to align to ESA 2010 but have not provided a specific timeline to that end.

([49]) Government Decree #41 (15 January 2024) on 'On endorsement of the Economic Reform Programme (2024-2026)'.

([50]) 'Basic Data and Directions', https://www.mof.ge/5653.

4. KOSOVO

4.1. EXECUTIVE SUMMARY

Following some slowdown in economic activity in 2023, Kosovo's economic reform programme (ERP) expects GDP growth to pick up, mainly on the back of a robust increase in private and public investment. Annual output growth eased to a still buoyant 3.3% in 2023 from 4.3% in 2022, primarily due to the negative contribution of the external sector to GDP growth. The ERP baseline scenario projects an annual average GDP growth of 4.6% in 2024-2026, which appears to be overly optimistic. In particular, the strong increase 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 investment projects and an uncertain economic environment for private investment. Major downside risks to this outlook stem from less dynamic growth in Kosovo's main EU (and non-EU) trading partners, tighter financing conditions, an acceleration of emigration flows following the EU visa liberalisation and lower-than-expected financial inflows from the diaspora.

After 3 years of substantial fiscal consolidation, the ERP expects a strong fiscal impulse in 2024, while ensuring compliance with the deficit rule in 2024-2026. Supported by strong revenue growth, the headline budget deficit fell to 0.2% of GDP in 2023, continuing the fiscal consolidation that started in 2021. Public capital spending increased substantially compared to 2022 but fell short of budget plans. The 2024 budget expects the headline deficit to rise to 2.7% of GDP, implying a strong fiscal stimulus mainly through an arguably very ambitious surge in public investment. However, the deficit (according to the fiscal rule definition) would not exceed the prescribed ceiling of 2% of GDP. The ERP expects the headline deficit to remain unchanged in 2025 and to fall to 1.9% of GDP in 2026. The public debt ratio is set to increase but remain low at slightly above 20% in 2026. However, the domestic public debt investor base remains narrow and Kosovo does not have access to international debt markets.

The main challenges facing Kosovo are the following:

- **The projected compliance with the deficit rule will serve as an anchor for fiscal policy but necessitates further reforms.** Implementing the planned large increase in capital spending while containing current expenditure remains key. Budgetary transparency and accountability could be improved by further reducing blanket allocations. Compliance with the 2% deficit ceiling over 2024-2026 could also be strengthened through policies to broaden the revenue base. A review of existing tax exemptions and preferential tax rates and the reduction of loopholes and exemptions through amendments to tax legislation would help mobilise revenues.

- **The significant increase planned in public investment requires comprehensive reforms to improve project planning and implementation.** Despite the authorities' continued efforts, Kosovo has made little progress in strengthening public investment management. Concrete steps, such as those recommended under the IMF's updated Public Investment Management Assessment (PIMA), could improve the execution of capital spending. Fiscal risks related to publicly owned enterprises (POEs) could be mitigated by improving their governance and financial oversight and accountability. This can be advanced by steps such as approving and publishing annual performance reports for POEs and by adopting amendments to the POE Law.

- **There are key structural obstacles to competitiveness and inclusive growth.** Structural bottlenecks, such as the high administrative burden for businesses and citizens, lack of proper resolution of commercial disputes and limited access to finance, continue to have a negative impact on fair competition in Kosovo. The large informal economy reduces budget revenues and hinders investment and business development, thereby constraining economic growth. The insufficient and unreliable supply of energy gives rise to significant costs for businesses while also putting pressure on public finance. The education system does not adequately equip students with

the necessary skills required by the labour market. This market is characterised by low participation and high unemployment rates, in particular for women and young people. Weak labour-market outcomes contribute to continuously high emigration. These challenges are expected to be addressed through key structural reforms identified in Kosovo's reform agenda under the new Growth Plan for the Western Balkans.

The implementation of the policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2023 has been partial. Strong public revenue growth substantially improved the budget balance. Compliance with the fiscal rule's deficit ceiling of 2% of GDP is expected to continue in 2024. The measures to mitigate the impact of the energy crisis on vulnerable households and businesses were mostly well-targeted. The law on public-sector salaries that came into force in February 2023, combined with a suitable value of the wage coefficient set by the government, ensured that the public wage bill did not exceed its legal ceiling. At the same time, actual spending on the war veterans' pension scheme slightly breached its prescribed legal ceiling. Tax revenue grew strongly, partly due to improved tax compliance and some formalisation gains, but there was little progress on reviewing tax exemptions. 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. Kosovo finalised its first competitive auction for renewable energy projects, however the Law on Renewable Energy Sources is still pending adoption. Medium to long-term measures planned in the EU Energy Support Package are still to be implemented. Limited progress has been achieved in the area of electricity market liberalisation with the first day-ahead market auction for electricity delivery in Kosovo held by ALPEX ([51]). Kosovo continued efforts to reduce informality by implementing planned activities, adopting a new action plan and relevant legislation. Necessary steps to complete the restructuring of SME and investment promotion agencies were taken, however their finalisation depends on a Constitutional Court decision. A roadmap for implementing key reforms to the education system was not developed. Kosovo has started implementing a dual education system. However the vocational education and training (VET) profiles remain largely unaligned with labour market needs. The restructuring of the public employment services is still underway, and further legislative steps and adequate budget allocation are needed to implement the Youth Guarantee and deliver relevant active labour market measures.

4.2. ECONOMIC OUTLOOK AND RISKS

Kosovo's economic growth moderated in 2023 mainly due to weaker external demand. Real GDP growth softened to 3.3% in 2023 ([52]), compared to 4.3% ([53]) in 2022. The key factor behind the deceleration was the negative contribution of net exports to growth, reflecting a notable slowdown in real exports growth. GDP growth was driven by an acceleration in private consumption growth on the back of rising real wages, higher bank lending and a slight increase in (net) remittances as a share of GDP. Also public consumption growth picked-up, largely due to higher public-sector wages. Growth in 2023 was also supported by a strong increase in public investment.

The ERP's baseline scenario projects a robust acceleration in real GDP growth in 2024-2025 before easing in 2026. Real GDP growth is set to pick-up to 4.6% in 2024 and further to 4.8% in 2025, before slowing to 4.4% in 2026. This acceleration is expected to be driven by a surge in public investment in 2024 (+23.1% year-on-year). Public investment looks set to benefit from: (i) improved

([51]) Albanian Power Exchange – ALPEX (Bursa Shqiptare e Energjisë Elektrike) is a joint venture company owned by the Transmission System Operators of Albania (OST) and Kosovo (KOSTT).

([52]) Macroeconomic and fiscal estimates and forecasts covering the period 2023-26 have been taken from the ERPs themselves; if available, preliminary macroeconomic and fiscal outturn data for 2023 have been taken from the relevant national sources (Kosovo Agency of Statistics (KAS), Ministry of Finance, Labour and Transfers (MoFLT) and the Central Bank of Kosovo (CBK)).

([53]) In December 2023, the Kosovo Agency of Statistics (KAS) revised the real GDP growth rate for 2022 downwards, to 4.3% (from 5.2%).

implementation of future project appraisal and selection, (ii) implementation of the administrative instruction already approved in May 2023, requiring budget organisations to include expropriation costs as part of their project envelopes, and (iii) ensuring that technical evaluation and documentation on new externally financed projects is finalised before signing the corresponding financial agreements. Private investment is also expected to increase by 8.7% y-o-y due to government support and the private sector's improving balance sheets. Private consumption is set to grow by 2.6% in 2024 and 3.4% on average, in 2025-2026, supported by higher bank lending and public-sector wages as well as lower inflation. Public consumption is projected to increase by 6.2% in 2024, followed by a more moderate pace, due to the planned increase in public sector salaries. Real exports are set to increase by 6.5% in 2024 and continue growing vigorously, by 7.2% on average in 2025-2026. In line with the envisaged robust investment increase, imports are expected to grow strongly, by 6.7% in 2024, before slowing to a pace of around 5% on average, in 2025-2026. As a result, the ERP projects net exports to provide negative contributions to GDP growth over the programme period; the largest in 2024 (-2.1 pps.) followed by a diminishing trend in 2025-2026. The programme expects the output gap to remain zero in 2024 and to turn positive thereafter, as real growth is projected to exceed the potential growth rate (estimated at 4.5%).

Table II.4.1:
Kosovo - macroeconomic developments

	2022	2023	2024	2025	2026
Real GDP (% change)	5.2	3.9	4.6	4.8	4.4
Contributions:					
- final domestic demand	2.8	1.0	6.2	5.4	4.1
- change in inventories	-0.3	0.3	0.5	0.5	0.5
- external balance of goods and services	2.8	2.6	-2.1	-1.1	-0.2
Employment (% change)	5.4	:	:	:	:
Unemployment rate (%)	12.6	:	:	:	:
GDP deflator (% change)	6.7	5.5	3.0	2.5	2.3
CPI inflation (%)	11.6	5.1	2.7	2.3	2.3
Current account balance (% of GDP)	-10.2	-6.8	-7.9	-7.9	-7.4
General government balance (% of GDP)	-0.5	-0.2	-2.7	-2.7	-1.9
Government gross debt (% of GDP)	20.0	17.3	18.8	20.4	21.4

Source: Economic Reform Programme (ERP) 2024.

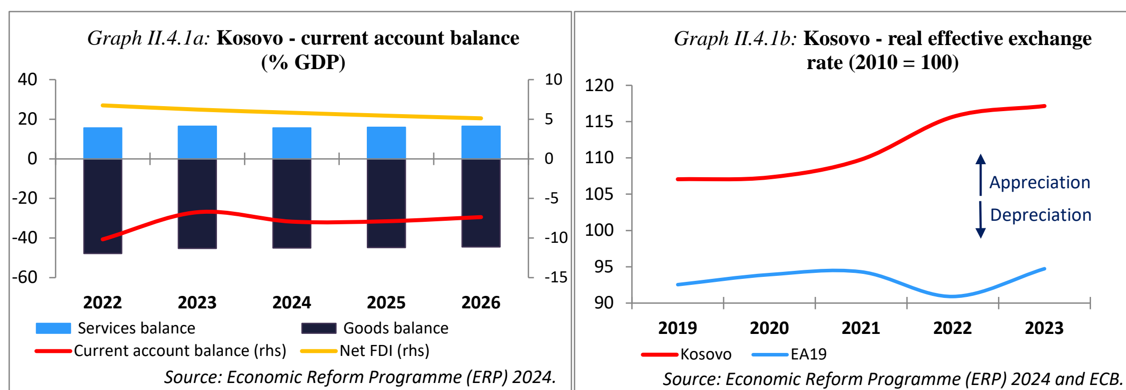
The ERP's baseline scenario appears overly optimistic and is beset by high uncertainty. GDP growth rates for 2024 and 2025 have been markedly revised downward from the previous year. Still, the growth path looks rather optimistic and much above the 4% average annual expansion projected by the IMF. In particular, the strong recovery in investment is likely to face constraints due to an uncertain economic environment for private investment, as well as persistent weaknesses in the planning, selection and management of public investment. The ERP itself notes that macro-fiscal risks remain high due to the linkages between Kosovo's economy and international partners through foreign trade and remittances inflows. Further increases in global energy and food prices - due to the escalation of Russia's full-scale war of aggression against Ukraine and geopolitical tensions, a tight monetary policy stance and the associated deceleration of economic activity in the euro area - will likely cause a further slowdown in inflows of remittances and will negatively affect external demand. Significant domestic risks stem from outdated power generation capacity and high import costs, which may result in new power cuts and higher energy subsidies as well as a pick-up in emigration flows due to the EU visa liberalisation. The ERP's 'low growth' scenario results in an average annual growth rate of around 2.3% in 2024-2026, which appears more realistic than the baseline. The scenario's main assumptions are an under-execution of public investment, lower foreign demand, a decline in remittances and higher financing costs for the banking sector. The programme would benefit from the inclusion of a comparison between its medium-term growth projections and the potential output growth estimates.

After a significant moderation in 2023, average inflation is expected to decline further in 2024-2026. Consumer price inflation decelerated substantially in the course of 2023, averaging 4.9%

for the year as a whole (compared to 11.6% in 2022) and falling to as low as 2.2% in February 2024. The key driver of moderating inflation was lower commodity prices in international markets. The ERP expects average annual inflation to decrease further to 2.7% and 2.3% in 2024 and 2025-2026, respectively, on the back of the continued slowdown in global commodity prices. The ERP's inflation projection is more optimistic than the IMF forecast of an annual inflation rate of 3.5% in 2024. The programme rightly acknowledges the external risk of any intensification in the war in Ukraine and the fallout from this on commodity prices and external demand, as well as other geopolitical tensions (such as those around the Red Sea). This would leave Kosovo exposed to renewed inflationary pressures caused by higher import prices for food, agricultural and energy products, the latter potentially exacerbated by shortfalls in domestic electricity production. Inflation risks also come from demand pressures due to higher public-sector salaries and pensions that were included in the 2024 budget, and a potential increase in social benefits.

The current account deficit narrowed significantly in 2023, but the ERP projects it to widen over the programme period as domestic demand picks up. The continued rebound of services exports, coupled with the energy-balance-driven decline in the merchandise trade deficit, resulted in the current account deficit narrowing to 7.6% of GDP in 2023 from 10.3% in 2022. Diaspora tourism from Western Europe and exports of IT services fuelled a 1.4 pps. increase in the services surplus to 16.9% of GDP. At the same time, despite the moderate fall in goods exports, the traditionally high merchandise trade deficit narrowed by 0.6 pps. to 47.6% of GDP, mainly due to a notable decline in energy imports, reflecting falling energy prices globally. The primary income surplus widened to 1.9% of GDP in 2023 from 1.3% in 2022. Remittances increased by 0.2 pps. to 13.9% of GDP, and are forecast to follow historical trends in 2024-2026 with an annual average growth of 5%. Errors and omissions (2.9% of GDP) may reflect unrecorded services exports and remittances, so the actual current account deficit could be smaller than the official estimates. The ERP expects the current account deficit to widen to 7.9% of GDP in 2024. This appears plausible, given the expected increase in imports, reflecting rising domestic demand and higher investment. A slight decrease in the deficit to 7.6% of GDP on average in 2025-2026 appears to be in line with the projected improvement in the overall trade deficit, mainly on the back of higher external demand.

External competitiveness and current account



Source: Economic Reform Programme (ERP) 2024.

Source: Economic Reform Programme (ERP) 2024 and ECB.

Net foreign direct investment increased slightly in 2023 and covered some 90% of the current account deficit, on the back of financial inflows from the diaspora into real estate. Net foreign direct investment inflows grew to 6.8% of GDP in 2023 from 6.3% in 2022, covering most (89%) of the current account deficit. The bulk was directed to non-tradeable activities, with real estate and financial and insurance services accounting for 61% and 21% of all foreign direct investment inflows respectively, doing little to improve export capacity. The ERP projects that net foreign direct investment inflows will be roughly stable at EUR 0.6 billion over the programme period. Due to the projected increase in nominal GDP, these inflows are therefore expected to gradually decrease from 5.8% of GDP in 2024 to 5.1% in 2026, which is not sufficient to fully cover the current account deficit. Kosovo's net international investment position slightly deteriorated to -18.8% of GDP in 2023, compared to almost -18% in 2022. Around two thirds of gross liabilities consist of foreign direct

investment, limiting external vulnerabilities. Reserve assets are largely stable at just above 2 months of imports over the ERP period.

Table II.4.2:
Kosovo - financial sector indicators

	2019	2020	2021	2022	2023
Total assets of the banking system (EUR million)	4 761	5 365	5 960	6 762	7 542
Foreign ownership of banking system (%)	86.7	86.5	85.5	84.9	84.3
Credit growth (%, average)	10.7	7.7	11.2	17.4	14.1
Deposit growth (%, average)	12.6	12.2	13.8	10.8	13.9
Loan-to-deposit ratio (end of period)	77.6	74.5	76.5	78.3	80.2
Financial soundness indicators (%, end of period)					
- non-performing loans to total loans	2.0	2.7	2.1	2.0	2.0
- regulatory capital to risk-weighted assets	15.9	16.5	15.3	14.8	15.8
- liquid assets to total assets	38.7	39.8	37.4	36.5	34.7
- return on equity	18.9	14.0	17.6	20.6	19.7
- foreign exchange loans to total loans	0.1	0.1	0.1	0.3	0.2

Source: Central Bank of Kosovo.

The mainly foreign-owned banking sector remained resilient and continued to expand at a robust pace. Annual bank lending growth decelerated to an average of 14.1% in 2023 from 17.4% in 2022, largely driven by slower growth in credit to businesses, reflecting tighter financing conditions. New loans to households, mostly for spending purposes, grew vigorously. The growth of bank deposits picked-up to an average of almost 14% in 2023 from 10.8% in 2022. Financial soundness indicators remained satisfactory, e.g. the loan-to-deposit ratio and non-performing loan (NPL) ratio ([54]) stood at 80.2% and 2%, respectively at end-2023. While bank profitability has slightly declined, with the average return-on-equity ratio falling to 19.7% in 2023 from 20.6% in 2022, the risks in the banking sector seem contained. Still, asset quality should be monitored closely in the context of higher interest rates and tighter liquidity. The ERP does not provide quantified forecasts for the financial sector but its underlying assumption is of a moderate increase in NPLs during 2024, necessitating increased provisioning for credit risks. Despite the fact that new mortgage lending to households declined in 2023, compared to relatively strong growth a year before, it would also appear appropriate to strengthen surveillance of the housing market, including by compiling residential sector statistics using bank loan data.

4.3. PUBLIC FINANCE

Fiscal consolidation continued in 2023 with a further reduction in the headline deficit due to strong revenue performance and despite a surge in public investment spending. The headline budget deficit stood at 0.2% of GDP in 2023, which corresponds to a surplus of 0.6% of GDP under the fiscal rule definition ([55]). The headline deficit outturn was lower than in 2022 (0.5% of GDP) and significantly undershot the target of 3.6% set in the revised 2023 budget. The lower deficit resulted primarily from a strong increase in government revenue (+14.4% year-on-year), partly due to improved tax compliance and some formalisation gains. Tax revenue increased by 13% y-o-y, with direct and indirect tax income growing healthily by 18.4% and 11.1%, respectively. Public expenditure

([54]) The stable NPL ratio was also supported by the denominator effect, i.e. continued credit growth.

([55]) 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 2026, provided the public debt ratio remains below 30% of GDP. A further rule stipulates 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 requires that public and publicly guaranteed debt cannot exceed 40% of GDP.

grew by 13.2% year-on-year due to a strong increase in capital spending (almost 33%), even though it only reached around 68% of the revised budget allocation, reflecting overoptimistic targets and weak implementation capacity. The execution of overall current expenditure was roughly in line with the revised budget plan. Wages and allowances recorded a strong increase of 17.3% y-o-y due to the implementation of the new law on salaries in the public sector since February 2023, while spending on goods and services rose by almost 16%. Government deposits fell to 2.4% of GDP, from 3.2% in 2022, reflecting higher nominal GDP, a shortfall of external budget support financing and a sizeable net negative domestic debt issuance.

The ERP objective for 2024-2026 is to maintain stable public finances and comply with fiscal rules, while supporting the economy mainly through higher capital spending. Over the programme period, public revenue is set to decline by 1.0 pp. to 28.1% of GDP by 2026, mainly due to a decrease in non-tax revenue, while tax revenue is projected to rise marginally in 2024 before stabilising at 25.6% of GDP in 2025-2026. Public expenditure is projected to increase by 0.7% of GDP over the ERP period to 30.1% in 2026, largely based on a very sizeable (2.2 pps.) upfront increase in capital spending in 2024, which brings public investment to around 8% of GDP, at which level it will remain over the programme period. Current spending is set to fall gradually by 1.1 pp. to 21.6% in 2026, driven by lower spending on goods and services as well as wages and salaries while transfers and subsidies are projected to remain stable as a percentage of GDP. After a large increase in 2024, the headline deficit and the deficit as per the fiscal rule definition are set to remain unchanged in 2025, compared to 2024, at 2.7% and 2% of GDP respectively, while they are projected to fall to 1.9% and 1.5% of GDP, respectively, in 2026. The implied fiscal impulse of 2.5 pps. in 2024 seems appropriate to support economic activity given the economic slowdown in 2023 and the sizeable uncertainty surrounding external demand as well as the emergence of a negative output gap before fiscal consolidation gradually resumes in 2025-2026.

Table II.4.3:
Kosovo - composition of the budgetary adjustment (% of GDP)

	2022	2023	2024	2025	2026	Change: 2023-26
Revenues	27.9	29.1	28.7	28.2	28.1	-1.0
- Taxes and social security contributions	25.2	25.7	25.9	25.6	25.6	-0.2
- Other (residual)	2.7	3.4	2.8	2.6	2.5	-0.9
Expenditure	28.4	29.3	31.4	30.9	30.1	0.7
- Primary expenditure	28.0	29.1	31.0	30.4	29.6	0.5
of which:						
Gross fixed capital formation	4.7	5.9	8.1	8.1	7.8	1.9
Consumption	11.4	12.1	12.5	12.0	11.4	-0.7
Transfers & subsidies	11.9	11.0	10.1	10.1	10.1	-0.9
Other (residual)	0.0	0.0	0.2	0.2	0.2	0.2
- Interest payments	0.4	0.4	0.4	0.5	0.5	0.1
Budget balance	-0.5	-0.2	-2.7	-2.7	-1.9	-1.7
- Cyclically adjusted	-0.9	-0.2	-2.7	-2.8	-2.1	-1.8
Primary balance	-0.1	0.2	-2.3	-2.2	-1.4	-1.7
- Cyclically adjusted	-0.5	0.2	-2.3	-2.3	-1.5	-1.8
Gross debt level	20.0	17.3	18.8	20.4	21.4	4.2

Sources: Economic Reform Programme (ERP) 2024, Commission calculations.

The 2024 budget aims to provide a significant fiscal impulse, primarily through a large increase in investment spending, albeit with sizeable risks surrounding its execution. The 2024 budget projects public revenue to be 28.7% of GDP, slightly lower than the 2023 outturn of 29.1% of GDP. Tax revenue is expected to increase marginally to 25.9% of GDP, supported by higher GDP growth, a further reduction in the informal economy and improved tax compliance. Grants are set to decrease significantly by 62.5% year-on-year, reflecting base effects due to the EUR 75 million (0.8% of 2023 GDP) energy-crisis-related budget support from the EU in 2023. The assumed small rise

in the tax revenue-to-GDP ratio looks plausible, due to authorities' initiatives to further strengthen tax compliance and tackle the informal sector ([56]). Total expenditure is planned to increase to 31.4% of GDP from 29.3% in 2023, mainly due to a 2.2 pps. rise in public investment spending. Compared to the 2023 outturn, capital spending is set to increase by around 53%. Such a strong increase appears overly optimistic, given the previous track record in implementing spending, and would require a comprehensive overhaul of the institutional framework for investment planning and management. Moreover, such a strong surge in public investment is also not in line with the projections underlying the current IMF stand-by arrangement, which expects a small increase in capital spending in 2024 to 6.1% of GDP from 6% in 2023. Current expenditure is set to decrease by 0.5 pps. to 22.6% of GDP in 2024 reflecting the government's intention to gradually decrease less growth-enhancing budget allocations as well as better targeting of energy-crisis related temporary support to vulnerable consumers. Spending on goods and services is expected to grow by 0.6 pps. to 4.9% of GDP as a result of reclassifications from capital to current expenditure, mainly in the Ministry of Defense. Notwithstanding the planned increase in the salary coefficients as foreseen in the Law on salaries of public officials that came into force in February 2023, the wage bill is expected to decrease by 0.2 pps. to 7.6% of GDP. Debt interest payments are set to remain unchanged at 0.4% of GDP in 2024. The 2024 budget includes a 1.3% of GDP allocation for contingencies, of which 0.7% of GDP is a blanket allocation. This is significantly lower than in the 2023 budget (2.7% of GDP). Still, such 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 to rise to 2.7% 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 decline slightly to 1.7% of GDP from 2.4% in 2023, which is still in line with the fiscal rule, as no privatisation proceeds are planned.

While general government debt is projected to remain low, weaknesses linked to a narrow investor base and a lack of market access remain. On the back of a marginal primary surplus and high nominal GDP growth, the debt-to-GDP ratio decreased by 3.5 pps. to 17.2% in 2023. This is well below the 2023 ERP projection of 22.6% and the fiscal rule ceiling of 40%. 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 started reimbursing in 2023 ([57]). Domestic debt decreased significantly by almost 13% in 2023 and is held by a narrow investor base. The KPST is the largest investor and accounts for 46% of the domestic debt stock (down from 49% in 2022). The KPST still has room to buy new bond issuances in the coming years, but it is approaching the legal limit ([58]). The appointment of new Board members in July 2023 allowed KPST to resume participation in the auction of Kosovo government securities in August. The share held by commercial banks fell slightly to 24% from 25%; the share held by the Central Bank of Kosovo increased to 22% in 2023, from 19% a year earlier. Foreign debt rose by around 8% in 2023 and consists of concessional financing from international financial institutions, such as the IMF, the World Bank, the European Investment Bank and the European Bank for Reconstruction and Development. The ERP projects a 1.6 pps. increase in the public debt ratio in 2024 to 18.8% of GDP and a continued gradual drift upwards to 21.4% of GDP in 2026. It projects government deposits to hover around 1.7% of GDP in 2024-2026, notably lower than the level expected in the previous year's ERP, which may not provide sufficient capacity to absorb potential new shocks. The lack of an international credit rating and access to international debt markets implies a need to diversify the investor base to ensure adequate financing. This could include insurance companies, non-financial private firms and possibly retail investors, including among the diaspora, which together currently hold only 8% of domestic debt. Kosovo is receiving technical assistance from the U.S Agency for International Development (USAID) to prepare an assessment for obtaining a sovereign credit rating from one of the three leading international credit rating agencies.

([56]) The Tax Administration of Kosovo (TAK) announced a new action plan to reduce informality in July 2023, and a tax procedures law was adopted by the government in December 2023.

([57]) The IMF estimates the liability to KPST to be 1.8% of 2020 GDP.

([58]) Government securities should not exceed 30% of KPST assets.

BOX II.4.1: DEBT DYNAMICS

Kosovo

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

	2022	2023	2024	2025	2026
Gross debt ratio [1]	20.0	17.3	18.8	20.4	21.4
Change in the ratio	-1.6	-2.7	1.5	1.7	1.0
Contributions [2]:					
1. Primary balance	**0.1**	**-0.2**	**2.3**	**2.2**	**1.4**
2. 'Snowball effect'	**-1.9**	**-1.3**	**-0.8**	**-0.8**	**-0.8**
Of which:					
Interest expenditure	0.4	0.4	0.4	0.5	0.5
Growth effect	-1.0	-0.7	-0.7	-0.8	-0.8
Inflation effect	-1.3	-1.0	-0.5	-0.4	-0.4
3. Stock-flow adjustment	**0.2**	**-1.2**	**0.0**	**0.2**	**0.4**

[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) 2024, Commission calculations.

The primary balance is projected to turn negative in 2024 and maintain a (gradually shrinking) deficit in 2024-2026, which is expected to drive the moderate increase in the public debt ratio over the same period. This debt-increasing factor is set to be partly offset by the impact of buoyant economic growth and, to a more limited extent, inflation. Interest expenditure is forecast to stay low and rougly stable at 0.5% of GDP in 2024-2026. Slightly positive contributions to the debt-to-GDP ratio are expected to come from stock-flow adjustments in 2025 and 2026, although their origins are not explained in the ERP.

Significant risks and uncertainties surround the fiscal scenario. Fiscal projections are likely to underestimate current spending, while the assumption of a surge in capital spending in 2024 appears unrealistically large. On the spending side, the decrease in the allocation for transfers and subsidies as a percentage of GDP seems rather benign, even if the elimination of untargeted government electricity subsidies, following the increase in electricity tariffs in March 2023, is taken into account. There is a risk that transfers and subsidies might decrease less than the targeted 1.4% or even increase in 2024, compared to the 2023 outcome, due to the repetition of initiatives such as raising basic pensions with one-off top-ups and child benefits ([59]), while existing schemes might prove more costly than expected. In particular, spending on war veteran pensions has repeatedly breached the legal cap of 0.7% of GDP in the absence of a reclassification of beneficiaries. The law adopted on 13 July 2023, which decouples war veterans' pensions from the minimum wage, would help contain overspending risks. However, the law is currently being reviewed by the constitutional court (following a request by the opposition) and it will not be decreed by the President before the court's ruling is received. The planned decrease in the wage bill also looks optimistic given the previous track record in this area. The projected increase of more than 50% in capital spending, compared to the 2023 outturn, seems overly ambitious given the track record in previous years and limited progress in improving planning, selection and management capacities for public investment.

Additional fiscal risks stem from poor financial oversight and accountability as well as weak governance of Publicly Owned Enterprises (POEs) which could require (further) large

([59]) These initiatives were taken in December 2023 with a fiscal cost of around EUR 69 million. The child benefits are not laid down in the respective legislation yet (apart from the Law on budget appropriations), while basic pension top-ups are implemented based on ministerial decisions.

subsidies [60] from the budget. Despite recent improvements in monitoring the fiscal risks emanating from POEs' operation, the approval of their annual performance report for 2022 has been delayed and the law that regulates their corporate governance has become obsolete as it is not aligned with recognised international standards. In mid-December 2023, the Assembly adopted a law for the creation of a sovereign fund managing state assets which, once established, is set to have a key role in improving the management and financial performance of POEs [61]. The 2024 budget includes an allocation of only EUR 3 million for reimbursing the COVID-19-related 10% withdrawal of pension savings from the Kosovo Pension Saving Trust (KPST) [62], thereby requiring higher allocations in the following years' budgets to meet this liability. On the revenue side, the projected rise in tax revenue of around 9% in 2024 looks plausible, with revenue gains expected to come from further reduction in informality and improved tax compliance. 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.4.2.: SENSITIVITY ANALYSIS

The ERP analyses the sensitivity of the debt-to-GDP ratio to three specific shocks:

1) If the deficit rule is followed and there is a slowdown in GDP growth of 1 percentage point in 2027-2036, debt would increase to 34.9% of GDP by the end of 2036 instead of 32.8% in the baseline scenario

2) If the deficit rule is not followed and the primary balance deteriorates by 1 percentage point of GDP in 2027-2036 due to higher spending, debt would increase to 37.7% of GDP by the end of 2036, i.e. 4.9 percentage points higher than in the baseline scenario.

3) No compliance with the deficit rule and a 1 percentage point increase in interest rates on loans, would bring the debt-to-GDP ratio to 38.8% by the end of 2036, i.e. 6 percentage points higher than in the baseline scenario.

The sensitivity analysis highlights the importance of complying with the 2% deficit rule, which acts as a debt stabiliser. Moreover, in view of the expected termination of financing from privatisation funds in the medium term, it is important to keep current expenditure under control.

The efficiency of public spending suffers from long-standing issues such as inappropriate targeting and transparency of social transfers. Although temporary energy-crisis related support for vulnerable households and firms was mostly well-targeted through means-testing procedures, a large share of specific category-based social transfers, including war-related pensions, which are non-contributory and financed from the budget, do not directly focus on reducing poverty.

Strengthening public investment management would support a shift to a more growth-enhancing budget structure. According to IMF estimates Kosovo has lower relative levels of capital stock than peer countries [63] and a lower growth rate in its real public capital stock [64]. Weaknesses

[60] The MoFLT cannot provide the exact amount of subsidies and capital transfers to POEs, as it is not possible to generate consolidated reports in the Kosovo Financial Management Information System (KFMIS) that capture all financial transactions to POEs, thereby posing a fiscal risk and undermining fiscal transparency.

[61] The law on the establishment of a sovereign fund is being reviewed by the constitutional court.

[62] The framework provides for five annual instalments of EUR 20 million each as of 2023. Only EUR 5 Million were disbursed in 2023.

[63] Albania, Bosnia and Herzegovina, Croatia, Montenegro, North Macedonia, Serbia, and Slovenia.

[64] Public capital stock in 2019 for Kosovo was estimated at 49.2% of GDP while it was at 82.3% for Albania, 75% for Croatia, 73.9% for Bosnia and Herzegovina, 63.4% for Montenegro, 57.4% for Slovenia and 34.5% or Serbia. Kosovo's real public capital stock growth was negative on average during 2014–2019. In contrast, real capital stock growth was estimated to be growing solidly for the peer countries in the region.

persist at the planning phase of public 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. Furthermore, the administrative instructions do not integrate a climate-awareness perspective in the appraisal and selection of capital projects. The latter are therefore not ready for implementation when approved. 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 the Ministry of Finance Labour and Transfers (MoFLT) budget circular, which requires budget organisations to include expropriation costs as part of the project envelope. Furthermore, technical evaluation and documentation on new externally-financed projects should be finalised before the corresponding financial agreements are signed. Shortcomings in managing public investment could be addressed by establishing the linkages among the e-procurement and Kosovo Financial Management Information (KFMIS) systems, as recommended under the IMF's updated public investment management assessment.

Continued tax policy reforms are essential to strengthen the revenue base. Kosovo's tax regime is plagued with numerous tax exemptions, preferential tax rates and special regimes, all of which erode the tax base. For this reason, it is necessary to undertake and publish a review of tax expenditure quantifying the revenue foregone on account of these practices. Furthermore, to reduce loopholes and exemptions the government is preparing amendments to the legislation on personal income tax (PIT), corporate income tax (CIT) and value added tax (VAT). These tax policy reforms are essential for raising revenue to compensate for the expected loss in customs revenue due to the implementation of the free trade agreement with Türkiye and the Stabilisation and Association Agreement with the EU.

The existing system of fiscal rules provides the main anchor for fiscal policy while safeguarding high out-of-budget capital spending. The 2024 budget appropriately aims to keep the deficit (according to the fiscal rule's definition) at the prescribed ceiling of 2% of GDP. The deficit is expected to remain unchanged in 2025 before decreasing to 1.5% of GDP in 2026. 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 2026, provided that public debt remains below the prescribed ceiling of 30% of GDP. Despite the planned increase in the salary coefficients due to the implementation of the law on salaries of public officials, the wage bill is expected to decline by 0.2 pps. to 7.6% of GDP in 2024, so the wage bill rule will be respected. The proper functioning of Kosovo's fiscal framework is also conditional on the quality of macro-financial statistics, which require substantial further improvement. Fiscal governance would also benefit from setting-up an independent, fiscal oversight body. It is therefore regrettable that the authorities do not seem to have the intention of advancing towards the establishment of a Fiscal Council.

4.4. MAIN MACRO-RELEVANT STRUCTURAL CHALLENGES

In November 2023, the Commission proposed a New Growth Plan for the Western Balkans ([65]) with the aim of supporting the region's economic convergence and accelerating the accession process. The plan involves a Reform and Growth Facility (EUR 2 billion in grants, EUR 4 billion in loans) that is to be disbursed in 2024-2027 as investment ([66]) and budget support, in exchange for implementing reforms that are to be set out in Reform Agendas prepared by the Western Balkan partners. The New Growth Plan is therefore an important tool for increasing reform incentives

([65]) https://neighbourhood-enlargement.ec.europa.eu/enlargement-policy/new-growth-plan-western-balkans_en.

([66]) Infrastructure investments need to comply with the EU environmental acquis, national and international nature protection and water management obligations, ensure public participation and consultation, and guarantee high quality environmental impact assessment reports that include cumulative impacts on nature and biodiversity.

to boost growth and convergence. In this context, with a view to ensuring an integrated surveillance of Kosovo's economy, this chapter briefly outlines the main structural challenges facing Kosovo.

Kosovo's corporate structure is dominated by family-owned small and micro companies mostly operating in the services sector. The services sector dominates economic activity, providing around 45% of gross value added in 2022 and 73% of employment. Besides travel services driven by the diaspora, which dominate the services sector, the ICT sector has also been growing at a fast pace. The share of industry in gross value added stands at almost 20%. Mining only accounts for a small share of GDP due to under-investment over the past three decades, while the manufacturing base is narrow. Kosovo is weakly integrated into global value chains, with goods exports comprising mostly low-value-added, unsophisticated products. Foreign direct investment, which could improve the competitiveness of the economy has mostly gone into non-tradeable sectors, primarily real estate.

Kosovo faces challenges in its business environment. The regulatory and institutional environment remains a key obstacle to private-sector development and competition. Kosovo's economy struggles with a large informal sector, weak rule of law and corruption, all of which impede its attractiveness for foreign and domestic investors. A high administrative burden for businesses and citizens, weak law enforcement and dispute settlement and limited access to finance continue to be serious development obstacles despite government programmes to improve the business environment. The Commercial Court, which became fully operational in August 2022, is expected to increase the efficiency of the judicial system ([67]) in settling commercial disputes, but the court still faces a large backlog of cases. Despite some new initiatives undertaken by the Kosovo Credit Guarantee Fund, the lack of easily accessible and affordable credit continues to be a barrier to companies' growth, due to banks' stringent loan requirements, which affect mostly smaller companies.

Widespread informal activity impedes economic development. According to estimates, the informal sector accounts for around 30% of GDP. First, it reduces the tax base, limiting the fiscal space to invest more in priority areas such as education, health and infrastructure. Second, it creates an uneven playing field among 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) ([68]). Informality also impairs the competitiveness and export potential of Kosovo's private sector: firms operating 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 therefore more vulnerable when they lose their job or leave the labour market. Their access to training is also negatively affected, which exacerbates the inadequacy of skills in 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 structures to provide them – discourages many informal employers and employees from formalising working arrangements.

The supply of energy is unreliable and insufficient to meet rapidly growing demand and is one of the main constraints on Kosovo's competitiveness, curbing productivity. 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 ([69]). The lack of energy security gives rise to significant costs for business and represents one of the biggest obstacles to attracting high-quality

([67]) The court is efficient in communicating its results to the public through a user-friendly online portal, improving transparency efforts.

([68]) 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)

([69]) World Bank (2020b), Doing Business 2020: Comparing Business Regulation in 190 economies.

foreign direct investment while also putting pressure on public finance. Kosovo also suffers from high technical and commercial losses in distribution and transmission grids, which stood at around 25% in 2021. More than 90% of electricity is produced by two outdated, unreliable and highly polluting lignite power plants, which the government plans to refurbish. The share of renewables in electricity generation is rising, but remains small. Their roll-out is expected to accelerate through the energy strategy adopted in March 2023 and the law on renewable energies, which has passed the first Assembly reading. The National Energy and Climate Plan (NECP), which should include the Energy Community Secretariat's recommendations, is pending the final adoption by the government.

The digital transformation of the economy is advancing step by step, but the digitalisation of public services is still at an early stage. 100% of households nationwide have access to fixed broadband electronic communications infrastructure. Fixed access internet penetration is estimated to be 129% of households, compared to 89% in the EU, and mobile telephony penetration is around 98% of the population. Kosovo has a small but rapidly growing ICT sector, particularly in the export of software development, smart phone application development and web design. Despite some improvements in implementing e-commerce programmes, there seems to be little progress in increasing the adoption of e-commerce practices among SMEs. The Digital Agenda strategy covering the period up to 2030 was approved by the government at end-June 2023. It provides a comprehensive framework for digital transformation, including 5G technologies and the digital transformation of businesses and public services.

The labour market situation remains challenging while the education system is not adequately aligned with labour market needs. Only around 40% of the working-age population is active while the unemployment rate is persistently high. The share of young people (aged 15-24) not in employment, education or training (NEET) was very high in 2022, at 33%, far above other Western Balkan peers. An increasing challenge is emigration, with current estimates ([70]) suggesting that more than one third of the polulation lives abroad as more educated and young people are seeking employment there. There are also significant gender differences in the labour market as around 80% of working-age women are economically inactive while those who are economically active are less likely than men to be employed. Capacity and staffing issues in the employment agency and the public employment services are delaying the implementation of the "Youth Guarantee" plan and other labour market support schemes. Despite some educational reforms, scores on the OECD's 2022 Programme for International Student Assessment (PISA) are very low and unemployment among tertiary education graduates is still high, pointing to the inadequate quality and relevance of education. The 2022-2026 education strategy, adopted in October 2022, aims to raise the quality of pre-university education and, in particular, to harmonise education and professional training. It also fully recognises the need to develop a real-time information system and forecasting on labour market needs, as well as a standardised methodology for labour market research. This commitment has yet to be translated into action.

([70]) D. Hazer, T. Cela, A. Krasniqi and V. Cenaj (2021), Economic and Tourist Effects of External Migration in Kosovo, Journal of Environmental Management and Tourism, 12(2): 50 (available at: https://journals.aserspublishing.eu/jemt/article/view/5979).

4.5. THE POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS PARTNERS, TÜRKIYE, GEORGIA, REPUBLIC OF MOLDOVA AND UKRAINE

The Economic and Financial Dialogue between the EU and the Western Balkans Partners, Türkiye, Georgia, Republic of Moldova and Ukraine

Brussels, 14 May 2024

[...]

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

1. Implement the foreseen shift in the 2024 budget spending structure from current to capital expenditure while ensuring compliance with the fiscal rules. Increase budgetary transparency by further reducing blanket allocations. Enhance the revenue side by reducing loopholes and exemptions through amendments to tax legislation, including personal income tax (PIT), corporate income tax (CIT) and value added tax (VAT).

2. Undertake and publish a review of tax expenditure quantifying the size of the revenue forgone from all exemptions, preferential rates and special regimes. Improve the execution rate of capital spending including by establishing the linkages between the e-procurement and Kosovo Financial Management Information System (KFMIS) systems, following the recommendations made under the IMF's updated Public Investment Management Assessment. Improve financial oversight and accountability of Publicly Owned Enterprises (POEs) by approving and publishing their annual performance report; adopt amendments to the POEs' Law to improve their corporate governance.

3. Continue to thoroughly assess price developments and possible second-round effects 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 are adequately staffed, particularly by finding ways to attract and retain skilled staff. Enhance risk-based supervision in line with best international and European practices, including by further strengthening the monitoring toolkit and the reporting framework across the banking system and improving data collection to enable a comprehensive assessment of financial sector risks.

Annex 1: Overview of the implementation of the policy guidance adopted at the Economic and Financial Dialogue in 2023

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey 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 guidance is similar to that of the country-specific recommendations usually adopted under the European Semester for EU Member States. Implementation of the guidance is evaluated by the Commission in the following year's ERP assessments.

The following table presents the Commission's assessment of the implementation of the 2023 policy guidance jointly adopted by the EU and the Western Balkans and Turkey at their Economic and Financial Dialogue at ministerial level on 16 May 2023.

Overall: Partial implementation (43.1%) ([71])	
2023 policy guidance (PG)	**Summary assessment**
PG 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.	There was **partial implementation** of PG 1. 1) **Substantial implementation:** In 2023, the government allocated and implemented around EUR 30 million (0.3% of GDP) to temporary energy-crisis related support for vulnerable households and firms by subsiding: a) electricity bills to mitigate the impact of tariff increases; b) the purchase of energy efficient equipment; c) monthly electricity bills of around 200 thousand households which saved energy, compared to the same period a year before, by double the rate of saving. These measures were well-targeted, because public authorities examined each beneficiary's application based on a means test, instead of automatically transfering financial support. Nevertheless, the one-off transfers to basic pension and child allowance beneficiaries, totalling around EUR 69 million (0.7% of GDP) at end-2023, were not targeted. Supported by slower than anticipated implementation of capital projects and solid revenue performance, the headline budget deficit fell to an estimated 0.2% of GDP in 2023, which corresponds to a surplus of 0.6% of GDP under the fiscal rule definition.
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.	2) **Partial implementation:** While the Law on salaries of public officials, which had come into force on 9 February 2023, set the value of the wage coefficient at EUR 105 for 2023, the increase of EUR 113 million in the public wage

([71]) 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.

	bill was lower than nominal GDP growth in 2022, thus the wage bill rule was respected. In relation to war veteran pensions, there has been no progress in re-classifying the beneficiaries list. The law adopted on 13 July 2023, which decouples war veterans' pensions from the minimum wage, would help contain overspending risks. However, the law is being currently reviewed by the constitutional court and it will not be decreed by the President before the court's ruling is received. There was a slight breach of the legal ceiling of 0.7% of GDP in 2023 as actual expenditure for this pension scheme exceeded the annual budget allocation by EUR 0.84 million and amounted to almost 0.8% of GDP. However, this is lower than the actual expenditure of 2022 (0.9% of GDP).
Undertake and publish a review of tax expenditure quantifying the size of the revenue forgone from all exemptions, preferential rates and special regimes.	3) **Limited implementation:** The World Bank is providing technical assistance to the MoFLT to prepare a comprehensive tax expenditure report. In December 2023, the government published a report summarising the main fiscal developments in 2022. The report provides a preliminary quantification of the size of the revenues forgone due to some of the tax exemptions and reduced rates in 2022.
PG 2: Increase the execution rate of capital spending by implementing the recommendations made under the IMF's Public Investment Management Assessment.	There was **limited implementation** of PG 2: 1) **Partial implementation:** Despite the authorities' efforts, the under-execution of capital expenditure remains a challenge for Kosovo. The execution rate increased only to around 68% in 2023, from 60% in 2022, but the year-on-year increase in public capital spending was substantial at almost 33%. This outcome benefited from: i) the re-operationalisation of the Procurement Review Body board in late 2022; ii) the implementation of the Law on public works support, adopted at the end of 2022, compensating contractors up until mid-2023 for higher project costs resulting from very high inflation at the time; iii) the budget circular approved in May 2023 requiring budget organisations to include expropriation costs as part of the project envelopes. The IMF's Public Investment Management Assessment (PIMA) update in June 2023 assessed that while several previous recommendations have been implemented, significant work remains, particularly at the planning stage of the investment cycle. Strengthening project appraisal, investment planning, and the MoFLT review function are priorities. Specifically, 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 financial oversight and accountability of Publicly Owned Enterprises (POEs), including by approving and publishing their annual performance report.	2) **Limited implementation:** The annual POEs performance report for 2022 has been submitted by the Ministry of Economy (in charge of supervising the central POEs) to the government and its approval is pending. The 2021 performance monitoring report was approved by the government in December 2022 and has been published on the Ministry of Economy's website, in Albanian only. During the reporting period, the Ministry of Finance continued to include the fiscal risk analysis for the main central POEs in the medium-term expenditure framework (MTEF), annual budget and the ERP. A stand-alone annual fiscal risk analysis was also published in November 2023. The fiscal risk analysis includes the POEs overseen by the Ministry of Economy as well as 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 has been available 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. The law on the establishment of a sovereign fund was adopted by the Asembly in mid-December 2023, but it is being reviewed by the constitutional court, following a request by the opposition. The sovereign fund is expected to take over six POEs to strenghten their management and attract private capital. The fund will operate as an autonomous public institution under the supervision of the Assembly. A concept document has been submitted to the government by the relevant working group, but there were no developments in amending the law on POEs with the aim of aligning their corporate governance with recognised international standards.
Review the options paper on the establishment	3) **No implementation:** The government has

of an independent body for fiscal oversight and inform the Commission about the follow-up.	not taken any steps to set up the independent body for fiscal oversight, following finalisation of the options paper on the matter.
PG 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.	There was **substantial implementation** of PG 3. 1) **Substantial implementation:** The central bank carefully monitored the evolution of price dynamics. However, no macroprudential tools have so far been used, for instance to curb credit growth. Fiscal policy as the main tool for demand management remained prudent overall. 2) **Substantial implementation:** The central bank is in the process of a functional reorganisation in line with the new Strategic Plan and intends to strengthen core policy areas also by recruiting additional experts. Efforts to enhance macroeconomic and stress-test modelling capacities are ongoing. Nonetheless, given the low starting point, efforts will need to continue. Increasing the attractivity of positions in core areas is key to attracting and retaining skilled staff. 3) **Partial implementation:** Asset quality is reported in accordance with IFRS9, the NPL ratio remained low, with adequate provisioning. Reporting of the liquidity coverage ratio in line with Basel III started in January 2023. In addition, the central bank initiated more frequent and detailed risk and liquidity reporting by banks. The central bank plans to amend legislation to enable the development of a secondary market for NPLs. Initial steps have been taken to address data gaps in the real estate property sector, but significant further progress is needed to allow for improved surveillance.
PG 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.	There was **partial implementation** of PG 4. 1) **Partial implementation.** Kosovo launched its inaugural solar auction in May 2023. Overall, the auction was considered a success, with six companies submitting offers. The process was deemed open and transparent, with the government being responsive to various requests from interested investors. Additionally, in March 2023 the government approved the new Energy Strategy for 2022-2031 and its implementation plan, setting ambitious targets for renewable energy sources. However, the Law on Renewable

Implement the 2023 Energy support action plan including energy efficiency measures.	Energy Sources is still pending adoption by the Assembly ([72]). 2) **Partial implementation.** Through the 75 million EU Energy Support Package for Kosovo, the government implemented various measures in 2023 to mitigate the effects of rising energy prices on households and businesses. By end of 2023, approximately €30 million had been executed on implementing different measures, including incentivising households to save energy, subsidies for insulating houses and installing energy-efficient heating equipment in both households and businesses. Targeted support was provided to families under the Social Assistance Scheme, including subsidies for biomass and their energy bills. Medium to long-term measures planned in the EU Energy Support Package are still to be implemented.
Improve system resilience, modernise the electricity grids and operationalise the wholesale day-ahead and intra-day electricity price markets on the path toward retail electricity market liberalisation.	3) **Limited implementation.** The go-live of the day-ahead electricity market to be operated by the Albanian power exchange ALPEX, as well as day-ahead market coupling of Kosovo – Albania, has been operationalised. The bulk supply agreement between Kosovo Energy Corporation (KEK) and the universal supplier KESCO is still in place. This impedes the further development of the wholesale market.
PG 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.	There was **partial implementation** of PG 5: 1) **Partial implementation.** In March 2023, the Ministry of Finance published the 2021-2022 annual report on the implementation of the National Strategy of Kosovo for the Prevention and Combating of Informal Economy, Money Laundering, Terrorist Financing and Financial Crimes 2019-2023. According to the report, of 71 activities, 44 (62% of them) were implemented, while 27 (38% of them) have not been implemented yet. The 2022-2023 annual report is still being prepared. 2) **Partial implementation.** In July 2023, the Tax Administration of Kosovo (TAK) adopted a new annual action plan to reduce the informal economy with the focus on addressing the incorrect or non-declaration and non-payment of personal income tax obligations, and to identify the high-income taxpayers who do not file or incorrectly file personal income tax obligations by using information from different sources. In

([72]) The Law has passed first Assembly reading while a second reading is pending.

	addition, to improve revenue mobilisation through digitalised processes, TAK launched 3 new digital services for taxpayers (in total there are 11 online services available), one of which allows taxpayers to report on tax irregularities. In December 2023, the Assembly adopted the Law on Administration of Tax Procedures. This law amended the legal requirement on a number of issues that impact the formalisation of economic activities or undeclared work, such as requirements to pay all salaries electronically to financial institutions, or employment contracts to be concluded and be notified to TAK a day before the employee starts working. It also regulated important sharing and information gathering with third parties, such as commercial banks, and partner countries. Other amendments include the requirement to reduce cash transactions to EUR 300 Euro.
Simplify the system of licenses and permits, and complete the restructuring of SME and investment promotion agencies and ensure adequate resources.	3) **Partial implementation.** According to the annual report covering the 2022-2023 period on the implementation of the 2022-2027 government program on prevention and reduction of administrative burden (ABR), 10 activities have been undertaken to develop methodologies or other tools to implement the programme, such as analyses, guides and catalogues. The analysis of independent institutions, which includes 110 permits, has begun, including a digitalisation analysis for another 150 permits. The implementation of the ABR programme is progressing in accordance with the timelines set in the programme. The Law on sustainable investment has passed all Assembly procedures and the Office of the Prime Minister has consulted stakeholders and put in place a proposed structure for organisation. However, the restructuring has to wait for the Constitutional Court's decision, as the Law was challenged for interpretation by some opposition parties. Funds were allocated in the 2024 budget law for both agencies, as planned in the 2024-2026 Medium-Term Expenditure Framework (MTEF).
PG 6: Develop a roadmap for the implementation of key reforms of the education system, including the recommendations under the ETF Rapid Education Diagnosis.	There was **limited implementation** of PG 6: 1) **No implementation.** The government has developed the 2022-2026 National Education Strategy, published in September 2022, but it has not been updated since the Rapid Education Diagnosis was published in 2023, and no roadmap has been developed. In addition, the organisation chart of the Ministry of Education, Science, Technology and Innovation (MESTI) is

	still pending approval. Additional resources for several departments, such as digital department and monitoring, have not been allocated. Implementation of support for early childhood education, which includes the development and implementation of new curricula, has not yet started.
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.	2) **Limited implementation.** Kosovo has started implementing the dual education approach (51% of learning done in companies) based on the example of Germany, Austria, Switzerland and the positive experiences of its diaspora. The reform effort is being supported by a task force on dual education. Reforms to ensure that the VET system aligns with labour market needs are ongoing. However, VET profiles offered by vocational schools remain largely unaligned with occupational standards and labour market demands. The authorities have increased the number of scholarships for students, including women in science, technology, engineering, and mathematics (STEM), to address the skills mismatch. The Ministry of Education, Science, Technology and Innovation has launched a campaign for the image of vocational education and training, to promote the benefits of a dual education system.
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.	3) **Partial implementation.** The piloting phase of the Youth Guarantee has started in two municipalities. Staff recruitment in the respective local employment agency offices is ongoing. However, there exists for now no quality offer to help the young people supported under the scheme. The necessary steps include the approval of the Active Labour Market Measures (ALMMs) regulation and allocating budget to the Youth Guarantee implementation. The 2023–2027 Employment Strategy has been finalised, although adoption is still pending. A new Law on employment is still in the drafting process and will include provisions regulating the employment agency and delivery of employment services. The draft Law on Youth was adopted by the government in the reporting period. The restructuring of the Employment Agency is still underway, and budget has been increased to procure training, adapt training programmes to the needs of the market and use the training centres more efficiently.

Annex 2: Compliance with programme requirements

The government adopted the Economic Reform Programme for 2024-2026 and submitted it to the Commission on 16 January 2024, within the set deadline. It is in line with the previously approved medium-term fiscal strategy and national development strategy. No components of the ERP are lacking.

Inter-ministerial coordination

The ERP was centrally coordinated, with the Ministry of Finance, Labour and Transfers as the National Coordinator for Kosovo, in close cooperation with the Strategic Planning Office in the Prime Minister's Office. They were supported by policy area coordinators from the line ministries. The inter-ministerial coordination process worked well.

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. Commission staff dealing with the ERP held consultations with representatives from civil society organisations, business organisations, international financial institutions and donors. 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 agency within the Prime Minister's Office.

Macroeconomic framework

The baseline scenario projects a robust acceleration of economic activity, which appears to be 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 2023 World Economic Outlook. The ERP assessment of macro projections is based on ERP annex data. The programme provides an alternative 'low growth' scenario. This is useful to illustrate the likely impact on Kosovo's economy of some expected developments and risks, such as underspending in capital investment, lower foreign demand, a decline in remittances and higher financing costs for the banking sector. The forecasts for the labour market and the financial sector are still lacking.

Fiscal framework

The fiscal projections are based on the adopted 2024 budget. For 2024, the ERP forecasts a decreased public revenue-to-GDP ratio, whereas public expenditure is set to increase from the 2023 level, mainly due to a large surge in capital investment. Some of the 2023-2024 fiscal data are not consistent with the main text. The ERP provides a useful debt sustainability analysis with three negative shock scenarios.

5. MOLDOVA

5.1. EXECUTIVE SUMMARY

The Moldovan economy started to turn the corner in 2023 after five consecutive quarters of contraction, and the ERP projects a gradually strengthening recovery over the programme period 2024-2026. Moldova was significantly affected by the Russian war of aggression against neighbouring Ukraine as well as a severe drought in 2022 and the ensuing energy and food price shocks. These events severely diminished households' purchasing power, eroded investor confidence and undermined export growth. Growth returned in the third quarter of 2023, on the back of a strong rebound in the agricultural sector (following the severe drought in the previous year) and significant expansion in the IT industry, which has emerged as one of the most dynamic sectors in the economy since 2022. The ERP, the first submitted by Moldova since it became an EU candidate country in June 2022, projects real GDP growth of 3.5% in 2024 on the back of continued strong agricultural exports and growing private consumption as real wages continue to recover. The ERP projects that the recovery will accelerate in 2025 and 2026. The outlook suggests continued improvements in labour market outcomes, characterised by a persistently low employment rate and high levels of informal employment. Inflation surged in 2022 before decelerating almost as rapidly in 2023, thanks to falling global food and energy prices and a timely monetary policy response. It has now returned to the central bank's target range of 5% +/- 1.5 percentage points and is expected to remain there over the course of the forecast horizon (i.e. until the end of 2026). The easing of monetary policy, which started at the end of 2022, should also support the recovery while fiscal policy focuses on gradually correcting the high general government deficits. Although the ERP does not present projections for the development of the current account balance, the Commission's 2023 autumn forecast projected that Moldova's current account balance would decrease, due to lower energy import prices and somewhat stronger growth in external demand in the coming years. The scenario presented in the ERP is plausible though subject to a number of significant downside risks related to developments in neighbouring Ukraine, the country's continued vulnerability to energy price shocks and weaker growth prospects in the country's main trading partners.

The ERP plans a gradual and front-loaded reduction of the deficit as the economic recovery takes hold, targeting a deficit of 4.6% of GDP in 2024 which will narrow further in 2025 and 2026. Moldova's public finances significantly deteriorated in 2023 (a deficit of 5% of GDP compared with 3.2% of GDP in 2022), reflecting weak growth and the high cost of measures to support households. Nevertheless, the budgetary outcome was significantly better than the planned deficit of 5.9% of GDP. This was largely due to (i) under-execution of expenditure and revenue overperformance due to high inflation; and (ii) the overestimated negative impact of a sizeable tax relief for small and medium-sized enterprises implemented from 2023. This negative impact has not yet materialised and constitutes a risk for 2024. After the slight reduction in the deficit (compared to the outturn) in 2024, the ERP projects more significant falls in the future, dropping to 3.8% in 2025 and 3.4% in 2026. Although the ERP does not present an estimate of the cyclically adjusted deficit, fiscal policy in 2024 and 2025 appears to appropriately balance the need to correct high deficits with the objective of supporting the nascent recovery. The bulk of the adjustment will be on the expenditure side, as support to households to mitigate the impact of high energy prices is phased out or made more efficient and better targeted. In 2025 and 2026, revenues will decline less quickly as a share of GDP than expenditure, though changes to the tax regime for cars and a new tax expenditure to support SME investment are set to undermine revenue growth towards the end of the forecast horizon. Crucial growth-enhancing public capital expenditure continued to be under-executed in 2023, albeit by less than in previous years, and a promising public investment management reform underpins the ERP's projections of increased investment in 2025 and 2026. After peaking at 37.2% of GDP in 2023, the public debt ratio is expected to fall slightly in 2024 followed by steeper reductions in 2025 and 2026, in part on account of the narrowing primary deficit and stronger economic growth. A relatively large

share of public debt (60%) is denominated in foreign currency, which exposes public finances to exchange rate risks. However, a large part of the debt has been extended by multilateral creditors at highly favourable terms.

The main challenges facing Moldova are the following:

- **Fiscal policy will need to increase much-needed public investment to support the nascent economic recovery and at the same time ensure fiscal sustainability via a fiscal adjustment that protects growth-enhancing spending.** Moldova faces a range of significant macroeconomic risks, including those related to Russia's war of aggression against Ukraine and energy supply risks that have recently re-emerged. The planned reduction of the fiscal deficit is therefore helpful in building buffers to mitigate future risks to the public finances. Public investment, although set to increase steadily from 2024 to 2026, remains well below the EU average and substantially below the level required to accelerate the country's convergence to EU income levels, in part due to persistent under-execution. The planned increase in public investment is underpinned by the expected implementation of the 'single project pipeline' (a key reform to the public investment management system) throughout the programme period. There is also scope to improve Moldova's capacity to produce macroeconomic and fiscal forecasts, including the cyclically adjusted fiscal balance, in order to better inform fiscal policy in light of the business cycle.
- **Given the limited fiscal space and competing spending priorities, public finance management reforms offer scope to broaden the revenue base and improve the efficiency of public expenditure.** To that end, the authorities plan to continue to pursue progress on the public finance management strategy for 2023-2030, in particular through measures to improve tax compliance and broaden the tax base. Tax expenditure reform is expected to identify measures to be phased out. Spending reviews, another relevant tool to create fiscal space, have seen uneven progress in recent years. The authorities are currently finalising a review of healthcare spending. Publishing the report following this review and setting out a clear implementation plan for reforms to healthcare spending would support the credibility of the authorities' efforts and strengthen the process for reviews in other major areas of expenditure. Similarly, assessing the efficiency of programmes which support access to finance for businesses, which remains persistently low, would ensure that they are more effective and represent good value for money. Last but not least, Moldova grapples with a large and loss-making sector of state-owned enterprises, which appear not to be adequately captured in the perimeter of general government at present. The authorities embarked on an ambitious reform of the sector in 2023. Progressing with further implementation steps in 2024, in particular on implementing the results of the 'triage' exercise and governance reforms, would be important for mitigating the fiscal risks and creating a level playing field for all businesses.

Moldova is facing a number of structural challenges as it seeks to promote inclusive growth, competitiveness and convergence with EU income levels. Even though Moldova did not yet include a section on structural reforms in its first ERP as this was voluntary, the Commission has drawn on its long-standing engagement with the country, including through different macro-financial assistance operations as well as the 2023 enlargement report, to identify some of the major structural challenges that Moldova faces. Firstly, persistently low levels of public investment remain a major obstacle that prevents the country from meeting its large investment and infrastructure needs. In addition, labour force participation remains very low, and the shortage of skilled labour and skills mismatches, along with a large informal sector, represent a major bottleneck for businesses and foreign investors. Despite impressive efforts to mitigate the implications of the recent energy crisis, the developments in the energy sector continue to pose significant risks to public finances. Finally, following a short but strong recovery after the pandemic, Russia's war of aggression against Ukraine has had a strong negative impact on investment sentiment in Moldova, compounding pre-existing challenges linked to corruption, the rule of law, low levels of economic diversification and low-quality public services.

5.2. ECONOMIC OUTLOOK AND RISKS

The Moldovan economy started to turn the corner in 2023, with growth rebounding in the third quarter of the year after five consecutive quarters of contraction. Real GDP grew by 0.7% in 2023 according to the official preliminary estimate. The economy has been heavily impacted by a series of compounding shocks, in particular to energy and food prices. These shocks include an energy crisis beginning in late 2021, the start of Russia's full-scale war of aggression against Ukraine, and a severe drought in 2022. Despite the timely response of fiscal and monetary policy, these developments triggered economic uncertainty and high inflation, both of which weighed on demand. Output in the first half of 2023 fell by 2.3% year-on-year as falling real wages continued to weigh on private consumption, and agricultural exports suffered following the poor harvest in 2022. However, real GDP grew by 2.6% year-on-year in the third quarter largely thanks to a stronger harvest in 2023 driving growth in exports while imports continued to lag. Real wages, having continued to fall in the first quarter of 2023, began growing in the second quarter of the year on the back of quickly falling inflation. This contributed to slight year-on-year growth in household consumption in the fourth quarter, the first in nearly two years. As a result of the sharp decline in inflation, the central bank began cutting interest rates in a series of seven steps from a peak of 21.5% in December 2022 to 3.75% in March 2024. The current account balance improved strongly in 2023 to a deficit of 11.9% of GDP, having narrowed by over 5 percentage points compared to 2022 due to depressed demand for imports and lower energy prices.

The ERP presents a steadily strengthening economic recovery, with real output growth of 3.5% in 2024 accelerating to 4.0% in 2025 and 4.2% in 2026. Growth in 2024 is set to be driven primarily by private consumption, as real incomes recover thanks to inflation stabilising within the central bank's inflation target and lending picking up modestly in the context of accommodative monetary policy. The ERP projects that a recovery in investment will support stronger growth in 2025 and 2026, though stronger private investment is contingent on a stabilisation of the situation in neighbouring Ukraine. The ERP presents a gradually narrowing negative output gap in 2023 and 2024, before closing in 2025 and turning positive in 2026.

The macroeconomic scenario presented in the ERP is plausible though subject to downside risks related to the high uncertainty about the further economic fallout from Russia's full-scale war of aggression against Ukraine, energy dependencies and growth prospects in the country's main trading partners. While real GDP growth in the fourth quarter of 2024 was slower than implied in the scenario, this was driven by changes in inventories, whereas household consumption and investment nevertheless posted year-on-year growth. The scenario relies in part on a strong uptick in investment in 2025 and 2026. Reforms in train to improve the execution of the government's capital budget may support public investment in those years. Nevertheless, it is likely to take time before the impact of those reforms can be fully seen. A strong increase of private investment will depend heavily on developments in Ukraine, though private investment will also be supported by lower interest rates thanks to the disinflation that took place in 2023 as well as a number of government business-support programmes. The ERP scenario is broadly aligned with the Commission's autumn forecast 2023 though the ERP assumes a slightly weaker growth in 2024 and 2025. The divergences reflect both different, but still plausible assumptions about the strength of exports and the responsiveness of imports to final demand growth, as well as the authorities' lower planned public investment in 2024 compared to 2023.

Starting from a weak initial situation, the labour market has shown modest improvements over the past year, though the labour market participation rate remains well below the regional average. Improvements were marked by a 2.8 percentage point year-on-year increase in the employment rate to 44.1% in Q3 2023, largely driven by an employment increase in agriculture thanks to favourable weather conditions in 2023 compared to the drought in 2022. The labour force participation rate exhibited a similar increase, though fell back slightly in the fourth quarter of 2023 to 44.7%. Unemployment increased slightly to 4.9% at the end of 2023. While unemployment remains

low it now is well above the levels before Russia's full-scale invasion of Ukraine. Other factors which may have led to improvements in the last 2 years may include the return of workers from Russia and Ukraine and the impact of Ukrainian refugees, contributing to a 1% boost in the labour force in the first half of 2023.

Looking ahead, the ERP projects minor increases in the employment rate throughout the reporting period, primarily supported by a positive economic outlook and rises in nominal wages boosting overall demand in the economy. The projected employment rate of 44.8% in 2026 is in line with the government's objective of reaching a 45% employment rate, which appears within reach considering the stron outturn of Q3 2023.

Table II.5.1:
Moldova - comparison of macroeconomic developments and forecasts

	2022		2023		2024		2025		2026	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	-4.6	**-5.0**	0.7	**2.0**	2.9	**3.5**	4.1	**4.0**	n.a.	**4.2**
Contributions:										
- final domestic demand	-6.1	**-6.2**	2.9	**1.7**	4.5	**4.0**	5.2	**4.2**	n.a.	**4.6**
- change in inventories	2.1	**2.2**	0.2	**0.0**	0.0	**0.0**	0.0	**0.0**	n.a.	**0.0**
- external balance of goods and services	-1.5	**-1.0**	-1.4	**0.4**	0.0	**-0.5**	0.3	**-0.2**	n.a.	**-0.4**
Employment (% change)	2.2	**2.1**	2.8	**:**	1.5	**:**	1.4	**:**	n.a.	**:**
Unemployment rate (%)	3.1	**3.2**	4.6	**:**	4.3	**:**	4.0	**:**	n.a.	**:**
GDP deflator (% change)	18.2	**19.3**	8.6	**11.6**	6.3	**5.8**	5.0	**6.3**	n.a.	**6.3**
CPI inflation (%)	28.7	**28.7**	13.4	**13.6**	4.7	**5.0**	4.7	**5.0**	n.a.	**5.0**
Current account balance (% of GDP)	-16.6	**-17.4**	-13.4	**:**	-10.1	**:**	-9.1	**:**	n.a.	**:**
General government balance (% of GDP)	-3.3	**-3.2**	-5.7	**-5.9**	-4.6	**-4.6**	-3.6	**-3.8**	n.a.	**-3.4**
Government gross debt (% of GDP)	35.3	**35.0**	35.3	**37.2**	37.5	**37.0**	37.4	**35.9**	n.a.	**34.2**

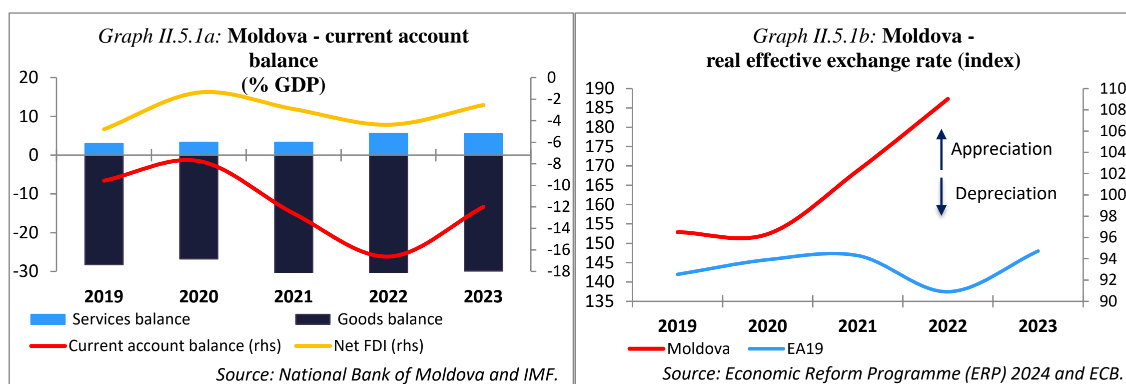
Sources: Economic Reform Programme (ERP) 2024, Commission Autumn 2023 forecast.

Inflation has been on a downward trend throughout 2023, falling steeply from 28.7% on average in 2022 to 13.4% in 2023. In response to the surge in inflation in 2022, the National Bank of Moldova increased its base rate to a peak of 21.5% in August 2022. Easing inflationary pressures subsequently allowed for a series of rate cuts starting in December that year, ultimately bringing the base rate to 3.75% in March 2024. Inflation re-entered the central bank's target range of 5% $^{+}/_{-}$ 1.5 percentage points in October 2023, with the deceleration driven in particular by falling food and energy prices as well as the appreciation of the leu. The ERP expects average inflation to continue to fall in the first half of 2024 given (i) the continued decline in imported inflation (including through lower energy prices); (ii) relatively moderate domestic demand; and (iii) further declines in food prices due to the stronger harvest. Inflation is expected to tick up again in the second half of 2024 as domestic demand picks up, and in particular as government support to households to pay energy bills diminishes and certain administered prices for electricity increase. The central bank projects inflation to then continue to decline modestly in the first three quarters of 2025 where the central bank's inflation forecast horizon ends.

The ERP does not present projections for the development of the current account balance, where developments in 2023 suggest a narrowing but still significant deficit. The Commission's 2023 autumn forecast projected a current account deficit of 13.3% in 2023, narrowing to 11.7% in 2024 driven in particular by lower energy import prices and stronger export growth as a result of the successful harvest in 2023, with the deficit narrowing further to 10.8% in 2025. Remittances as a share of GDP are projected to remain relatively high, albeit at a significantly lower level than before 2022. Moldova's current account balance is structural, reflecting its strong reliance on agricultural and low value-added manufacturing exports as well as its dependence on energy imports. The recent significant worsening was primarily due to the surge in the price of imported energy, and while Moldova has taken significant steps to improve energy security, its vulnerability to price fluctuations remains significant.

The ERP suggests that there has been a significant decline in price and cost competitiveness in 2023 and that the leu is significantly overvalued. Wages have risen steadily in recent years and the real effective exchange rate (REER) has been on a consistent upward trajectory since 2015-2016. Average nominal earnings increased by 15.5% annually in 2022, though this increase was overtaken by skyrocketing inflation in 2022 leading to a sharp decline in real wages by about 13%. Both minimum wages and public sector salaries further increased in 2023 while inflation has been declining, leading to a slight recovery of real wages by 3.4%. Modest productivity growth could not compensate for the higher real wages resulting in a general increase in unit labour costs. The rise in unit labour costs in Moldova has outpaced rises in regional neighbour countries, although unit labour costs in Moldova remain below the regional average. The sharp increase of the REER starting in Q2 of 2021 partly reflected the Balassa-Samuelson effect (i.e., an adjustment of the equilibrium REER for Moldova as a catching-up economy). The productivity differential with Moldova's main trading partners was gradually declining until the end of 2021, suggesting a catching up process. However, the ERP suggests a large REER gap in recent years reaching a peak in the second half of 2023. This, in fact, suggests that the leu is overvalued. The latest IMF estimations suggest an overvaluation of the leu of about 22% in 2022. Moldova's share of world exports increased only very marginally between 2016 and 2022. The steep increase in the REER last year could weigh on Moldova's exports more heavily in the coming years. Moldova's exports continue to be characterised by labour-intensive and low-productivity sectors such as agricultural outputs and textiles. This underscores the relevance of price and cost competitiveness especially in the short run. In recent years high productivity ICT services have become a more significant share of Moldova's exports, a trend which, if sustained, could help make its export base less sensitive to price/cost competitiveness.

External competitiveness and current account



The mainly foreign-owned banking sector remained stable throughout the pandemic and ongoing geopolitical crisis. Bolstered by a series of measures taken by the central bank in response to a major banking fraud in 2014, the capital adequacy, liquidity and profitability of commercial banks have remained elevated or have risen in recent years. As of Q3 2023, capitalisation, at 30%, remains well above the regulatory minimum, and the liquidity coverage ratio, at 256%, exceeds the prescribed 100% limit by a large margin. This is partly driven by remaining legacies from the aftermath of the bank fraud case. Two banks, for instance, still hold additional sizeable capital and liquidity buffers against potential losses from ongoing litigation. In addition, reserve requirement ratios were increased in 2022 to counter inflation. They were then relaxed in 2023 in response to falling inflation though not returning to pre-2022 levels. This slight relaxation did not yet lead to increased lending to the private sector. The sector's increased profitability in recent years can primarily be attributed to the growth in interest income and fees. The ERP outlines a set of amendments to the legal framework to support financial stability and intermediation while further aligning its legal framework to the EU acquis.

Bank lending to households and businesses is at a relatively low level. While both credit and deposit growth have been volatile in recent years, deposits, especially in domestic currency, recorded the highest growth in 2023 since 2019. Conversely, credit growth experienced its lowest increase of

less than 4% reflecting the sluggish recovery and still high uncertainty. This led to a decline in the loan-to-deposit ratio to 56.1% the lowest level in the last 5 years. According to the IMF, credit to the economy is projected to stand at a relatively low 21.4% of GDP, a decrease by 1.9 percentage points from 2022. Currency substitution is declining, with the share of deposits held in foreign currencies further declining by 3 percentage points to 36.8% in 2023. The share of non-performing loans (NPLs), continued to decline in 2023, falling by 0.8 percentage points from 6.4% in 2022 (due to a drop in the last quarter of 2023), possibly reflecting the slight economic recovery towards the end of the year. Both supply of and demand for credit are being hampered by uncertainty about the future impacts of Russia's war of aggression in Ukraine and the economic outlook coupled with new regulations about responsible lending. In addition, the lack of bankable businesses and the high level of informality in the economy further limits credit to the private sector. The government has, however, taken decisive steps to improve access to finance through several support programmes providing guarantees as well as interest subsidy measures. The impact of such programmes in the current context is still to be evaluated, including the risks of contingent liabilities.

Table II.5.2:
Moldova - financial sector indicators

	2019	2020	2021	2022	2023
Total assets of the banking system (EUR million)	4708.0	4912.0	5897.4	6446.2	7952.5
Foreign ownership of banking system (%)	87.1	86.6	86.6	88.9	88.9
Credit growth (%, average)	13.9	13.1	23.5	9.4	3.7
Deposit growth * (%, average)	7.7	16.5	13.1	5.4	19.9
Loan-to-deposit ratio (%, end of period)	59.1	57.3	62.6	64.9	56.1
Financial soundness indicators (%, end of period)					
- non-performing loans to total loans	8.5	7.4	6.1	6.4	5.6
- regulatory capital to risk-weighted assets	24.8	27.3	25.9	29.2	30.0
- liquid assets to total assets	50.6	50.7	48.6	52.2	54.5
- return on equity	14.6	8.7	12.3	17.0	16.3
- foreign exchange loans to total loans	33.3	30.5	26.5	30.5	25.8

* Total deposit growth.
Sources: Central bank of Moldova.

5.3. PUBLIC FINANCES

The under-execution of expenditure, together with a less significant revenue overperformance, led to a budget deficit of about 5.0% of GDP in 2023, significantly better than the planned deficit of 5.9%. Revenue overperformance compared to the 2023 amended budget was driven in particular by corporate income tax and excise duties which offset shortfalls in VAT and grants. The ERP does not provide an analysis for this general overperformance, though it may reflect weaknesses in revenue projections in the context of high inflation. In particular, the expected negative impact of a new 0% tax rate on reinvested SME income did not materialise in 2023, having been estimated at MDL 1.2 billion or about 2% of total tax revenue. The ERP now expects this negative impact to extend into the next 2 fiscal years. Strong performance from the above-mentioned revenue categories compensated for a shortfall in the level of grants from foreign donors. Compared to the outturn in 2022, revenue excluding grants was 9.5% higher in 2023 as a result of (i) a mix of tax increases, in particular in excise duties in accordance with commitments under the EU-Moldova Association Agreement; and (ii) underlying factors including rising public sector wages and high inflation.

Expenditures, both current and capital, were under-executed compared to the amended 2023 budget. General government current expenditure was 96% of the revised 2023 budget, with shortfalls in particular in goods and services but also the wage bill. More detailed breakdowns of expenditure outturn by policy sector are not yet available. More importantly, central government capital expenditure (i.e. excluding local government capital expenditure for which consolidated data are not yet

available) was 83.4% of the amended 2023 budget, a significant shortfall but an improvement compared with 2022 reflecting more realistic spending targets including a downward revision in the amended budget in 2023. Compared to 2022, total expenditure was significantly higher (18%) driven in particular by much higher social transfers in the form of compensation for households to mitigate the impact of the energy crisis. In addition, public sector wages increased significantly in 2023, and interest payments nearly doubled due to higher rates on foreign loans and higher issuance of T-bills.

Table II.5.3:

Moldova - composition of the budgetary adjustment (% of GDP)

	2022	2023	2024	2025	2026	Change: 2023-26
Revenues	33.4	32.9	31.3	30.8	29.9	-3.5
- Taxes and social security contributions	30.0	29.3	29.2	29.1	28.3	-1.7
- Other (residual)	3.3	3.6	2.1	1.7	1.5	-1.8
Expenditure	36.6	38.8	36.0	34.6	33.3	-3.3
- Primary expenditure	35.6	37.0	34.4	33.3	32.0	-3.6
of which:						
Gross fixed capital formation	1.2	1.2	1.0	1.5	1.7	0.5
Consumption	:	:	:	:	:	:
Transfers & subsidies	16.0	16.6	15.2	14.8	14.2	-1.8
Other (residual)	18.4	19.3	18.2	17.0	16.1	-2.3
- Interest payments	1.0	1.8	1.5	1.3	1.2	0.2
Budget balance	-3.2	-5.9	-4.6	-3.8	-3.4	-0.2
- Cyclically adjusted	:	:	:	:	:	:
Primary balance	-2.2	-4.2	-3.1	-2.5	-2.1	0.1
- Cyclically adjusted	:	:	:	:	:	:
Gross debt level	35.0	37.2	37.0	35.9	34.2	-0.8

Sources: Economic Reform Programme (ERP) 2024, Commission calculations.

The ERP presents a fiscal strategy which aims to increase much-needed public investment to support the nascent economic recovery and at the same time ensures fiscal sustainability via a fiscal adjustment that protects growth-enhancing spending. The ERP projects a gradual, though front-loaded, narrowing of the deficit, to 4.6% of GDP in 2024 and to 3.8% in 2025, with a smaller decline to 3.4% in 2026. Revenue as a share of GDP is expected to shrink steadily from 32.9% of GDP in 2023 to 29.9% in 2026, driven by lower reliance on donor funding and a revenue-decreasing reform of car taxation in 2026. Expenditure is projected to decline more quickly as a share of GDP over this period, driven in particular by slower nominal growth in both the wage bill and social transfers. The latter reflects in part the phasing out and better targeting of compensation for high energy bills in 2024. The ERP projects a decline in public investment in 2024, in part reflecting more realistic targets as a result of a new effort to reform public investment management which strengthens the role of the Ministry of Finance in ensuring that projects included in the annual budget are mature. Public investment is projected to begin increasing again in 2025 and 2026. The ERP does not provide an estimate of the cyclically adjusted balance. However, considering the large positive output gap expected in 2026, and what was only a slight decrease in the headline deficit in that year, the projected fiscal stance might result in a pro-cyclical fiscal expansion in that year.

Expenditure measures in the 2024 budget include several potentially growth-enhancing measures to improve the efficiency of spending, although the ERP only provides estimates of the quantitative impact of a few of these measures**.** Better targeting of the Energy Vulnerability Reduction Fund to reach the most vulnerable parts of the population and a move away from covering energy bills to income support is expected to improve the efficiency of the fund. This will possibly lead to lower expenditure, while all other social protection expenditures previously covered by local budgets will be centralised under the national government. An additional spending measure in 2024 will increase the one-off childbirth allowance. Among other professions, teachers' salaries will be increased significantly

following central government salary increases in previous years. Public investment ([73]) is projected to reach 2.4% of GDP reflecting a decrease compared with 2023, possibly indicating a more realistic planning of the capital budget, bringing it back to its pre-pandemic level and below regional peers. Support for business remains a key priority, with several measures aiming to promote investments and access to finance such as the '373' interest subsidy programme and the Credit Guarantee Fund.

Revenue measures for 2024 are expected to be relatively minor, with the exception of a tax expenditure to support investment by SMEs which was implemented in 2023 but the impact of which is expected now in 2024 and future years. The introduction of the 0% tax on non-distributed income for SMEs introduced in 2023 was expected to lead to a revenue loss amounting to 0.4% of GDP, which did not occur. Nevertheless, this impact is now expected in 2024 and 2025 instead. The ERP does not provide an estimate of the impact of the new customs code which came into force on 1 January 2024. However, the 2024 budget incorporates a decline in revenue from customs duties compared to 2023 amounting to about 0.1% of GDP. The ERP does not provide cost estimates for the other revenue and expenditure measures for 2024, nor does it describe how these measures align with the government's priorities. For 2026, the ERP presents a significant drop in excise duties as a share of GDP resulting from the change in the taxation of cars from the excise regime to the VAT system.

BOX II.5.1: THE 2024 BUDGET

Following the presentation of the draft budget on 1 December 2023, the 2024 budget was adopted by the Moldovan Parliament on 22 December 2023. According to the annual budget calendar, the government is supposed to submit the draft budget by 15 October and parliament should adopt it by 1 December. The 2024 budget aims to achieve a fiscal deficit of 4.6% of GDP and a primary deficit of 3.1% of GDP.

The budget provides for a 10-15% salary increase for teachers, police officers and workers in the judiciary. Compensation of energy bills through the Energy Vulnerability Reduction Fund will continue, albeit at lower amounts and with better targeting. The one-off allowance for the birth of a child will be increased.

Total revenue is expected to fall to 31.3% of GDP in 2024 due to a sharp decline in grant revenues (from 2.2% of GDP in 2023 to 0.7% of GDP in 2024) and a fall in foreign trade taxes as a result of the new customs code. Total expenditure is expected to fall to 35.9% of GDP, driven in part by savings on measures that had been implemented to support households and businesses facing elevated energy bills in 2022 and 2023.

After peaking in 2023, the public debt ratio is expected to fall slightly in 2024 followed by steeper reductions in 2025 and 2026. The debt ratio grew by 2.2 percentage points to 37.2% of GDP in 2023, driven by the large primary deficit and higher interest payments on short-term domestic debt, with inflation helping to mitigate the increase. The ERP projects a backloaded reduction in the public debt, beginning with a modest decline of 0.2 percentage points in 2024 before falling more steeply in 2025 (by 1.1 percentage points) and 2026 (by 1.7 percentage points). This decline is primarily driven by the deficit reduction in these years as well as by projected lower interest rates on domestic debt as monetary policy eases. The large stock-flow adjustment contributing to the falling public debt ratio throughout the ERP time horizon is not explained.

Although most of Moldova's public sector debt stock was extended on concessional terms by multilateral lenders, there was a modest increase in the share of domestic borrowing in 2023. A large share (59.5%) of Moldova's debt is denominated in foreign currency, contributing to significant exchange rate risk. At the same time, the average maturity (8.9 years) and conditions of the external public debt are favourable given that currently about 60% of public debt is owed to multilateral institutions including the IMF, the World Bank and the EU. Debt repayment needs on

([73]) Public investment is defined as the acquisition of fixed assets by the general government (item 31) in the annual budget execution reports of the national public budget.

external debt will increase moderately in 2024 in part due to a revolving loan from the EBRD in 2022 to both finance emergency gas supplies and build up a strategic gas reserve. Domestic debt issuance continues to consist largely of T-bills maturing within 1 year due to the underdeveloped domestic financial market and prohibitively high interest rates in the last year, though the government's debt management strategy includes plans to extend the average maturity of domestic debt to deepen the market for government debt and facilitate domestic finance. The first successful issuance of a 10-year domestic bond took place in September 2023. Interest rates on longer-term government debt have fallen sharply over the course of 2023 as a result of monetary policy easing, with the rate on 2-year bonds falling from 13% in January 2023 to 5.5% in January 2024.

BOX II.5.2: DEBT DYNAMICS

Moldova

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

	2022	2023	2024	2025	2026
Gross debt ratio [1]	35.0	37.2	37.0	35.9	34.2
Change in the ratio	2.5	2.2	-0.2	-1.1	-1.7
Contributions [2]:					
1. Primary balance	**2.2**	**4.2**	**3.1**	**2.5**	**2.1**
2. 'Snowball effect'	**-3.1**	**-2.4**	**-1.6**	**-2.1**	**-2.1**
Of which:					
Interest expenditure	1.0	1.8	1.5	1.3	1.2
Growth effect	1.4	-0.6	-1.2	-1.3	-1.4
Inflation effect	-5.5	-3.6	-2.0	-2.1	-2.0
3. Stock-flow adjustment	**3.3**	**0.4**	**-1.7**	**-1.5**	**-1.7**

[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) 2024, Commission calculations.

Major sources of risk to the public finances are related to the possible interruption of the current arrangement for natural gas supply from Russia to the Transnistrian region as well as Moldova's vulnerability to economic shocks related to Russia's war of aggression in Ukraine and climate change. In 2023, the authorities agreed a continuation of the deal reached in December 2022 under which the MGRES power plant, located in the Transnistrian region, will supply about 90% of Moldova's total projected volume of electricity supply in the summer period and 65% in the winter, when combined heat and power plants near Chișinău will provide the balance of demand. The price of supply remains unchanged at USD 66/MWh, below the prevailing average price in the EU. However, the MGRES power plant relies on free Russian gas which transits Ukraine to reach the Transnistrian region. The current Ukraine-Russia gas transit agreement expires at the end of 2024, and it is not clear whether it will be possible to continue to import Russian gas to the Transnistrian region after that point. A failure to continue gas shipments would likely have fiscal consequences due to increased electricity prices and possibly serious economic disruption to the Transnistrian region and Moldova at large. The authorities are examining the potential costs associated with this risk.

In addition, Moldova's economy continues to remain exposed to the effects of Russia's war of aggression against Ukraine. Although food and energy prices declined markedly over the course of 2023, investor and consumer sentiment – therefore to some extent economic growth – will depend

on developments in neighbouring Ukraine. In addition, Moldova remains highly exposed to risks associated with climate change, namely drought and floods. Extreme weather events have led to significant losses in the past, including a 30% drop in agricultural production as a result of the drought in 2022.

Although the ERP itself does not provide an overview of fiscal risks nor a corresponding sensitivity analysis, the government publishes a fiscal risk statement with the annual budget. For 2024, the government has identified macroeconomic shocks and negative financial market developments as elevated risks, alongside the possibility that the government would need to bail-out state-owned enterprises, in a context in which 40% of state-owned enterprises reported losses in 2021 and many lack adequate corporate governance standards. The latest analysis of fiscal risks related to state-owned enterprises dates from 2021, though the authorities have been taking steps under the IMF programme to improve the financial reporting of state-owned enterprises to the Public Property Agency. The authorities have committed to including an assessment of climate-related risks in the next fiscal risk statement.

The ERP presents a number of credible improvements to the quality of public finances. On the expenditure side, the relatively low level of potentially growth enhancing public investment is set to steadily increase, in line with the recommendations of the first enlargement report for Moldova published by the Commission in November 2023. This would be facilitated by the ongoing reform of the public investment management system, namely the establishment of a ‘single project pipeline’ for all investment projects regardless of financing source, vetted by the Ministry of Finance, for inclusion in the medium-term budgetary framework and annual budget. Furthermore, the reform of the Energy Vulnerability Reduction Fund planned for 2024 will shift towards better targeted support and ensure that the model for support incentivises energy savings, leading to more efficient and effective expenditure. Finally, the authorities are finalising a spending review into the health sector which should identify opportunities to increase efficiency in an important area of spending which amounted to 5.5% of GDP in 2023.

On the revenue side, while efforts are ongoing to broaden the tax base by assessing and eventually eliminating certain tax expenditures, which are sizeable in Moldova, the ERP presents a number of measures which represent new tax expenditures. In 2022 and 2023, the authorities published a tax expenditure report focused on measuring foregone revenues. The report started in 2022 with income taxes and VAT and expanded to other taxes including excises, import duties and real estate tax in 2023. The authorities have committed to taking this analysis one step further by conducting a cost-benefit analysis of existing tax expenditures with a view to identifying measures to be phased out. However, the ERP presents measures for 2024 that seem to introduce new tax expenditures such as for certain luxury goods and deductions for expenditure by trade unions and employers’ organisations.

The numerical fiscal rule is not respected, and while the conditions for activating the escape clause remain in place, the rule has been suspended for longer than the permitted period. The public finance law stipulates that the budget deficit, excluding grants, should not exceed 2.5% of GDP, though capital investment financed from external sources can be excluded from the deficit. In 2018 and 2019, this fiscal rule was respected, but since 2020 the escape clause has been activated on the grounds a decline in economic activity (2020-2021) and exceptional circumstances endangering national security (2022-2024), although according to the law the escape clause may only be activated for 3 years in a row. The planned budget deficits for 2025 and 2026 also exceed the numerical rule though not when excluding foreign-financed investment projects. The Ministry of Finance is now considering proposals to amend the fiscal rule which may be an opportunity to examine its appropriateness in promoting countercyclical fiscal policy. There are no immediate plans to set up an independent fiscal council given capacity constraints, though the authorities plan to re-examine the issue in 2026 (the previous analysis was done in 2015-2016).

5.4. KEY STRUCTURAL REFORM AREAS

Moldova's first ERP submission includes only the macro-fiscal framework, while information on structural challenges and reform plans were optional and not included this year. The Commission identified the following macro-relevant structural challenges in the 2023 enlargement report based on an independent analysis drawing on input and discussions with the authorities and other stakeholders.

Moldova continues to struggle to properly identify, prioritise, evaluate, cost and implement public investment projects, leading to continual under-execution of the budget set aside for this purpose. In 2022, Moldova executed only about 60% of its budgeted public capital investment expenditure. In 2023, the execution of capital investment improved, but foreign-financed projects remain at risk of under-execution due to a lack of capacity to comply with the procedures and public procurement processes of foreign donors, in particular international financial institutions. Difficulties executing public investment plans limit the country from adequately addressing its very large infrastructure needs, including those related to energy security, transport connectivity, and trade facilitation. A new regulation governing the identification, selection and appraisal of all public investment projects funded from any source (the 'single project pipeline') was adopted in October 2022.

Moldova was hit hard by an energy crisis in 2021 which worsened in 2022 as a result of Russia's war in Ukraine. With support from international donors and the EU, Moldova has since made impressive efforts to reform its energy sector, adopting the EU energy law and diversifying its gas supply, leading to the phase out of gas imports from Russia. During the last heating seasons, the impact of the energy crisis on households was mitigated through the EU-funded Energy Vulnerability Reduction Fund that provided support to about 760,000 out of 1.3 million homes in 2022-2023. In 2023, the government improved the targeting of the programme to increase its efficiency. In addition, for the 2024-2025 heating season Moldova intends to delink the support from energy consumption, moving from covering energy bills to cash transfers thus incentivising energy savings. The country continues to benefit from electricity at stable and low costs produced by the power plant MGRES in the Transnistrian region (territory not under the control of the government of the Republic of Moldova). This power plant runs on highly subsidised Russian gas which poses a major security of supply risk. In the coming months, the government is expected to prepare an analysis on the fiscal impact of a possible interruption of natural gas supply used for electricity generation.

The shortage of skilled labour is a major issue for both private and public-sector employers, while labour force participation stands at a relatively low level and skills mismatches persist despite relatively high level of spending on education. The main reasons for low labour market participation include informal employment, (seasonal) work abroad, low salaries as compared to social benefits, the relevance of remittances, a mismatch between the skill level of the workforce and what employers require and high level of home childcare preventing female employment. In 2023, a concept note on reforming the National Employment Agency was adopted. The employment support law has been modified to incentivise those receiving social benefits to enter the job market. To increase female employment, the government has made significant efforts to increase childcare services and to provide more benefits for parents, i.e., more flexible and higher maternity allowances as well as paternity leave. In addition, the government is developing a programme to combat undeclared work, and, as of March 2023, unannounced inspections were allowed in cases of undeclared work. A new director of the State Labour Inspectorate has just been appointed and new inspectors have been hired.

State-owned enterprises play an important role in the economy, and necessary reforms are still in the early stages. There are approximately 900 state-owned enterprises, while out of those a large number exist on paper only. In 2023, a triage of about 180 central government state-owned enterprises took place categorising them among: 1) those to be kept in state ownership, 2) those to be privatised (either immediately or following restructuring), and 3) those to be liquidated. However, no concrete actions have yet been taken to implement the results. In addition, the government set out a plan to improve corporate governance of state-owned enterprises and accountability, notably by

adopting a model code of governance. Further steps included legal changes to set up audit committees at state-owned enterprises and to allow independent board members as well as the introduction of a process to professionalise boards through an improved selection process.

Foreign direct investment (FDI) as share of GDP has been historically relatively low in Moldova. Following a short but strong recovery after the pandemic, Russia's war of aggression against Ukraine has had a strong impact on investment sentiment in Moldova, with most foreign investors halting their investment plans. Nevertheless, there are signs that the situation has been stabilising since the beginning of 2023. FDI, however, has been concentrated in Moldova's so-called free economic cones which benefit from special tax regimes with investments often having limited knock-on effect on the local economy. The government supports industry and technology parks to attract foreign and local innovative companies as well as high skilled labour. A new programme dedicated to FDI promotion and attraction is expected to be adopted in 2024. The main implementing agency, Moldova Invest, has been restructured several times undergoing the latest reform in 2023. Looking ahead, the main measures to attract FDI will need to include qualification of the labour force, administrative support and aftercare services. In addition, the upcoming national strategy for economic development is expected to provide a broader vision to guide economic policy making, including a clear focus on promoting FDI, while the forthcoming Growth Plan should set out strategic short- and medium-term reform and investment priorities critical for economic convergence.

5.5. THE POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS PARTNERS, TÜRKIYE, GEORGIA, REPUBLIC OF MOLDOVA AND UKRAINE

The Economic and Financial Dialogue between the EU and the Western Balkans Partners, Türkiye, Georgia, Republic of Moldova and Ukraine

Brussels, 14 May 2024

[…]

In light of this assessment, Participants hereby invite the Republic of Moldova to:

1. Gradually reduce the fiscal deficit as the economic recovery takes hold, while building fiscal buffers to mitigate risks to the public finances; to that end, prepare an analysis on the fiscal impact of a possible interruption of natural gas supply used for electricity generation. Increase public investment as planned in the ERP, while applying the new single project pipeline framework covering all investment projects regardless of financing source. Improve the capacity to produce macroeconomic and fiscal forecasts, in particular of the cyclically adjusted fiscal balance.

2. Continue to broaden the tax base and improve tax compliance in line with the Public Finance Management Strategy 2023-2030. Finalise and publish the ongoing spending review of the health sector and undertake further reviews in the most significant areas of expenditure such as social protection. Review the main programmes supporting businesses' access to bank finance such as the '373 interest subsidy programme', the Fund for Entrepreneurship and Economic Growth Investments and the 'Credit Guarantee Facility' with a view to improving their effectiveness in addressing the bottlenecks to provision of credit, and assessing their potential to support the implementation of Environmental, Social and Governance (ESG) principles. Take steps to implement the results of the state-owned enterprise 'triage' exercise and ensure the implementation of recent governance reforms related to the professionalisation of boards and the establishment of audit committees at state-owned enterprises.

3. Ensure a sufficiently tight monetary policy stance as long as necessary to anchor inflation expectations at levels consistent with price stability, underpinned by a thorough assessment of potential second-round effects and developing an inflation expectations survey. Ensure the independence of the central bank, including the personal independence of decision-makers. Enhance risk-based supervision in line with best international and European practices, including by further strengthening the reporting framework across the banking system, harmonising the regulatory and supervisory landscape between the banking and the non-bank financial sector, and improving data collection to enable a comprehensive assessment of financial sector risks.

ANNEX: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Economic Reform Programme 2024-2026 was endorsed by the Inter-ministerial Committee for Strategic Planning, chaired by the prime minister, on 15 January 2024 and submitted to the Commission the same day.

As agreed in advance with the Commission, the ERP consists of the macro-fiscal framework only, as Moldova did not submit the chapters on structural reforms for this first round. The macro-fiscal framework is missing a number of elements, namely an alternative macroeconomic scenario and the sections on the structural balance, sensitivity analysis, and the sustainability of public finances. The Moldovan authorities alerted the Commission in advance that capacity constraints would prevent them from submitting these sections for this first round.

Inter-ministerial coordination

The prime minister designated the Ministry of Finance as the national ERP coordinator. The finance ministry worked closely with the Ministry of Economic Development and Digitalisation, the Ministry of Labour and Social Protection, the National Bank of Moldova and the National Bureau of Statistics in the preparation of the ERP. The document was also shared with experts from the EU-funded technical assistance project team at the Ministry of Finance for their input. The inter-ministerial coordination worked well.

Stakeholder consultation

The draft ERP was sent to a leading independent Moldovan think tank for comments and suggestions. As the ERP contains only the macro-fiscal framework and not the structural reform chapters, the document was not submitted separately for public consultation this year.

Macroeconomic framework

The programme presents a clear and concise picture of past economic developments, though it is limited by a lack of available data for example in the presentation of current account developments. The presented framework is coherent and consistent, though it does not provide an alternative macroeconomic scenario, nor does it provide a forecast for the external or financial sectors.

Fiscal framework

The major policy documents underpinning the fiscal framework are listed, though the link between the fiscal framework and specific priorities could be made more explicit. The programme contains references to obligations under the EU-Moldova Association Agreement, though it does not yet make reference to recommendations from the first enlargement report published in November 2023.

Key revenue and expenditure measures are generally not costed; only 3 of the 20 listed measures identify the estimated fiscal impact of the measure in question. Budget implementation for 2023 is presented up to the end of October 2023, the latest available data at the time of drafting. Moldova's fiscal reporting does not follow ESA2010 standards, and therefore does not meet the Commission's fiscal notification requirements.

6. MONTENEGRO

6.1. EXECUTIVE SUMMARY

Montenegro continued to record high economic growth in 2023, which is set to slow down in 2024-2026. A successful tourism season and strong private consumption, supported by a large inflow of foreign nationals, were the key drivers of economic growth in 2023, estimated at 5.8%. The main headwind came from high albeit moderating inflation, while tighter financing conditions weighed on investment. The baseline scenario set out in Montenegro's economic reform programme (ERP) projects real GDP growth to slow to an annual average of 3.2% in 2024-2026, driven by domestic demand on the back of rising private and public consumption and recovering investment. Net exports are projected to provide only a marginal contribution to GDP growth as tourism services, which exceeded their 2019 level already in 2023, are expected to decelerate from double-digit growth. The balance of risks is tilted to the downside as inflation might fall less than projected, eroding disposable income, while higher financing costs could negatively affect investment. Imports may increase by more than expected if investment plans, in particular the construction of the Bar - Bojare highway, are realised.

The ERP's fiscal scenario projects a sizeable deterioration of the budget balance in 2024 and a gradual deficit reduction in the following 2 years, which is set to lead to a modest pace of debt reduction. The 2023 budget performed much better than expected and recorded a surplus, estimated at 0.5% of GDP, driven by strong growth in indirect taxes, one-off revenues and lower-than-budgeted spending. The 2024 deficit is largely driven by strong increases in social transfers and capital spending. Budgetary adjustment in 2025-2026 is expected to rely on a sharp deceleration in public spending, which is projected to lead to a drop of 2.3 percentage points (pps) in the spending ratio and a small primary surplus in 2026. However, the envisaged spending restraint appears overly optimistic and is not underpinned by concrete measures. The public debt ratio, which has fallen very substantially in recent years, is set to continue declining but only slowly, to 61% of GDP in 2026. Debt refinancing needs remain large, peaking at 11% of GDP in 2025.

The main challenges facing Montenegro are the following:

- **High mandatory spending and a limited revenue base, together with upcoming large debt repayment needs call for a stronger fiscal consolidation than envisaged in the ERP.** Amid external and internal risks, the economic outlook is positive with decelerating but stable growth in Montenegro. However, debt repayment needs are set to increase sharply, first in 2025 and later in 2027 and 2029, which, coupled with tight financing conditions, raise vulnerabilities. Given Montenegro's monetary framework, fiscal policy is the main tool to manage aggregate demand and support further disinflation. This calls for a comprehensive medium-term fiscal plan with conrete consolidation measures and a commitment to bring the debt ratio below 60% of GDP as prescribed by the fiscal rule. Broadening the tax base, streamlining tax exemptions and incorporating new budget revenue initiatives would contribute to rebuilding fiscal buffers and reducing public debt. Further fiscal space could be gained by reviewing and reforming mandatory spending on the public wage bill, social and health expenditure.
- **Improving the long-term sustainability of public finances requires strenghening fiscal governance and the management of public investment.** While fiscal rules are in place, they are weak and lack a strong enforcement mechanism. Major new spending initiatives have not been adequately costed, resulting in high mandatory expenditure. Large infrastructure projects need better management and prioritisation given the limited fiscal space available. Setting up an independent fiscal institution would help strengthen the costing of new initiatives and help improve fiscal discipline. Improving the oversight and risk management of state-owned enterprises (SOEs) would over time alleviate their burden to the budget.

- **Improving the business environment, fostering private sector development, advancing the green and digital transition, and developing human capital are the key structural challenges Montenegro is facing.** There is a need to address, among others, weaknesses in the regulatory environment, informality, difficulties in access to finance and challenges in monitoring and managing SOEs. Montenegro's energy transition plans are in line with the European Green Deal, implying further development of the energy sector through investements in green energy and decarbonisation. Digitalisation focuses on developing digital services and improving cyber security. Structural labour market challenges, including persistently low rates of labour market activity and high unemployment, especially among women, young people and the low-skilled, continue to undermine potential growth and improvements in living standards. These challenges are expected to be addressed through key structural reforms identified in the country's reform agenda under the new Growth Plan for the Western Balkans.

The implementation of the policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2023 has been partial. In 2023, the fiscal outcome was better than envisaged in the revised budget due to very good performance of indirect tax revenue and one-off revenue items. No new medium-term fiscal strategy has been adopted. Nor has progress been made on public investment management and the review of tax expenditures. Although a legal basis has been created to set up a Fiscal Council, the call for appointing Council members was unsuccessful due to an insufficient number of applicants. Montenegro has made limited progress on preparations to roll out the Youth Guarantee implementation plan, on preparing a clear timeline and financial planning for the reform of the social and child protection system, and on developing a mechanism to continuously monitor active labour market measures. The government adopted a programme and action plan for 2024-2026 on supressing the informal economy. Progress was made on digitalisation but was limited on reforms related to the green agenda and to SOEs.

6.2. ECONOMIC OUTLOOK AND RISKS

Montenegro's economy continued to grow strongly in 2023, exceeding expectations. Based on quarterly data, full-year real GDP increased by 6.0% year on year (y-o-y) in 2023, on the back of strong growth in private consumption and service exports. Growth in private consumption was supported by rising wages and pensions as well as a high inflow of foreign nationals (in particular Turks, Russians and Ukrainians). Exports were boosted by the continued strong growth in tourism. The main headwind came from high albeit moderating inflationary pressures reflecting both international and domestic factors. Tight monetary conditions weighed on investment. The ERP estimates annual growth at 5.8% in 2023 which is well above 4.4% as projected in the ERP for 2022-2025 ([74]). Supported by a significant number of foreign workers, labour market conditions improved substantially with the average unemployment rate falling to a new historical low of 12.2% by the end of 2023, down from 15.1% in the previous year.

The ERP's baseline scenario projects GDP growth to average around 3.2% in 2024-2026 with a mildly decelerating trend. The ERP expects domestic demand to be the key driver of growth with a positive albeit decelerating profile of private and public consumption as well as investment. Higher employment and wages together with increased pensions are set to support private consumption while the recovery of investment is expected to be driven by new investment projects in energy, tourism and road infrastructure, notably a continuation of the construction of the Bar - Bojare highway. Further marginal support for GDP growth is projected to come from net exports, mainly tourism services, which exceeded their pre-pandemic level already in 2023, and are forecast to decelerate from double-digit growth. Import growth is also set to slow down from 10.6% in 2023 to an average of 4.8% in 2024-2026. The ERP estimates a positive output gap of 2.7% in 2023 which is

([74]) Macroeconomic and fiscal estimates and forecasts covering 2023-2026 have been taken from the ERPs themselves; if available, preliminary macroeconomic and fiscal outturn data for 2023 have been taken from the relevant national source (statistical office of Montenegro (MONSTAT), Ministry of Finance, central bank of Montenegro).

projected to decline mildly to 2.2% in 2026. Compared to the previous year, the ERP revises GDP growth downwards by 0.2 pps and 0.5 pps for 2024 and 2025 respectively. The ERP also contains an alternative downside scenario which assumes a deterioration in external environment and in particular a slower growth in the EU. The resulting fallout on investment and trade - including lower tourism activity - together with higher inflation and interest rates, would result in significantly lower GDP growth, ranging from 1.4% in 2024 to 1.7% in 2026.

The baseline ERP scenario of moderating growth is plausible though somewhat optimistic and subject to external and domestic risks. The baseline growth scenario for 2024 is more positive than the Commission's autumn forecast but the divergence narrows in 2025. The key difference in 2024 stems from a higher growth of private consumption, which is subject to a risk of inflation that is higher than the 5% assumed in the ERP. The downside scenario assumes inflation of 7% in 2024 which would lead to private consumptuion growing by only 1.4%. Further differences relate to the programme's assumption on capital investment which is based on the implementation of a new investment cycle. The deceleration in import growth forecast for 2024 in the baseline scenario seems somewhat sharp given the projected consumption and investment dynamics, and Montenegro's reliance on imports as a very small and open economy. The ERP rightly refers to external risks related to higher inflation, tight monetary conditions and slower global growth, including in the EU countries. Domestic risks stem from limited fiscal space, which constraints the response to unexpected adverse shocks to the economy. Positive risks relate to improvements in the domestic regulatory environment and progress on EU-related reforms.

Table II.6.1:

Montenegro - comparison of macroeconomic developments and forecasts

	2022		2023		2024		2025		2026	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	6.1	**6.4**	4.9	**5.8**	2.7	**3.8**	2.3	**3.0**	n.a.	**2.9**
Contributions:										
- final domestic demand	7.6	**7.4**	6.8	**7.1**	3.1	**4.9**	2.7	**2.7**	n.a.	**3.0**
- change in inventories	2.5	**2.6**	0.0	**0.0**	0.0	**0.0**	0.0	**0.0**	n.a.	**0.0**
- external balance of goods and services	-3.5	**-3.6**	-1.9	**-1.3**	-0.5	**-1.1**	-0.4	**0.2**	n.a.	**0.0**
Employment (% change)	17.2	**18.2**	5.4	**9.5**	2.2	**2.2**	0.8	**1.8**	n.a.	**1.7**
Unemployment rate (%)	15.0	**14.7**	13.6	**13.2**	13.2	**12.6**	13.0	**12.0**	n.a.	**11.6**
GDP deflator (% change)	n.a.	**12.4**	n.a.	**5.7**	n.a.	**2.3**	n.a.	**2.5**	n.a.	**1.8**
CPI inflation (%)	11.9	**13.0**	9.0	**9.0**	5.7	**5.0**	3.8	**3.4**	n.a.	**2.5**
Current account balance (% of GDP)	-13.3	**-12.9**	-12.6	**-12.7**	-12.3	**-13.1**	-12.1	**-12.0**	n.a.	**-10.9**
General government balance (% of GDP)	-5.2	**-3.7**	-2.3	**0.5**	-3.4	**-3.4**	-3.5	**-2.9**	n.a.	**-2.4**
Government gross debt (% of GDP)	69.5	**69.3**	61.0	**62.2**	63.5	**61.6**	61.2	**61.3**	n.a.	**61.0**

Sources: Economic Reform Programme (ERP) 2024, Commission Autumn 2023 forecast.

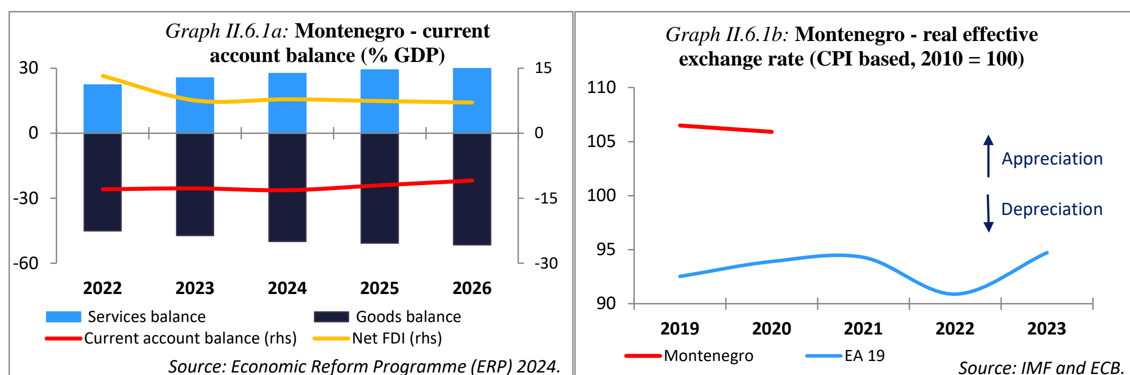
Inflation eased in 2023 and is projected to decline further in 2024-2026. Following record growth in 2022, inflation steadily declined throughout 2023 from 16.2% y-o-y in January to 4.3% in December ([75]) and averaged 8.6% for the year as a whole. The ERP estimates a cumulative increase of prices in 2022-2023 of over 23% as compared to 2021. Inflation has been driven by surging global commodity prices, such as food and fuel, as well as domestic policy-induced increases of wages and pensions. The ERP expects the average inflation rate to ease further, from 5% in 2024 to 2.5% in 2026, due to the high base in 2023 and stabilising import prices, in particular for food and fuels. Average wage growth is expected to be 5% in 2024 before levelling out to 4% in 2025-2026. 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 a major increase in the minimum pension rate (52%) from January 2024 and other social transfers included in the 2024 budget.

([75]) In February 2024 inflation remained unchanged at 4.3% y-o-y.

The ERP projects a gradual decrease in the current account deficit. In 2023, the current account deficit is estimated to have narrowed to 11.4% of GDP from 12.9% in 2022 as very high growth in services exports (21%) mitigated a decline in merchandise exports caused by weaker performance in metal exports. In near future, the ERP assumes stable growth in merchandise exports (6% in 2024-2026) combined with a slowdown in merchandise imports (from 11% in 2024 to 6.5% in 2026). These dynamics are set to result in a widening deficit of goods trade which is projected to be mitigated by a growing surplus of services trade. Growth in services exports and imports are also set to slow down from 12% and 8% in 2024 to 9% and 6% in 2026, respectively. The secondary account surplus declined to 6.4% of GDP in 2023 and is projected to recover to 7.9% in 2026. Overall, the ERP projects the current account deficit to narrow from 13.1% in 2024 to 10.9% in 2026. This is a more cautious scenario than in the previous year's ERP, which assumed a decline to 8.9% of GDP in 2025. A high import dependency and poor diversification of the production base remain key structural weaknesses of the Montenegrin economy. The assumption of higher imports growth in 2024 is in line with the projected investment profile.

Though set to decline, foreign direct investment (FDI) inflows are expected to finance two thirds of the current account deficit. Net FDI inflows declined by 47% y-o-y in January-September 2023, due to a combination of lower inflows of equity investment and inter-company debt (by 26% y-o-y) and higher outflows (25%). The latter was mainly driven by the withdrawal of funds by non-residents. More than a half of FDI inflows (53%) went into real estate. As a share of GDP, full-year net FDI inflows are estimated to have declined to 6.3% in 2023 from 13.2% the previous year. They are projected to increase to 7.8% of GDP in 2024 and to decline gradually to 7.1% of GDP in 2026. This profile implies that around two thirds of the current account deficit would be covered by FDI in 2024-2026. The ERP attributes this dynamic to a 'base effect' without providing a more substantial explanation. At the end of 2023, Montenegro's net international investment position was negative at 109% of GDP as compared to 130.4% by end-2024. The external debt declined to 140.8% of GDP in 2023 (supported by the denominator effect, as GDP increased by 11.8% in nominal terms in 2022) from 165.8% in 2022.

External competitiveness and current account



Graph II.6.1a: **Montenegro - current account balance (% GDP)**

Source: Economic Reform Programme (ERP) 2024.

Graph II.6.1b: **Montenegro - real effective exchange rate (CPI based, 2010 = 100)**

Source: IMF and ECB.

The banking system remains stable with adquate levels of liquidity and profitability. Most temporary measures aimed at preserving the liquidity and solvency of domestic banks, adopted in the context of the spill-over effects of Russia's invasion of Ukraine, expired during 2023. The central bank of Montenegro (CBM) strengthened the supervisory process in November by requiring credit institutions to pass the conformity check before paying dividends. As a precautionary measure, the central bank kept a repo line from the European Central Bank to address exceptional liquidity needs in the event of unforeseen circumstance. Banks continued to fund themselves mainly through domestic deposits which increased by 15.5% in 2023. Credit growth rose to 10.8% from 6.6% in the previous year. Borrowing costs increased with the nominal weighted average lending rate reaching 6.5% by the end of 2023 as compared to 5.3% at the beginning of the year. The widening spread between lending and deposit rates, reaching 623 basis points in Q3-2023 from 566 at the end of 2022, supported the profitability of the banking sector: The return on assets increased to 2.6% from 1.7% over the same period. The

non-performing loan ratio declined moderately to 5.0% of total loans at the end of 2023, as compared to 5.7% in 2022.

Table II.6.2:
Montenegro - financial sector indicators

	2019	2020	2021	2022	2023
Total assets of the banking system (EUR million)	4 604	4 587	5 329	6 407	6 735
Foreign ownership of banking system (%)	67.9	80.3	80.0	82.0	83.7
Credit growth (%, average)	4.2	5.0	6.6	6.1	10.8
Deposit growth (%, average)	1.8	-2.5	12.8	23.3	15.5
Loan-to-deposit ratio (end of period)	88.1	93.7	80.0	70.1	74.8
Financial soundness indicators (%, end of period)					
- non-performing loans to total loans	4.7	5.5	6.2	5.7	5.0
- regulatory capital to risk-weighted assets	17.7	18.5	18.5	19.3	20.3
- liquid assets to total assets	20.8	22.2	26.4	31.0	23.7
- return on equity	9.0	4.1	4.6	14.4	19.8
- foreign exchange loans to total loans	0.4	0.2	0.2	0.2	0.1

Source: Central Bank of Montenegro.

6.3. PUBLIC FINANCE ([76])

Supported by extraordinary revenue growth, the 2023 budget outcome substantially exceeded the target envisaged in the revised budget. The initial budget set the general government deficit target at 5.9% of GDP, compared to the 2022 outcome of 4.3% , due to higher mandatory social spending and cautious assumptions on the revenue side. Following the amendment of the 2023 budget in November to accommodate much stronger growth in public revenue and allocate additional funds for energy, social and health transfers and public wages, the overall deficit target was reduced significantly to 3.4% of GDP. The actual budget outcome is estimated to have been in surplus, at 0.5% of GDP, due to a combination of much higher revenue (44.3% of GDP versus 37.6% predicted in the revised budget) and less pronounced increase in spending (43.8% versus 40.9% of GDP). Public revenue growth was supported by high consumer spending fuelled by a large inflow of foreign nationals, high inflation, a successful tourism season and improved tax discipline. Revenues also benefited from an increase in social contributions following public sector wage increases as well as one-off revenues related to the economic citizenship programme, the termination of a hedging arrangement ([77]) and the energy-related budget support from the EU. Overall, total revenues increased by 26.3% y-o-y or by 5.1 pps of GDP, while total spending rose by 12.8% or 0.9 pps of GDP. Current expenditure increased by 17.2% y-o-y, driven by higher social transfers (23.6%), an increased wage bill (19.3%) and a surge in interest payments (34.9%). In parallel, capital spending declined by 9%, raising a question mark on the composition and quality of public spending.

([76]) The assessment of the fiscal framework is based on a revised fiscal scenario provided to the Commission after the official ERP submission, and not on the fiscal tables presented in the ERP. The revision is mainly explained by: (i) the budget outcome of 2023; and (ii) revised projections for the local government sub-sector, which led to a significant revision of general government finances.

([77]) The hedging transaction in the form of cross-currency swap was concluded in the amount of USD 818 million covering a loan provided by Exim China Bank with a maturity of 14 years. The cross-currency swap operates on the principle of exchanging euro and dollar cash flows between the contracting parties, in accordance with the agreed terms and in accordance with the loan repayment plan to which the hedging arrangement is linked. The Ministry of Finance decided to keep the hedging arrangement until all four repayment instalments have been repaid and closest to the date of mandatory termination i.e. July 2023. The transaction was terminated (by the outgoing government) in early June 2023 when the market gain reached around USD 64 million.

Table II.6.3:

Montenegro - composition of the budgetary adjustment (% of GDP)

	2022	2023	2024	2025	2026	Change: 2023-26
Revenues	39.2	44.3	44.1	43.3	42.8	-1.5
- Taxes and social security contributions	34.1	37.2	38.7	38.5	38.2	1.0
- Other (residual)	5.1	7.1	5.4	4.8	4.6	-2.5
Expenditure	42.9	43.8	47.5	46.2	45.2	1.3
- Primary expenditure	41.2	41.9	45.5	43.9	42.7	0.7
of which:						
Gross fixed capital formation	5.3	4.3	5.2	5.0	5.1	0.7
Consumption	13.0	13.7	13.6	12.8	12.3	-1.4
Transfers & subsidies	19.7	20.8	22.7	22.4	22.1	1.3
Other (residual)	3.2	3.1	4.1	3.7	3.2	0.1
- Interest payments	1.6	1.9	2.0	2.2	2.5	0.6
Budget balance	-3.7	0.5	-3.4	-2.9	-2.4	-2.8
- Cyclically adjusted	-3.4	-0.1	-4.3	-3.8	-3.1	-3.0
Primary balance	-2.1	2.4	-1.4	-0.7	0.2	-2.2
- Cyclically adjusted	-1.8	1.8	-2.3	-1.6	-0.6	-2.4
Gross debt level	69.3	62.2	61.6	61.3	61.0	-1.3

Sources: Economic Reform Programme (ERP) 2024, Commission calculations.

While fiscal consolidation remains a priority, the ERP projects a worsening budget balance in 2024 (compared to the actual 2023 outcome) and gradual adjustment in the next 2 years. A number of ad hoc measures in previous years ([78]) weakened the tax base and resulted in higher mandatory spending. The ERP sets out some fiscal consolidation measures which contain reduced discretionary spending, applying stricter criteria for the selection of mature investment projects and better collection of revenue as well as the expansion of the tax base. All new spending measures are required to be fiscally neutral, i.e. financed from current revenue but not from new borrowing. This concept excludes capital expenditure and therefore does not limit the extent of the deficit. Public revenue is set to level out from the record 44.3% of GDP in 2023 to 44.1% in 2024 and then decline to 42.8% in 2026. Other (non-tax) revenue, which was supported by one-off items in 2023, is set to decline from 7.1% to 5.4% of GDP in 2024 and to 4.6% in 2026. Key items supporting public revenue will remain VAT and excise duties, which are projected to account for around 74% of tax revenue in 2024-2026. The share of social contributions is set at nearly 20% of budget revenue for this period. Public spending is set to increase from 43.8% of GDP in 2023 to 47.5% in 2024 before declining to 45.2 % in 2026. The main items driving higher spending relate to growing social transfers and capital investment. This projected path would result in a sharp widening of a headline deficit to 3.4% in 2024 and a gradual fall by 0.5 pps per year thereafter. The primary balance is projected to achieve a surplus of 0.2% of GDP in 2026. The projected fiscal adjustment is backloaded, but more ambitious than last year's programme which did not envisage any reduction of the primary deficit. The debt ratio is assumed to be on a declining path from 62.2% of GDP in 2023 to 61% in 2026 which is well below the projections of the previous ERP. Overall, the assumed fiscal path of a substantial widening deficit in 2024 and a gradual adjustment in the subsequent years would result in exceeding the limits prescribed by the rules of fiscal responsibility ([79]) in 2024, but partially complying with them in 2025-2026.

Driven by strong growth in social transfers and capital spending, the general government deficit is set to widen in 2024. Compared to the 2023 output, government revenue is set to

([78]) These included abolishing the mandatory health contributions, introducing a non-taxable share of wages, introducing additional allowances for all children and for mothers of three or more children, large increases in minimum pensions and wage increases in the public sector.

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

decrease marginally, by 0.2 pps to 44.1% of GDP, although the 'other' (non-tax) revenue category is set to decline by 1.7 pps to 5.4% of GDP due to expiring one-off items. Tax revenue is set to increase by 1.5 pps to 38.7% of GDP, which seems rather optimistic given an exceptional performance in 2023. Nearly half of government revenue is projected to come from VAT and excise duties, which would increase by 13% each and account together for 22.2% of GDP. While pension increases should support household consumption and VAT income, further additional revenues are expected thanks to higher legal trade in tobacco products, changes in the excise calendar and new excise duties on products with added sugar. Revenues from labour and corporate income taxation are projected to rise by 12% and 9%, respectively, as compared to 2023, in line with economic trends, the narrowing of the informal economy and the ongoing adjustment of public wages. Revenues from social security contributions are expected to remain stable at 8.6% of GDP. Public spending is projected to increase by 3.7 pps to 47.5% of GDP, due to a strong increase in mandatory current spending, mainly driven by social transfers, and higher allocation for capital investment. Social benefit spending is planned to increase by 22.6% y-o-y, or by 2 pps to 14.4% of GDP, reflecting the increase in the minimum pension (52%) and the regular pension indexation. The gross wage bill is assumed to remain roughly unchanged at 10.7% of GDP, but it will increase by 5% y-o-y in nominal terms, due to a new collective bargaining agreement and a higher number of workers employed. The capital budget is set at 5.2% of GDP, which is 1.1 pps higher than in 2023 due to the planned start of the second phase of the Bar-Boljare highway.

BOX II.6.1: THE BUDGET FOR 2024

* On 28 December, Parliament of Montenegro adopted the 2024 Budget Law, which targets a deficit of 3.4% of projected GDP, assuming real growth of 3.8% and inflation levelling out to 5%.

Table: **Main measures in the budget for 2024**

Revenue measures*	Expenditure measures**
• Increase in indirect revenues due to higher consumption supported by an increase in minimum pension to EUR 450 *(Estimated impact: 0.4% of GDP)* • Implementation of excise increase through regular excise calendar, and introducing the new excise product and suppressing the grey economy on tobacco market *(Estimated impact: 0.6%)* • One-off change in non-tax revenue due the implementation of the economic citizenship programme *(Estimated impact: 0.4% of GDP)* • Implementation of the new Law on Games of Chance *(Estimated impact: 0.3% of GDP)* • Returning the VAT rate on the pre-crises level from 7% to 21%, in the field of tourism and hospitality as of 1 January 2024 *(Estimated impact: 0.2% of GDP)*	• Increasing the minimum pension to EUR 450 *(Estimated impact: 1.5% of GDP)* • Regular adjustment of pensions *(Estimated impact: 0.8% of GDP)*

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

Source: ERP.

In the medium term, the ERP projects that budget deficits will decline as a result of the rapidly decelerating growth of public spending. The budget revenue as share of GDP is set to decrease from a high level due to decelerating growth of tax revenue and shrinking other revenues. Tax revenue is forecast to grow at some 4% in nominal terms in 2025-2026, supported by lower tax debt, an accelerating excise calender, the revision of the taxation of games of chance and measures to tackle informality. The budgetary adjustment should mainly be driven by a sharp deceleration of public spending, from an annual increase of 15% in 2024 to 2.7% in 2025 and 2.5% in 2026, leading to a 2.3 pps drop in the spending ratio in 2025-2026. The ERP refers to the principle of controlled growth of current spending and a reduction in non-productive spending, but the assumptions on the main spending items raise some concerns. Notably, the projection of an almost stable wage bill in nominal terms, leading to a 0.5 of GDP reduction per year might prove overly optimistic and not in line with historical wage trends and the inflation outlook in 2025-2026 which is likely to generate at least some wage adjustments. Social transfers are projected to grow by 5% in 2025 and 4% in 2026, after a major increase (22.6%) in 2024. This assumption seems rather optimistic, as an average pension is indexed three times a year, resulting in a 39% increase by the end of 2024 ([80]). The capital budget is set to remain roughly stable at some 5% of GDP, which is above the level achieved in 2023, but in line with historical trends.

After significant declines in recent years, the ERP projects the public debt ratio to decrease only moderately, to 61% of GDP in 2026, while financing needs are set to rise sharply. The ERP estimates that total public debt decreased sharply, to 62.2% of GDP at the end of 2023 from 69.3% in the previous year. Total financing needs amounted to 6.1% of GDP, which were mainly covered by new borrowing (4.6%), government deposits (0.9% of GDP) and privatisation revenues (0.3%). Despite a widening primary deficit in 2024, the ERP expects the public debt to level out to 61.6% of GDP, helped by GDP growth, inflation and negative stock-flow adjustments, the latter partly related to the continued use of government deposits to meet financing needs. In 2025-2026, rising interest expenditure is set to be the main debt ratio-increasing factor while an offseting impact is expected from GDP growth and inflation. The ERP projects a small primary deficit in 2025 which should turn into a surplus in 2026, contributing to a continued modest debt reduction. Debt repayment needs are set to rise sharply, from 4.8% of GDP in 2023 to 7.6% in 2024 and 11% of GDP in 2025, bringing gross public financing needs to a record 14.1% of GDP in 2025. The surge in 2025 is driven by a maturing Eurobond (EUR 500 million or 6.7% of projected GDP) which needs to be refinanced. Government deposits, which stood at 3.6% of GDP in September 2023, are planned to help debt repayment by 1% of GDP in 2025-2026.

A new hedging arrangement covers currency exchange and interest rate risks. While the average debt maturity shortened by 2 years in 2020-2022, the termination of hedging arrangement for a US dollar denominated loan from China in 2023 resulted in a significant increase in the average weighted interest rate and in the share of non-euro-denominated debt (to around 20% of the total).While the share of debt with a fixed interest rate remained practically unchanged from previous year at 77.8% of the total, the share with a variable interest rate (22.2%), is mainly linked to Euribor, which was expected to result in higher borrowing costs due to tightening global financial conditions. This, along with currency exchange risks, has been addressed by concluding a new hedging arrangement after the submission of the ERP.

([80]) Following the 52% hike in the minimum pension rate to EUR 450 as of 2024, the government announced that there will be no regular adjustments of the minimum pension for the next 2 years.

BOX II.6.2: DEBT DYNAMICS

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

	2022	2023	2024	2025	2026
Gross debt ratio [1]	69.3	62.2	61.6	61.3	61.0
Change in the ratio	-14.7	-7.1	-0.6	-0.3	-0.3
Contributions [2]:					
1. Primary balance	**2.1**	**-2.4**	**1.4**	**0.7**	**-0.2**
2. 'Snowball effect'	**-11.6**	**-5.2**	**-1.6**	**-1.0**	**-0.3**
Of which:					
Interest expenditure	1.6	1.9	2.0	2.2	2.5
Growth effect	-4.5	-3.6	-2.2	-1.8	-1.7
Inflation effect	-8.7	-3.5	-1.3	-1.4	-1.1
3. Stock-flow adjustment	**-5.2**	**0.5**	**-0.4**	**-0.1**	**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) 2024, Commission calculations.

The favourable snowball effect is set to moderate sharply, as nominal GDP and inflation are set to slow down while interest costs rise. A continued moderate debt reduction is set to be ensured by the improving primary balance, which is projected to turn positive in 2026. Using government cash deposits to repay maturing debt is projected to generate some downward stock-flow adjustments in 2024 that will decline in the following 2 years.

While the ERP presents a broad balance of risks to the baseline scenario, some risks deserve deeper consideration. Political risks relate to geopolitical tensions and the internal environment, which could lead to new spending pressures, undermining the sustainability of public finance and credit conditions for the forthcoming borrowing. The lack of a comprehensive fiscal strategy creates a risk of further ad hoc measures, as shown by the ongoing discussion to raise the minimum wage up to EUR 700 and increase net wages, potentially by reducing the pension contribution rate. Such decisions would constitute a major risk and have heavy consequences for Montenegro's fiscal sustainability, requiring a substantial increase in indirect taxes to offset the costs. Given the 2023 output, public revenue is revised significantly upwards as compared the previous ERP, resulting in lower government deficits. Spending projections signal consolidation attempts, but the underlying assumption, such as freezing the public wage bill, lacks credibility. The ERP indicates positive risks to the baseline scenario, related to the implementation of the Growth Plan for the Western Balkans, the reform of the Revenue and Customs Administration, strengthened measures against the informal economy, the concession of Montenegro's airports and the growth impact of the highway construction. Negative risks stem from possible delays in the implementation of structural reforms, adverse external trends, in particular inflation, and delays in the implementation of revenue-supporting measures. Further negative risks relate to possible cost overruns in highway construction projects and contingent liabilities related to SOEs. 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.6.3: SENSITIVITY ANALYSIS

The ERP includes a detailed analysis of the deficit, with a comparison between baseline and low growth 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 1.2% of GDP in 2023 to 8.4% in 2024 and adjust to 6.4% in 2025. In addition, the public debt-to-GDP ratio would reach 76% of GDP by 2026 implying higher fiscal sustainability risks.

Shortcomings in the composition of public finance include a narrow tax base and high mandatory spending. Abolishing mandatory health contributions and introducing a non-taxable part of wages has substantially weakened the tax base ([81]), while growing public spending is mainly driven by current expenditure (86% of the total) leaving little space for capital investment. Public investment would also benefit from more efficient capital budgeting and implementation. While the ERP mentions the need to strengthen the tax base with a comprehensive tax reform, there is a risk that lowering the tax wedge on labour would deliver the opposite result and further weaken public revenue. Higher taxation of illegal assets, raising excise rates for goods with adverse health effects, reducing the informal economy and tax debt are all steps in the right direction, but it is unclear whether their impact would be sufficient to compensate for continuous growth of mandatory spending. The reforms of the pension and healthcare systems, renumeration of public employees, together with the reform of SOEs, are essential for limiting the increase of current spending and freeing the resources for investment projects (e.g. on education, infrastructure and digitalisation), aimed at increasing productivity and the competitiveness of the economy.

Compliance with existing fiscal rules requires tighter fiscal consolidation than that envisaged in the current ERP. The current medium-term fiscal planning breaches the numerical rules for general government debt for the entire period, while the general government deficit is projected to fall below the limit of 3% of GDP in 2025-2026, partly due to overoptimstic assumptions on containing public spending. The ERP confirms the urgent need for reforms in the areas of health, social benefits, pensions and public sector wages, which are indispensable for achieving the fiscal consolidation and medium-term sustainability of public finance. The ERP also suggests considering a revision of existing fiscal rules, as they are too weak to anchor fiscal policy, and possibly introducing additional rules or reinforcing the current budgetary planning process. A requirement for fiscal neutrality, which was applied for the 2024-2026 fiscal planning, could be institutionalised while respecting the current limit for budget deficit and the need to achieve a primary surplus. A commitment to anchor public debt to 60% of GDP could be a useful tool in strengthening fiscal sustainability. Further support for monitoring the implementation of fiscal policy could come from the Fiscal Council, which would be tasked with evaluating new measures prior to their adoption. Montenegro adopted the Law on budget and fiscal responsibility, creating the legal basis for setting up the Fiscal Council. However, the public call for Council members has so far failed and the government plans to relaunch a call in 2024.

([81]) Given the importance of the tourism industry, Montenegro's tax mix is very dependent on revenues from taxes on goods and services, accounting for 62.6% of total tax revenues in 2021. For comparison, taxes on goods and services average to 49.2% and 32.1% in WB6 economies and OECD countries, respectively. As a share of GDP, VAT revenues account for 19.9% in Montenegro, which is almost twice as much as the OECD average of 10.6%. OECD (2022).

6.4. MAIN MACRO-RELEVANT STRUCTURAL CHALLENGES

In November 2023, the Commission proposed a New Growth Plan for the Western Balkans ([82]) with the aim of supporting the region's economic convergence and accelerating the accession process. The plan involves a Reform and Growth Facility (EUR 2 billion in grants, EUR 4 billion in loans) that is to be disbursed in 2024-2027 as investment ([83]) and budget support in exchange for implementing reforms that are to be set out in reform agendas prepared by the Western Balkan partners. The New Growth Plan is therefore an important tool to increase reform incentives to boost growth and convergence. In this context, with a view to ensuring an integrated surveillance of Montenegro's economy, this chapter briefly outlines the main structural challenges facing the country.

Montenegro's comparative advantage is due to 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.

An improved business-oriented institutional and regulatory environment would facilitate private sector development. A burdensome regulatory and institutional environment hinders private sector dynamism as well as domestic and foreign investment and provides incentives, specifically to micro and small enterprises, to engage in undeclared work and transactions. This is compounded by the excessively complex legal framework, weak law enforcement ([84]), a lack of transparency in administrative decision making and financial burden from local taxation and para-fiscal charges.

Pushing forward reforms and privatising SOEs and improving their governance and profitability remain a challenge. Insufficient performance of SOEs translates into fiscal risks and a potential increase in public spending within limited fiscal space. The caretaker government stepped back from previous plans to formulate the State's ownership strategy and set out a portfolio of key companies that should remain in state possession, as well as to improve the management practices and financial performance of SOEs. As there was no political agreement on the direction and scope of such reforms, the government also stepped back from its plans for setting up a holding company to manage and reform SOEs ([85]), and limited the scope of its 2022 measures to set up a small unit in the Ministry of Finance to monitor fiscal risks related to SOEs. The performance of Montenegro's SOEs, including those at the local level, could be enhanced by establishing a legal SOE framework, which would incorporate principles of good corporate governance, and transforming SOE management structures, eliminating political patronage and improving financial performance to reduce fiscal risks.

The informal economy is 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, labour market weaknesses, insufficient enforcement capacity of the public authorities, corruption and tax non-compliance. The impact of the informal economy is particularly harmful for SMEs that operate 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

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([82]) https://neighbourhood-enlargement.ec.europa.eu/enlargement-policy/new-growth-plan-western-balkans_en

([83]) Infrastructure investments need to comply with the EU environmental acquis, national and international nature protection and water management obligations, ensure public participation and consultation, and guarantee high quality environmental impact assessment reports that include cumulative impacts on nature and biodiversity.

([84]) There are considerable challenges in dispute settlement in Montenegro, despite progress in implementing reforms. The time to resolve a commercial dispute has been consistently increasing and the commercial court is still challenged by weak enforcement and limited implementation capacity. Similarly, the Constitutional court spent 6 months without a quorum and there is still one vacancy to be filled, which could increase the backlog of cases.

([85]) The SOE Montenegro Works, which was created in August 2021 and tasked with monitoring SOEs' financial performance, was liquidated in July 2022.

companies, which particularly hinders the development of sectors of the economy that are based on knowledge and skills. Effective policies to reduce informality would help create a supportive environment for the SME sector, enabling it to also benefit from the presence of skilled migrant labour in the country. The ERP sets out measures aimed at strengthening the business environment and supressing the informal economy, such as introducing a new integrated IT system for public revenue management and streamlining trade in goods and services.

Montenegro's green transition remains at an early stage. The national energy and climate plan is under development and expected to be adopted in 2024. The plan is expected to align with the 2030 energy and climate targets approved by the Energy Community Ministerial Council in 2022. As EU Member States move towards greener economies, Montenegro would benefit from aligning its policies with those of the EU. This would strengthen its competitiveness during the accession process (for example on the Carbon Border Adjustment Mechanism), and ultimately help it cope with increased market pressures. It should notably implement the Energy Community's Decarbonisation Roadmap and put in place a carbon pricing instrument compatible with the EU ETS, along with a reliable and transparent framework for monitoring, reporting and verifying 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) Montenegro could leverage its natural endowments in hydro, solar and wind power, increasing energy production and exports, while also helping to achieve the country's climate goals, and supporting the achievement of coal phase out.

The pace of investment in digital infrastructure is slow. The telecoms operator auctioned 5G spectrum and awarded it to three major operators in December 2022, but a framework for 5G cybersecurity requirements is still pending. All three operators are obliged to activate 5G in every municipality by the end of 2024, providing 5G coverage to 50% of population by 2026. 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. In rural areas, 37% of households were without internet access. The main goal of the national broadband plan is to provide a higher percentage of household coverage by fixed broadband internet access at a speed of 100Mbps.

The digitalisation of the public sector, and the development of transactional e-government services for the public and for businesses feature prominently among the government's priority reforms, as set out in a series of important strategic documents ([86])**.** Although digitalisation gained additional momentum during the COVID-19 pandemic ([87]), state authorities failed to produce tangible improvements. The cyberattacks during in the second half of 2022 seriously disrupted the government's digital services and brought the issue of cybersecurity to the forefront, but it consequently left little space for improvements to e-governance. The ERP refers to digitalisation and cyber security measures, which are expected to result in the digitalisation of the public administration and to strengthen cyber security and broadband infrastructure through a multidisciplinary approach. This reform measure should improve confidence in digital services, increase the efficiency of public services and contribute to productivity growth.

With the economic recovery, labour market indicators also continued to improve and surpassed pre-crisis levels, but structural challenges remain. According to the labour force survey (LFS), the average unemployment rate fell to 12.2% in Q4-2023, down from 13.4% a year earlier, while the employment rate also increased to 63.8%, up from 59.6%, the previous year. Despite

([86]) 2022-2026 digital transformation strategy, 2022-2026 strategy for the digitalisation of the education system, 2022-2026 cybersecurity strategy and the Law on electronic documents.

([87]) In 2022 Montenegro implemented the new customs law, requiring electronic data processing for information exchange among customs authorities and economic entities. This improves efficiency in customs procedures, leading to a more secure and digitally streamlined trade environment for both businesses and the government agencies.

these improvements, the 2023 LFS results once again confirmed large regional disparities, with the unemployment rate standing at 3.5% in the tourism-heavy coastal region, at 7.7% in the central region, and at 29.2% in the poorer northern region. The gender gap narrowed somewhat, but the activity rate of women (63.6%) remained significantly below that of men (77.5%). Remaining major structural challenges are youth unemployment, standing at 23.7% for the population aged 15-24, and long-term unemployment, as 76.1% of all unemployed have been looking for a job for more than 12 months. 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. Despite ongoing reform efforts, the public employment service's capacity for job mediation remains weak and lacks a continuous monitoring of active labour market policies, which in turn prevents the design of quality, targeted and effective employment activation measures. The Employment Agency of Montenegro's reform and readiness remain key challenges and are important for not only implementing the Youth Guarantee, but also for ensuring a healthy, well-functioning labour market in the long term.

A mismatch of skills remains a significant challenge, particularly for graduates of vocational education and training (VET) 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 VET and higher education graduates are long-standing challenges. A high share of people transitioning from VET programmes to higher education and other programmes are less suited to market needs. Occupational mismatches (i.e. over-qualification) are highest for people with 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. 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. The 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.

6.5. THE POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS PARTNERS, TÜRKIYE, GEORGIA, REPUBLIC OF MOLDOVA AND UKRAINE

The Economic and Financial Dialogue between the EU and the Western Balkans Partners, Türkiye, Georgia, Republic of Moldova and Ukraine

Brussels, 14 May 2024

[…]

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

1. Adopt an appropriately tight fiscal stance in 2024 to comply with the budget target and support further disinflation, and use revenue overperformance for deficit reduction and accumulation of government deposits. Adopt a medium-term fiscal strategy, including concrete consolidation measures supporting the achievement of a non-negative primary balance and the public debt ratio not exceeding 60% of GDP by 2026. Elect and appoint members of the fiscal council, and ensure and make publicly available a proper costing of new fiscal initiatives.

2. 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). Improve SOE oversight by producing and publishing the related fiscal risk assessments. Implement the public investment management assessment (PIMA) recommendations, prioritising key public infrastructure works within the available fiscal space while avoiding exceptions regarding project selection.

3. Continue to thoroughly assess price developments and possible second-round effects, and stand ready to use the limited tools available under the chosen monetary framework to ensure price stability. Progress with the implementation of secondary legislation for the Law on Credit Institutions and the Law on Resolution of Credit Institutions and transpose the Bank Recovery and Resolution Directive II. Further enhance risk-based supervision in line with best international and European practices, including by improving data collection to enable a comprehensive assessment of financial sector risks.

ANNEX 1: OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2023

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey 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 guidance is similar to that of the country-specific recommendations usually adopted under the European Semester for EU Member States. Implementation of the guidance is evaluated by the Commission in the following year's ERP assessments.

The following table presents the Commission's assessment of the implementation of the 2023 policy guidance jointly adopted by the EU and the Western Balkans and Turkey at their Economic and Financial Dialogue at ministerial level on 16 May 2023.

Overall: partial implementation (38.9%) ([88])	
2023 policy guidance (PG)	**Summary assessment**
PG 1: Adopt an appropriately tight fiscal stance in 2023 to help disinflation, while providing targeted support to vulnerable households and firms, if needed.	There was **limited implementation** of PG 1: 1) **Substantial implementation**: In early 2023 the caretaker government adopted some structural measures to support budget revenue. Good economic performance, supported partly by the inflow of foreign nationals, resulted in a strong increase in budget revenue making it possible to achieve a small surplus - a much better outcome than planned in the revised budget. The decision to increase minimum pensions supports the most vulnerable households.
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.	2) **Limited implementation**: A medium-term fiscal strategy, including concrete consolidation measures, has not been adopted. Fiscal projections set out in the 2024 budget foresee the continued moderate reduction of the public debt-to-GDP ratio, while the primary balance is projected to become positive in 2026. But the unerlying measures to achieve the required speding restraint are not well developed.
Ensure proper costing of new fiscal initiatives before considering them for adoption.	3) **No implementation**: Important initiaves, such as the 52% increase in minimum pension, were not accompanied by a proper cost assessment.

([88]) 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.

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 to be shared with the Commission, prepare concrete budgetary recommendations to reduce tax expenditure (such as exemptions, deductions, credits, deferrals).	There was **limited implementation** of PG2. 1) **Limited implementation:** In cooperation with the IMF, the Ministry of Finance set key priorities and agreed technical assisstance to improve the capital budget planning. 2) **Substantial implementation:** Amendments to the Law on budget and fiscal responsibility were adopted. The government launched a public call for members of the Fiscal Council, but it was unsuccessful due to an insufficient number of applicants. A new call is expected in Q1-2024 and the Fiscal Council should be set up by the end of 2024. 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 to prepare an economic impact analysis/quantification of the scale of tax exemptions.
PG 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	There was **substantial implementation** of PG 3: 1) **Partial implementation**: The central bank carefully monitored developments in price dynamics and observed some increases in lending rates and slowing credit growth. Fiscal policy that led to large net wage increases added to underlying inflationary pressures. So far the central bank has not used macroprudential tools, which are among the few tools it has at its disposal to influence lending activity and therefore also inflation.
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.	2) **Substantial implementation**: Following the completion of all Asset Quality Review follow-ups, on-site checks were conducted to determine the correctness of capital adequacy calculations. Non-performing loans (NPLs) continued to decline. On the real estate sector, the central bank created an indicator on the departure of real estate prices from its fundamentals to monitor financial system risk. Some data gaps remain.
Continue to improve and implement legislation to further align with the EU framework on regulation and supervision, including on deposit insurance, and accelerate efforts to provide	3) **Substantial implementation**: Progress was made on key legislation that further aligns Montenegro's regulation and supervision with the current EU framework, including on enabling

viable and timely solutions for swift and effective NPL resolution.	regulations to implement the Law on credit institutions. The coverage ratio of insured deposits has been raised incrementally. Following the adoption of the Law on resolution of credit institutions, the CBM prepared resolution plans, determined the minimum requirement for own funds and eligible liabilities (MREL), and set up a Resolution Fund which it manages. However, progress on legislation and actions to strengthen the broad institutional framework for efficient insolvency has been limited, with an inter-agency working group set up by the CBM needing to be actively resumed.
PG 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.	There was **limited implementation** of PG 4. 1) **Limited implementation:** Preparation of the National Energy and Climate Plan (NECP) is significantly delayed. Preparatory work on two climate-related laws is underway. Some activities have been undertaken to facilitate preparation of laws on energy and cross border exchange of electricity and gas. Several secondary legislation acts on energy efficiency were adopted, but implementation is still lagging. The energy projects, Montenegro Energy Efficiency Project and Promotion of Energy Efficiency in Public Buildings are underway. 2) **Limited implementation**: Montenegro joined Digital Europe programme in June 2023, but the government support for SMEs participating in the calls for proposals is not specified. The launch of a new government e-portal has been postponed to the end of 2024. Initial activities to establish a new cybersecurity architecture, including a cybersecurity agency and a secure data centre are underway. 3) **Limited implementation**: Initial activities for development of a new regulatory framework for SOEs have been carried out. The analysis of a current legal framework remains to be completed. Adoption of the strategy on state ownership, the roadmap for reforms of SOE governance and the related legislative proposals are yet to be drafted.
PG 5: Based on the results of the informal economy survey, establish an action plan to reduce informality. Ensure cooperation between central and local	There was **partial implementation** of PG 5. 1) **Full implementation:** In December 2023, the government adopted a programme for supressing the informal economy for 2024-2026, with an accompanying action plan. 2) **Limited implementation:** While some forms of cooperation between central and local

authorities to implement the plan, including prevention and incentives to legalise informal businesses and employees.	authorities have been announced within the newly adopted programme for supressing the informal economy, the implementation is yet to take place.
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.	3) **Limited implementation:** A number of actions targeting the inspection services and the scrutiny of the relevant legal framework has been announced within the newly adopted programme for supressing the informal economy. However, the analytical work and foreseen actions should start in mid-2024 and be finalised in 2025.
PG 6:	There was **limited implementation** of PG6.
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.	1) **Limited implementation**: The new government (re)appointed a working group to coordinate the Youth Guarantee implementation plan (YGIP) as well as a new Youth Guarantee coordinator. The YGIP (revised version from October 2023) is to be adopted in April 2024. Activities to prepare the pilot are progressing slowly. The digitalisation of the agency has started with the development of a single IT system. This takes the form of an application-based, modular built platform, organised to enable all of the agency's business processes. It aims to serve as a single gateway for employment for all sectors and sections of the Employment Service, as well as for the general public and companies, and - through data sharing - for other public administration bodies, both at national and local level. The system is planned to be up and running before the end of 2024.
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.	2) **Limited implementation**: The implementation of the roadmaps, methodology and manuals for the design, implementation and monitoring of ALMMs has yet to take place. Capacity building activities for the Employment Agency of Montenegro staff for the implementation of the Youth Guarantee were identified.
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.	3) **Limited implementation**: A new social and child protection strategy is under preparation, but the new Law on social and child protection, aimed at improving the quality and financing of services provided at national and local level, has not yet been drafted. The adoption of the Law on the disability determination system is planned for Q4-2024.

ANNEX 2: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government of Montenegro submitted its 2024-2026 economic reform programme to the Commission on 12 January 2024.

Inter-ministerial coordination

The Ministry of Finance coordinated the work to prepare the 2024 ERP. An inter-ministerial working group involved all relevant ministries.

Stakeholder consultation

The national ERP coordinator organised an initial consultation on the design of ERP measures in November 2023. Another public consultation on the draft ERP took place in December 2023, and included a roundtable discussion with members of the public.

Macro framework

The programme presents a clear and concise picture of past economic developments and covers relevant data available at the time of submission. The information provided is coherent, concise and well structured. The macroeconomic framework is coherent, consistent and sufficiently comprehensive and provides a good basis for policy evaluation and discussions. Statistical tables were not complete in the first submission and were subsequently revised several times.

Fiscal framework

The fiscal framework is well detailed, in line with stated policy objectives and consistent with the ERP macroeconomic framework. However, fiscal projections were revised due to inaccurate budgetary planning of local governments. After correcting the projections for local governments, the factors behind the ERP's projected revenues and expenditures are in line with the existing legislative measures, and are presented clearly. 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 2023. Reporting on the progress of 2023 structural reform measures is generally of good quality. The 2024-2026 ERP sets out six major reforms, indicating the underpinning measures, as well as the costing of structural reforms.

7. NORTH MACEDONIA

7.1. EXECUTIVE SUMMARY

Following sluggish economic activity in 2023, the economic reform programme (ERP) optimistically projects growth to gradually accelerate to above 5% in 2026. Coping with the repercussions of the cost-of-living crisis and weak external demand, the post-pandemic economic recovery remained slow. Annual GDP growth dropped to 1% in 2023, mainly reflecting muted domestic investment. Domestic demand was driven by private consumption, which benefited from an increase in remittances and a rebound in real wage growth from July 2023, in line with gradually abating inflation. Supported by tighter monetary policy and abating foreign price pressures, headline inflation continued to ease gradually to 3% in February 2023 from its peak of 19.8% in October 2022. Real GDP growth is expected to strengthen to an annual average of 4.4% in 2024-2026, mainly as increased public infrastructure spending would support domestic demand. External demand is also set to pick up, but the external balance would have a negative contribution to growth, albeit gradually less so over the programme's timeframe. The ERP's growth scenario appears optimistic, partly as there are large deficiencies in public investment management and in the regulatory framework for attracting private co-financing, in addition to downward risks due to geopolitical uncertainties, including continued problems with supply of input factors and global commodity price developments.

The 2023 budget deficit was above the government's target and higher than the 2022 outcome. Mainly as a result of weaker than projected GDP growth and in spite of revenue-enhancing tax measures and the phasing out of some energy support measures, the general government budget deficit, at 4.9% of GDP, was above the government's target of 4.8% as well as above the 2022 outcome (4.4%). The ERP projects gradual fiscal consolidation, with the deficit falling by 1.6 percentage points (pps) between 2023 and 2026. The primary deficit would shrink to its pre-COVID level (0.9% of GDP) by 2026. Fiscal consolidation is projected be driven entirely by savings in current expenditure, notably in government consumption as well as subsidies and social transfers. The revenue-to-GDP ratio is also expected to decline somewhat over the programme's timeframe. Public debt is projected to rise above 60% of GDP in 2024, partly due to the financing needs of major transport infrastructure projects (Road Corridor 8 and 10d), and to drop thereafter.

The main challenges facing North Macedonia are the following:

- **Fiscal consolidation needs to advance to restore fiscal space and ensure compliance with fiscal rules.** The 2022 Organic Budget Law (OBL) requires the fiscal deficit to not exceed 3% of GDP as of 2025. In 2024, the government plans to lower the deficit to 3.4%, mainly by expenditure savings deriving, inter alia, from phasing out energy subsidies and reforming agricultural subsidies. These measures need to be rigorously adhered to, and fiscal slippages in an election year should be avoided. On the revenue side, ongoing implementation of the 2020 tax reform package is an important step in increasing public revenue and should be extended with further tax base-broadening measures. Also in view of the increasing fiscal risks, strengthening fiscal governance, in particular through the provisions of the OBL that will fully enter into force in 2025, would facilitate the return to a more prudent fiscal position. In this regard, swift adoption and implementation of the OBL by-laws is essential, as is capacity-building in the new Fiscal Council's secretariat, so that the Fiscal Council can fully take up its functions.
- **Addressing large infrastructure investment needs requires substantial improvements in the management of public investment.** The country's capital stock is ageing rapidly, impacting negatively on the already weak productivity growth. The government is intent on addressing the substantial gaps in public infrastructure in the medium-term and is raising capital expenditure to above 5% of GDP. However, capacities for managing investments according to established methodologies is weak, which calls for a swift implementation of the 2021 public investment management (PIM) action plan. The new PIM unit in the Ministry of Finance still needs to become

fully operational and adopt joint methodologies and criteria for the appraisal, selection and monitoring of investment projects applicable to all public sector entities. An increase in fiscal risks, partly stemming from the major construction projects carried out by state-owned enterprises, which may need state guarantees for borrowing or are poorly governed, require the centralisation and improvement of their monitoring. The need to raise additional private funding requires new financing structures and an adequate legal and regulatory framework to control associated fiscal risks, in particular with regard to public-private partnerships.

- **Key structural challenges are linked to the skills mismatch in the labour market, the informal economy, a large infrastructure investment gap, and the need to progress with the green transition.** The education system does not adequately equip young people with the key competences that they need to actively participate in the regular labour market. Persistent structural problems of the labour market, such as low participation rates, especially for women, and high youth unemployment dampen productivity growth. Substantial infrastructure investment needs, a large informal economy, low innovation activity and digitalisation gaps are undermining the competitiveness of domestic companies. Managing the green transition and meeting the greenhouse gas reduction targets set out in the European Green Deal requires large-scale investment and regulatory and legal adjustments. North Macedonia's economy relies heavily on coal-fired electricity production, and the shift towards renewable energy sources, as well as improvements in energy efficiency, are likely to be costly. These challenges are expected to be addressed through key structural reforms identified in the country's reform agenda under the new Growth Plan for the Western Balkans.

The implementation of the policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2023 has been partial. The government has implemented adequate measures to protect the households and firms that were most affected by the commodity price shock. The Parliament adopted amendments to several tax laws, cutting tax expenditures and broadening the revenue base. The new Fiscal Council has been set up and its rulebook and statutes have been adopted. However, the Council's secretariat is not yet operational, due to recruitment obstacles. A new PIM Department has been set up in the Ministry of Finance, but the draft law on public-private partnerships has not yet been adopted by the government. The Central Bank has tightened monetary policy to combat inflation until September 2023, and it has taken further measures to increase the use of the local currency. Key legal changes to safeguard the National Bank's independence were adopted by the government and submitted to the Parliament. The government adopted a new strategy to formalise the informal economy as well as the smart specialisation strategy, meant to strengthen research and innovation. It has also enhanced the digitalisation of public services. The new Energy Efficiency Fund was given a legal basis and now needs to be made operational. Furthermore, the government adopted three key laws on education, strengthened active labour market policies and improved the coordination between labour market institutions.

7.2. ECONOMIC OUTLOOK AND RISKS

The post-pandemic recovery of the economy remains slow. Annual GDP growth fell to 1% in 2023 from 2.2% in 2022. Domestic demand was driven by private consumption, bolstered by strong growth in wages, with real wages rebounding again after July 2023 in line with gradually abating inflation, and rising remittances. Still, domestic demand growth remained weak overall. Gross capital formation dropped starkly, mainly as a result of a draw-down of inventories, which had posted a strong built-up in the preceding year, as businesses were faced with uncertainty about the future course of commodity prices. Public consumption also declined as fiscal support measures were being phased out and operational cost was cut in the government's endeavour to bolster fiscal consolidation. Net exports, driven by a steep decline in commodity imports, and in spite of a simultaneous, energy crisis-related strong drop in metal exports, made a positive contribution to GDP growth.

The programme's baseline scenario predicts that real GDP growth will accelerate during the ERP's lifetime. Growth is expected to strengthen over the programme's timeframe, mainly as increased public infrastructure spending would support domestic demand. The economy is projected to grow by an average of 4.4% per year between 2024 and 2026, expanding by as much as 5.5% in 2026 (with projections for 2024 and 2025 somewhat lower than in the previous programme) ([89]). Growth of domestic demand is expected to accelerate gradually, while the external balance would have a negative contribution to growth, albeit gradually less so over the programme's timeframe. Private consumption growth is set to pick up gradually each year, to reach 3.7% in 2026, about the pre-COVID-19 5-year average, and investment is expected to increase strongly, by 8.7% y-o-y on average. The output gap is projected to narrow gradually, but to remain negative throughout the programme's timeframe. This is in contrast to the previous programme, which expected the output gap to close in 2024-2025, but seems plausible given that the previous programme assumed higher GDP growth for 2023. Export growth is projected to accelerate each year from 2023 in line with an expected recovery in foreign demand. This, together with accelerated investment growth, would also spur imports (+5.9% y-o-y on average in 2024-2026), but by less than exports (+6.2%).

The baseline scenario is usefully complemented by two alternative scenarios. Assuming that annual export growth turns out to be lower by 1.8 pps per year in 2024-2028, compared to the baseline scenario and implying a negative impact on the growth of domestic demand, average annual output growth would be lower by 0.6 pps over this period. The second, domestic risks scenario assumes weaker growth of investment, by an average of 2.2 pps per year, in response to lower implementation of public infrastructure projects and a withdrawal of fiscal support for private enterprises. This would also lead to average annual output growth that is 0.6 pps lower than the baseline scenario.

The ERP baseline scenario seems optimistic given the downside risks weighing on domestic demand. The government projects economic growth to be driven by a large surge in private and public investment over the programme's timeframe. This expectation is subject to a number of risks. Deficiencies in public investment management and fiscal risk monitoring may impact negatively on the strength and the efficiency of public capital spending. This also concerns the planned introduction of structural financing instruments, such as public-private partnerships, where a 2022 draft law that addresses shortcomings of the current system has still not been adopted by the government. Still, domestic demand is plausibly expected to benefit from the large increase in government capital expenditure, as the financially important Corridor 8 and 10d infrastructure projects, carried out by foreign contractors, have a large domestic component, which would induce spillovers to the domestic economy. Moreover, the macroeconomic and fiscal outlook continues to be affected by high uncertainty related to the further potential economic fallout from Russia's full-scale war of aggression against Ukraine (particularly on energy supply and inflation) and renewed tightening of financing conditions that could restrain domestic demand.

([89]) The programme's projections also deviate from those of the May 2023 Fiscal Strategy, which assumes an average annual growth rate of 4.9% between 2024 and 2026. The programme does not offer an explanation for these divergences.

Table II.7.1:
North Macedonia - comparison of macroeconomic developments and forecasts

	2022		2023		2024		2025		2026	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	2.1	**2.2**	2.0	**2.3**	2.7	**3.4**	2.8	**4.8**	n.a.	**5.5**
Contributions:										
- final domestic demand	3.1	**4.8**	2.6	**2.3**	4.0	**5.0**	4.2	**5.2**	n.a.	**5.7**
- change in inventories	3.5	**n.a.**	-1.4	**n.a.**	-0.1	**n.a.**	0.0	**n.a.**	n.a.	**n.a.**
- external balance of goods and services	-4.4	**-2.6**	0.8	**0.0**	-1.2	**-1.5**	-1.3	**-0.4**	n.a.	**-0.1**
Employment (% change)	0.5	**-0.2**	0.9	**-0.3**	1.4	**2.0**	1.6	**3.0**	n.a.	**3.3**
Unemployment rate (%)	14.2	**14.4**	13.8	**12.8**	13.7	**11.9**	13.5	**11.0**	n.a.	**10.1**
GDP deflator (% change)	8.0	**7.7**	14.2	**8.9**	8.1	**6.0**	8.0	**2.0**	n.a.	**2.0**
CPI inflation (%)	14.2	**14.2**	9.5	**9.5**	4.1	**3.5**	2.1	**2.0**	n.a.	**2.0**
Current account balance (% of GDP)	-5.9	**-6.2**	-3.5	**-1.2**	-3.6	**-2.4**	-2.4	**-2.4**	n.a.	**-2.3**
General government balance (% of GDP)	-4.5	**-4.4**	-4.8	**-4.8**	-3.8	**-3.4**	-3.5	**-3.0**	n.a.	**-3.0**
Government gross debt (% of GDP)	50.9	**50.4**	51.0	**50.2**	51.7	**52.0**	51.1	**50.3**	n.a.	**50.2**

Sources: Economic Reform Programme (ERP) 2024, Commission Autumn 2023 forecast.

Inflationary pressures are expected to decrease further in 2024, and then to stabilise at 2%. 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. After rising to 14.1% in 2022, average annual inflation declined to 9.4% in 2023, largely reflecting the drop in global commodities prices, and, later in the year, a gradual abatement of second-round effects on domestic sectors. While headline inflation reached single-digit territory in mid-2023, core inflation remained sticky throughout 2023. By early 2024, the inflation differential with the euro area had narrowed considerably. The Central Bank tightened its monetary stance by raising the key policy rate in 14 steps from 1.25% as of April 2022 to 6.3% in September 2023. The government introduced a number of regulatory measures to contain food price inflation and subsidised the electricity costs of households and small business. 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, which is much higher than in the euro area. The programme projects that annual average consumer price inflation will drop to 3.5% in 2024 before falling to its long-term average of 2% in 2025 and 2026. This is mainly based on a projected slowdown in second-round effects of recent rises in commodity prices on domestic sectors. While the programme's assumptions about global price developments seem plausible in the medium term, recent increases in wages and pensions, resulting from the new indexation formula for pensions and minimum wages ([90]), which links their adjustment not only to price developments, but also to gross average wage developments, are increasing domestic risks to price stability. Average gross monthly wages rose by 15.3% y-o-y in 2023. In 2024, the government expects nominal wages to post somewhat lower growth, but to still rise significantly (8.4% y-o-y), mainly as a result of the March 2023 increase in the minimum wage, which, in turn, implies further increases in public sector wages and in pensions. The programme expects the increase in nominal wages to slow down to 6.1% per year over the remainder of the programme's horizon.

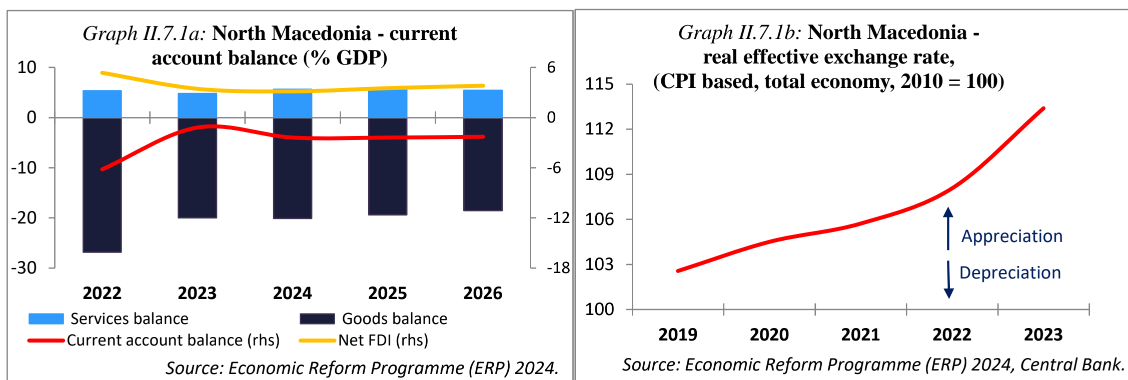
The current account balance has improved substantially and external vulnerabilities remain contained. As a large energy importer, North Macedonia's trade balance deteriorated sharply in 2022 in response to the energy crisis. As energy prices have come down substantially from their peak while domestic production of electricity increased, the current account swung into surplus in 2023, amounting to 0.7% of GDP at end-year. This improvement was also supported by an increase in current transfer inflows, even though the surplus in the services trade balance dropped. The ERP projects the current account deficit to stabilise as of 2024 at a level of around 2.4% of GDP. The merchandise

([90]) The Minimum Wage Law was amended in this regard in March 2022. The minimum wage was raised by 12% starting from April 2023, and will be adjusted again in March 2024 to reflect last year's increase in gross nominal wages and in the cost of living.

trade deficit, which narrowed in 2023 by 8 pps y-o-y to 18.9% of GDP, is expected to narrow further between until 2026, reflecting the projected pick-up in global trade, even as import growth is also set to accelerate in line with the pick-up in domestic demand. The services surplus would rise, mainly as exports of IT services related to the major road infrastructure works (which are carried out largely by foreign firms) would strengthen. These improvements would, however, be over-compensated by a projected drop in current transfers (to below their pre-COVID-19 5-year average of 6.7% of GDP) and a widening primary income deficit during this period ([91]). After record high inflows in 2022 (5.8% of GDP), the programme expects foreign direct investment (FDI) to remain at around its pre-COVID-19 5-year average (3.5% of GDP) throughout the programme's lifetime, fully financing the current account deficit during this period. This assumption is plausible, underpinned by ongoing 'nearshoring' (foreign companies relocating production facilities closer to their main markets in the EU) and by the positive prospect of EU accession.

External debt is sustainable and its structure poses little risk. Gross external debt, excluding central bank transactions, stood at 73.3% of projected GDP at the end of Q3-2023 (-6.3 pps y-o-y) ([92]). Long-term debt accounted for the bulk of the total (70%). A high level (the programme estimates an average of 42.3% over the programme's timeframe) of total external debt is made up of intercompany loans and trade credits, which are a less risky and more flexible category of debt. Regarding the structure of general government external debt, about 65% is accounted for by Eurobonds (2022) and about 72% is at fixed rate (2022). The ERP projects gross external debt to increase slightly between 2023 and 2026, mainly due to growing intercompany loans, which are an important instrument for improving liquidity for foreign-owned companies. Foreign reserves increased strongly in 2023, mainly due to Central Bank interventions in the foreign exchange market. At the end of 2023, they were 17.5% higher y-o-y and equivalent to over 4 months of prospective imports of goods and services. The CPI-deflated real effective exchange rate (REER), as a measures of external competitiveness, appreciated by 5.6% in 2023, continuing the trend seen in previous years. Nominal unit labour cost (ULC) rose by some 8% in 2023, reflecting the strong rise in nominal wages in a context of subdued productivity growth.

External competitiveness and current account



Graph II.7.1a: **North Macedonia - current account balance (% GDP)**

Source: Economic Reform Programme (ERP) 2024.

Graph II.7.1b: **North Macedonia - real effective exchange rate, (CPI based, total economy, 2010 = 100)**

Source: Economic Reform Programme (ERP) 2024, Central Bank.

The banking sector remains well-capitalised and liquid. Banks' capital adequacy ratio, already at comfortable levels, increased further to 17.4%, with a high share of profits going into capitalisation. Liquidity in the banking sector, already high, improved further. Annual growth of deposits accelerated in 2023, to 8.4% on average in October and November, driven by deposits in domestic currency. At the same time, bank lending to the private sector lost some momentum in 2023, increasing by 5.2% y-o-y in Q4, partly reflecting lower corporate financial needs due to the drop in energy prices. Foreign-currency-denominated loans amounted to some 42% of total loans at the end of Q4, having decreased

([91]) The programme does not sufficiently explain the projection for the drop in remittances.

([92]) For end-23, the programme (external debt sustainability analysis drafted by the Central Bank based on their own GDP projections) projects gross external debt to have increased, on an annual basis, on account of higher borrowing by the government and public enterprises.

only marginally from the previous year's level. The funding of loans by deposits remained solid, with the loan-to-deposit ratio for non-financial clients at 81.6% at the end of the year. To bolster deposits in local currency, the Central Bank further increased the differential between reserve requirements on deposits in local and in foreign currency ([93]). To support financial stability, the Parliament passed the new law on bank resolution in October 2023 which sets up a bank resolution fund and guidelines for the process of bank resolution, with the Central Bank as the responsible body. As an important macroprudential measure, the Central Bank introduced a counter-cyclical capital buffer of 0.5% of exposures by banks, applicable from August 2023, with further adjustments, based on cyclical systemic risk assessments and credit growth, in January (to 0.75%). Aiming to improve credit demand quality in the housing market, a new debt-service to income ratio and a loan-to-value ratio have been in application since July 2023. Prices in the housing market have been rising at double-digit growth, and credit risks have been increasing given the substantial share of variable rate mortgages. The ratio of non-performing to total loans (financial and non-financial sector) dropped slightly y-o-y, to 2.8% at the end of 2023, and loan-loss provisioning improved further. Banking sector concentration remains moderate, with some 56% of assets held by the three biggest banks in 2023. 9 of the sector's 13 banks are predominantly under foreign ownership.

Table II.7.2:
North Macedonia - financial sector indicators

	2019	2020	2021	2022	2023
Total assets of the banking system (EUR million)	8 945	9 490	10 363	11 103	12131
Foreign ownership of banking system (%)	72.8	75.0	76.3	77.7	78.8
Credit growth (%, average)	7.2	6.4	5.8	9.6	6.2
Deposit growth (%, average)	9.6	7.8	8.3	4.2	9.1
Loan-to-deposit ratio (end of period)	83.8	82.0	81.8	85.5	81.6
Financial soundness indicators (%, end of period)					
- non-performing loans to total loans	4.8	3.4	3.2	2.9	2.8
- regulatory capital to risk-weighted assets	14.8	15.3	15.8	16.6	17.2
- liquid assets to total assets	31.9	32.5	32.4	30.0	31.8
- return on equity	11.7	11.3	12.9	12.2	16.1
- foreign exchange loans to total loans	42.3	42.3	41.2	43.2	42.2

Sources: National Bank of North Macedonia, IMF.

7.3. PUBLIC FINANCE

The 2023 budget deficit was higher than the 2022 outcome, mainly as a result of weaker than projected GDP growth. The full-year fiscal deficit in 2023 amounted to 4.9% of estimated GDP, slightly above the target (4.8%), and considerably higher than in 2022 (4.4%). It exceeded the 2023 deficit target set in the previous year's programme. The expenditure ratio rose by substantially more than the revenue ratio in 2023. A budget reallocation became necessary in September 2023, mainly to accommodate higher public sector wages and pensions and higher social transfers, while leaving the deficit target unchanged ([94]). The reallocation also reassigned funds to new anti-crisis support measures to help households and companies cope with the still elevated cost-of-living and production input prices. In this process, capital expenditure allocations were slashed by 7.7% and a budget reserve of EUR 225 million, intended in the 2023 budget for energy support, was partly reallocated. Revenues increased by 14% y-o-y, boosted by a one-off "solidarity tax" on excess corporate profits, which was adopted in 2022 and not included in the 2023 budget. Revenue from this tax amounted to an additional 0.6% of GDP (EUR 76 million). Current expenditure was driven by high

([93]) Starting in June 2022, the National Bank had raised the reserve requirement on FX deposits by 3 pps.

([94]) The new requirements followed from the July 2023 public sector wage agreement and the rise in minimum wages in March 2023, which drove a 8.4% increase in pensions as of March 2023 due to the new indexation methodology.

transfer payments, yet at the same time the government also reduced untargeted crisis support measures. The total expenditure ratio in terms of GDP (37.9%) turned out higher than anticipated in the previous programme (37.4%). Among social benefits, transfers to the pensions fund posted a particularly high increase, by 14.8% y-o-y. Transfers to the health fund rose by 11%. Support to mitigate high energy costs to households and companies, which implied almost universal energy subsidies in 2022, via transfers to the domestic electricity producer ESM, was restructured and made more targeted, partly as a result of reforms of the electricity market ([95]). Moreover, the allocations for ESM in 2023 were partly unused and reallocated. Subsidies to ESM still amounted to some 0.8% of projected GDP in 2023. ([96]) The government also adjusted the VAT on electricity for households from the reduced 5% rate to 10% as from 1 January 2023, ([97]) and reverting it to the standard rate of 18% from 1 July 2023.

Execution of capital expenditure reached a record high in 2023. Despite the cut in the budget reallocation, implemented capital expenditure was 52% higher in 2023 than in 2022, reaching 97% of the government's target, well above the average of the previous 5 years (83%). A large amount was spent on first payments towards the construction of the Corridor 8 and 10d road infrastructure projects ([98]).

The programme's fiscal scenario projects a gradual reduction of the budget deficit in the medium term based on lower current expenditure. Between 2023 and 2026, the public expenditure ratio is projected to decline from 38.5% of GDP (government projection in the programme) to 36.1% (-2.4 pps), driven by an adjustment of current spending, while capital spending is set to stay at an average level of 5.5% of GDP over the programme period. The general government revenue ratio, already low by regional comparison (outcome 2023: 33% of estimated GDP, compared to 33.7% as projected by the programme), is projected to remain at just below 34% of GDP in 2024 and to drop gradually to 33.1% of GDP in 2026. As a result, the budget deficit is projected to fall by some 1.9 pps to 3% of GDP between 2023 and 2025-2026 (in line with the fiscal rule). The primary deficit is projected to decrease by 2.3 pps in this period, reaching its pre-COVID level of 0.9% in 2026 ([99]). A large contribution to consolidation is expected in the programme's later years from social transfers, which, while rising as a share of GDP in 2024, are expected to drop thereafter until 2026 by a cumulative 0.9 pps. This projection is not underpinned by concrete policy changes, however. Rather, through recent measures on revising the indexation of pensions, the government increased mandatory spending on social transfers for the medium term. The ERP's projection for the development of the cyclically-adjusted primary budget deficit between 2024 and 2026 points to fiscal tightening in 2024 (1.7 pps) and in 2025 (0.4 pps), and an impulse of 0.4 pps in 2026, all this while the output gap is expected to remain negative.

([95]) In 2022, the government changed the electricity block tariff structure, but prices for households remain heavily subsidised. Effective on 1 January 2024, the government implemented, as part of new prior actions agreed with the IMF in relation to the PLL, reforms of the electricity market which included higher prices charged by ESM and a gradual reduction in the size of the regulated market (for which ESM is the mandatory supplier).

([96]) IMF estimate. In the 2024 budget, these allocations were cut, in the context of policies agreed with the IMF under the 2022 PLL, to an estimated 0.3% of GDP.

([97]) The planned increase from 5% to 10% had been postponed from July 2022 to January 2023.

([98]) The 2023 budget had allocated EUR 243 million for the construction of part of Road Corridor VIII and XD by the Bechtel-Enka consortium.

([99]) Compared to the previous programme, the primary balance is projected to improve earlier in the cycle. The previous programme had assumed a return of the primary balance to its pre-COVID level by 2027 - 1 year later than the current programme.

Table II.7.3:
North Macedonia - composition of the budgetary adjustment (% of GDP)

	2022	2023	2024	2025	2026	Change: 2023-26
Revenues	32.1	33.7	33.7	33.5	33.1	-0.6
- Taxes and social security contributions	28.7	29.7	29.7	29.6	29.3	-0.4
- Other (residual)	3.3	4.0	4.0	3.9	3.8	-0.2
Expenditure	36.5	38.5	37.1	36.5	36.1	-2.4
- Primary expenditure	35.4	37.0	35.4	34.5	34.1	-2.9
of which:						
Gross fixed capital formation	4.2	6.4	5.5	5.4	5.7	-0.7
Consumption	10.3	10.4	10.6	10.1	9.8	-0.5
Transfers & subsidies	20.8	20.2	19.3	19.0	18.6	-1.7
Other (residual)	0.0	0.0	0.0	0.0	0.0	0.0
- Interest payments	1.1	1.5	1.7	2.0	2.0	0.5
Budget balance	-4.4	-4.8	-3.4	-3.0	-3.0	1.8
- Cyclically adjusted	-3.6	-3.5	-2.1	-2.0	-2.4	1.2
Primary balance	-3.3	-3.3	-1.7	-1.0	-1.0	2.3
- Cyclically adjusted	-2.4	-2.1	-0.4	0.0	-0.4	1.7
Gross debt level	50.4	50.2	52.0	50.3	50.2	-0.1

Sources: Economic Reform Programme (ERP) 2024, Commission calculations.

The 2024 budget benefits from further tax reforms and lower energy subsidies. The general government fiscal deficit is projected to drop to 3.4% of GDP in 2024. According to the programme's projections, the general government's total revenue ratio will stay at 33.7% of projected GDP in 2024, while the expenditure ratio is expected to drop by 1.4 pps to 37.1% of GDP. Revenues in 2024 are expected to be boosted by the full-year effect of earlier tax measures and a number of further tax reforms that took effect on 1 January. A notable example is the Law on profit tax, enacted in September 2023, which eliminates the tax exemption for: (i) sport donations; (ii) profits of entities with revenues not exceeding 3 million MKD per year; and (iii) life insurance premiums paid by employers on behalf of and at the expense of employees. Other reforms to broaden the tax base include amendments to the Law on excise taxes (October 2023), to the VAT Law (September 2023) and to the Decree on motor vehicle taxation, which entered into force on 1 January 2024 ([100]). In parallel, two revenue-increasing one-off measures in force in 2023 expired, namely the solidarity tax adding 1.7% of total 2023 revenue, and the EU energy budget support amounting to 1.6% of total 2023 revenue. The ERP includes an estimate of tax expenditures for the most important tax categories, based on 2022 data, as well as a projection until 2028, in line with the respective requirement of the OBL. ([101]) On the expenditure side, capital expenditure is projected to drop somewhat as a share of GDP in 2024, compared to 2023 (-0.9pps). The government expects subsidies to drop by 1.2pps y-o-y in 2024, mainly on account of lower energy and agricultural subsidies ([102]). Social transfers are expected to rise slightly (+0.3pp of GDP). Further savings on the expenditure side are arising from a pre-funding payment, out of 2023 budgetary savings, on the major multi-year road infrastructure project (Road Corridor 8/10d) allocations for 2024, amounting to 0.2% of GDP.

([100]) According to a World Bank estimate, the changes in direct taxation, value added tax, excise duties and taxation of motor vehicles would lead to additional tax revenues of about 0.7% of GDP per year.

([101]) The OBL requires the government to present a report to the Parliament every year, as of 2025, on foregone revenue from tax expenditure, to accompany the Final Account of the State Budget for the previous year. The May 2023 fiscal strategy also includes a report and a table on tax expenditures, which does not seem consistent with the ERP figures. This discrepancy between the two documents should have been clarified in the ERP.

([102]) The extent of the expected reduction of subsidies appears large, compared to the IMF estimate, which projects the most recent energy reform measures to yield savings of some 0.5 pps, and the reform of agricultural subsidies to yield another 0.2 pps, i.e.savings of 0.7 pps y-o-y in 2024 in total.

The fiscal scenario is subject to substantial risks. First, there is considerable uncertainty about the total costs of the large Corridor 8/10d project. A fiscal risk assessment by an external contractor is not likely to be finalised before the summer. Second, given the low progress on improving the management of public infrastructure, including the centralised monitoring of fiscal risks across the public sector, implementation of the ambitious capital expenditure agenda may again remain behind the target, or capital expenditure might be cut in a budget reallocation in favour of current expenditure increases. This is particularly likely in the run-up to the elections. Third, estimated savings from the electricity market reform depend not only on the government's implementation of these reform measures, but also on global developments affecting electricity prices. Therefore, continued (even if reduced) subsidies for the domestic electricity producer continues to pose a fiscal risk. Further fiscal risks might arise from current energy investment projects by ESM meant to diversify power supply for electricity generation and benefiting from government guarantees. Lastly, the mandatory indexation of minimum wages, which is raising average wages (and therefore also public sector wages) and the indexation of pensions create uncertainty as to their size, given dependence on both price and nominal wage developments in the economy.

BOX II.7.1: DEBT DYNAMICS

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

	2022	2023	2024	2025	2026
Gross debt ratio [1]	50.4	50.2	52.0	50.3	50.2
Change in the ratio	-1.0	-0.1	1.8	-1.7	-0.1
Contributions [2]:					
1. Primary balance	**3.3**	**3.3**	**1.7**	**1.0**	**1.0**
2. 'Snowball effect'	**-3.5**	**-3.6**	**-2.6**	**-1.3**	**-1.5**
Of which:					
Interest expenditure	1.1	1.5	1.7	2.0	2.0
Growth effect	-1.0	-1.0	-1.6	-2.3	-2.6
Inflation effect	-3.6	-4.0	-2.7	-1.0	-0.9
3. Stock-flow adjustment	**-0.8**	**0.1**	**2.7**	**-1.4**	**0.4**

[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) 2024, Commission calculations.

The ERP projects that general government gross debt will peak in 2024 at 52% of GDP before declining to 50.3% in 2025 and further to 50.2% in 2026. While the projection for 2024 is similar to the one in last year's programme, the projection for 2025 is now more optimistic. The primary budget deficit is projected to narrow by a total of 2.3 pps in 2023-2026, with a corresponding reduction in the extent it contributes to the increase in the debt ratio. Reflecting expectations of a further decline of inflation to its long term average in 2024, the debt-decreasing impact of inflation is projected to diminish after 2025, while the effect from real growth is forecast to increase and to become the main debt-reducing factor. Interest payments are expected to have a stronger debt-driving impact, assuming rising refinancing costs, while the contribution from stock-flow adjustments is projected to turn negative in 2025, possibly in response to a drawdown of government deposits at the Central Bank to meet a part of large upcoming financing needs.

General government debt is projected to remain above 50% of GDP during the programme's lifespan. At the end of 2023, general government debt amounted to 53.3% of estimated GDP (+2.8 pps y-o-y). In March 2023, the government issued a Eurobond of EUR 500 million, mainly to refinance

the July repayment of a previous Eurobond. In December, EUR 93 million was disbursed as part of a World Bank development policy loan on top of around EUR 165 million disbursed as part of the IMF PLL second tranche ([103]). Given the uncertainty about some foreign funding in the middle of the year, the government decided to increase domestic borrowing instead, and the share of domestic borrowing in total financing rose to 42.6% from 31.3% in 2022. In 2023, only 72.3% of planned foreign inflows were realised. A negative primary balance as well as stock-flow adjustments will lead to an increase in the debt ratio in 2024 (see the box above). Public debt, which includes the debt of public enterprises, amounted to 62.2% of estimated GDP in 2023. The programme expects public debt to decline to below 60% only by 2025, and to continue falling in 2026. Guaranteed debt, mainly for public enterprises and most of it external public debt with government guarantees, amounted to 8.5% of estimated GDP in 2023 and is expected to rise further in 2024, as the government envisages rising costs for energy and road infrastructure projects that are carried out by public enterprises. However, it is projected to decline gradually thereafter, to 5.9% of GDP in 2028 ([104]). The ERP estimates that gross financing needs in 2024 will amount to some 8.5% of projected GDP (down from 10.6% in 2023), rising to 9.6% in 2025 and 9.9% in 2026 ([105]). Financing obligations are expected to be met 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.

The structure of general government debt implies moderate risks. External debt accounted for some 60% of total general government debt at the end of 2023. This has remained unchanged since 2020. Foreign currency debt accounted for 71% of total general government debt (some 5 pps lower than 1 year earlier) and the share of euro-denominated debt as a proportion of total debt stood at 65%. Risks stemming from exchange rate depreciation are mitigated by the de facto currency peg to the euro. Regarding interest rate risk, North Macedonia's public debt strategy stipulates that at least 60% of total debt must be at fixed interest. Moreover, the government further extended the maturities of domestic issues, which was beneficial in light of higher than initially planned domestic financing in 2023.

BOX II.7.2: 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 1.3 pps in 2024-2028, the budget deficit would increase by an average of 0.7 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 0.6 pps and an average annual increase in the deficit of 0.3 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 3.8% on average in 2023-2027 (compared with 4.2% 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 2024 by 1 pp more than assumed in the baseline scenario, the debt-servicing cost would surge by 7.4% in 2024, compared to the baseline scenario), and the impact of a 10% depreciation of the euro with respect to other currencies in the portfolio (leading to a 0.7% increase in debt-servicing cost in 2023). The impact on debt developments stemming from a deterioration in these two parameters is more pronounced in 2023 than projected in last year's programme for 2023.

([103]) Table 4.7 in the ERP presents the composition of deficit financing in 2024 as projected earlier in the year, including a higher level of foreign inflows than materialised in the end. The amount of foreign loans in 2022 was also significantly lower than projected in last year's ERP. 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 that were due in 2023.

([104]) These projections are in contrast to the previous programme, which assumed that guaranteed debt would peak at 9.5% in 2024 and decline by more in 2025.

([105]) The IMF estimates that gross financing needs in 2025 and 2026 will stand at around 13% of GDP each year, rising from some 10.8% in 2024.

The expenditure structure is gradually shifting towards an increased share of capital expenditure. Social transfers, including pension payments (taking into account the new pension indexation formula and the planned ad hoc pension increase in 2023) ([106]) amounted to some 47% of total expenditure in 2023, while capital expenditure accounted for 14%, much above its 10-year average. The share of capital expenditure is projected to rise to 14.8% of total expenditure in 2024, and then to 15.9% in 2026. Social transfers are expected to decline gradually in the mid-term, to 43.1% of total expenditure by 2026. However, further shifting the focus from current to growth-enhancing capital spending in the budget can only be successful with improved PIM capacities and enhanced and centralised monitoring of fiscal risks across the public sector. Capacities for public investment management remain weak. While the Ministry of Finance set up a new Department for PIM, recruitment and capacity-building are advancing only slowly. Progress on developing a standard methodology for project design and appraisal, ensuring an efficient selection of public investment projects, needs to accelerate. Currently, while projects funded by external donors follow the relevant procedures, which often vary between institutions, procedures followed for domestically funded projects are determined by respective budget units.

There are plans to better involve the private sector in the financing of public infrastructure, such as through public-private partnerships (PPPs). To improve the legal framework for PPPs, the government has finalised a draft law, reviewed by the European Commission, which includes provisions for better management of fiscal risks and for a harmonisation of terms and conditions of PPP contracts. 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). A suitable regulatory framework for PPPs would extend the government's choices of funding and thus contribute to modernising the ageing public infrastructure. Overall, fiscal risk monitoring remains incomplete and fragmented among institutions. Currently, fiscal risks, such as contingent liabilities arising from PPPs financed by municipalities, are not systematically reported to the central government. ([107])

The adoption of implementing acts under the new Organic Budget Law (OBL) is progressing slowly. The OBL, which was passed by the Parliament in September 2022 and will enter into force in its entirety by 1 January 2025 introduces fiscal rules ([108]) and a Fiscal Council and strengthens the medium-term budget procedure. Fiscal Council members have been appointed by the Parliament and have taken up work assignments, although there have been some challenges in recruting staff to the Council's secretariat. Adoption of the OBL's 32 by-laws, for which the government drafted an action plan, including the essential by-law on budget classification, and the introduction of an IFMIS (Integrated Information System for Financial Management) to ensure the smooth implementation, is progressing slowly. The OBL contains provisions that are crucial to improving the fiscal framework, such as strengthening public investment management by attributing a central role to the Ministry of Finance in selecting new investment projects. The new law also calls for better monitoring and presentation of fiscal risks in the public sector, by giving the new Fiscal Council a key role in this respect, and by mandating an assessment of fiscal risks as part of the mid-term fiscal strategy.

([106]) Pension expenditure accounted for 32.7% of total current expenditure in 2023 (+1.3 pps y-o-y).

([107]) 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.

([108]) The new Organic Budget Law introduces a 3% limit for the general government deficit and a 60% limit for general government debt (in principle applicable since 2023, but suspended in response to an escape clause until 2025).

7.4. MAIN MACRO-RELEVANT STRUCTURAL CHALLENGES

In November 2023, the Commission proposed a New Growth Plan for the Western Balkans ([109]) with the aim of supporting the region's economic convergence and accelerating the accession process. The plan involves a Reform and Growth Facility (EUR 2 billion in grants, EUR 4 billion in loans) that is to be disbursed in 2024-2027 as investment ([110]) and budget support in exchange for implementing reforms that are to be set out in reform agendas prepared by the Western Balkan partners. The New Growth Plan is therefore an important tool to increase reform incentives to boost growth and convergence. In this context, with a view to ensuring an integrated surveillance of the economy of North Macedonia, this chapter briefly outlines the main structural challenges facing the country.

Low productivity growth has negatively affected convergence with the EU in the past decade. After a steady, though gradual catching up with EU living standards prior to the financial crisis, the pace of convergence has slowed down considerably in the past decade. North Macedonia's GDP per capita stood at 42% of the EU average in 2022, only slightly up from 38% in 2018. Structural problems of the labour market, the skills mismatch between labour market requirements and graduate qualifications, a large informal economy, low innovation activity, as well as substantial infrastructure investment needs to boost the competitiveness of the domestic economy are among the factors restraining productivity growth.

Structural challenges in the labour market are posing increasing risks to economic growth and inflation. The labour market proved resilient throughout COVID-19 and the recent cost-of-living crisis, thanks to multiple government support measures. However, long-term features, such as: (i) low participation rates (around 53%), in particular for women (around 42%); (ii) high outflows from the labour force due to emigration; (iii) high youth unemployment; and (iv) the skills mismatch, are increasingly impacting on macroeconomic and price developments as well as heightening fiscal risks through the evolution of public sector wages and pensions.

While the number of higher education graduates is rising, the skills they obtain often do not meet labour market requirements. North Macedonia has made good progress in increasing the proportion of people with higher education, but curricula are not well suited to equipping graduates with skills to match labour demand. Insufficient funds impedes the implementation of the 2018-2025 education strategy, which also targets the skills problem. Public spending on education, at less than 4% of GDP, remains below the EU average. Moreover, spending is inefficient, mainly on account of outdated formulas for the redistribution of public education funds by the municipalities, and intersectoral coordination needs to be improved. The envisaged annual report on the implementation of the education strategy, which should include recommendations for a new formula for higher education funding, has not yet been published. The percentage of adults participating in learning was 2.6% in 2020, which is significantly below the EU-27 average of 10.8% (2021). The further development of qualifications is key to bringing medium-skilled and low-skilled people into the labour market. In 2023, the government adopted a new Law on vocational education and training (VET), a new Law on secondary education, and a Law on adult education, all of which adress some of these shortcomings in the education system. However, the new Law on Labour Relations, which would extend labour market regulation to non-standard forms of working such as teleworking has not yet been adopted, and the setting up of regional VET centres, as envisaged in the new VET law, has been slow.

The high level of informality in the economy distorts the level playing field for business. The informal economy causes competitive distortions for domestic companies. According to IMF estimates,

([109]) https://neighbourhood-enlargement.ec.europa.eu/enlargement-policy/new-growth-plan-western-balkans_en

([110]) Infrastructure investments need to comply with the EU environmental acquis, national and international nature protection and water management obligations, ensure public participation and consultation, and guarantee high quality environmental impact assessment reports that include cumulative impacts on nature and biodiversity.

it could account for as much as 38% of GDP ([111]). The number of informal employees as a proportion of total employees is estimated to have decreased from 18.6% in 2018 to 13% in 2022. The main forms of informality are unregistered labour and partially undeclared wages. Implementation of the government's 2018 strategy and action plan to combat the informal economy remains sluggish, particularly on the formalisation of undeclared workers. To address informality, the programme proposes a new model for the formalisation of seasonal, temporary and occasional work, but it is rather vague - although it does acknowledge that the lack of coordination between the involved public institutions is an obstacle. In September 2023, the government adopted the new (2023-2027) strategy for formalisation of the informal economy with an action plan until 2025. The strategy aims at reducing the size of the informal economy to some 26% of GDP by the end of 2027. The tax reforms adopted by the government at the end of 2022 strengthen the tax-paying culture and thereby fight the informal economy, which could be reinforced further by streamlining para-fiscal charges. Moreover, the provision of State aid continues to suffer from a lack of transparency, which may distort the level playing field for companies. This could be improved by setting up a proper register and by reducing the high number of aid providers.

Low digitalisation and muted innovation activity restrain the competitiveness of businesses. The economy would benefit from increased access to broadband, an expansion of e-government services and the development of digital skills. The percentage of households with internet access at home increased by 10.1 pps. between 2017 and 2021, to 83.6%. A fixed broadband connection to the internet is used by 88% of household users, and by 92% of businesses with 10 or more employees, but smaller companies still face obstacles ([112]). More effort needs to be made to improve digital skills, including by: (i) setting up a national framework for digital skills for students and teachers; (ii) increasing IT tools in primary and secondary schools; and (iii) expanding access to fast-speed internet to small business and to non-urban areas. R&D activity remains low: at 0.4% of GDP, including a small share (0.1% of GDP) from the private sector, the economy's expenditure on research and innovation remains significantly below the EU average. Allocations to the Fund for Innovation and Technological Development and its programmes have increased, but their effectiveness, design and methodology could benefit from an independent evaluation. ([113]) Links between businesses and others involved in innovation are very weak. In December 2023, the government adopted the new smart specialisation strategy, which includes a strategy for innovation and measures to boost the economy's research and innovation potential.

Decarbonising the economy and improving energy efficiency requires large-scale investments and regulatory and legal adjustments. North Macedonia's economy relies heavily on coal-fired electricity production. Renewable energy 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). In the post-pandemic period, North Macedonia has managed to increase domestic electricity production, thus reducing its dependence on energy imports. North Macedonia adopted its National Energy and Climate Plan (NECP) in 2022. It aims to increase the share of renewable energy sources in gross domestic energy consumption to 38% by 2030. The shift towards renewable energy sources, as well as improvements in energy efficiency, to meet targets for greenhouse gas reductions set under the European Green Deal will require significant investments. Timely introduction of a carbon tax to prepare for the full implementation of the carbon border adjustment mechanism (CBAM) in North Macedonia can contribute to meeting the emissions targets. Well-managed public investment and improved access to private investments, such as through a risk-mitigating framework for public-private partnerships would also facilitate the green transition.

([111]) The IMF figure is at the upper range of estimates.

([112]) However, despite overall progress in fixed and mobile broadband penetration, rural areas continue to face challenges due to uneven broadband development. In April 2023, only 15.3% of households in underserved rural areas had access to high-speed broadband, compared to 69.8% in well-served areas.

([113]) In 2022, the Fund underwent a compliance audit by the State Audit Office, which identified several compliance issues that remain to be addressed. Namely, the audit concluded that there is a need to reinforce the FITD's financial governance, align its support programmes with policy priorities, and improve performance indicators for its financial instruments.

7.5. THE POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS PARTNERS, TÜRKIYE, GEORGIA, REPUBLIC OF MOLDOVA AND UKRAINE

The Economic and Financial Dialogue between the EU and the Western Balkans Partners, Türkiye, Georgia, Republic of Moldova and Ukraine

Brussels, 14 May 2024

[...]

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

1. Implement the 2024 budget as adopted and ensure the fiscal target is met, in particular by controlling wage spending and reducing energy subsidies (as foreseen under the current IMF programme); adopt the budget for 2025 in a timely manner and in line with the fiscal rules. Strengthen the administrative capacity for the regular preparation and publication of the tax expenditure report and explore all options to further broaden the tax base. Introduce an integrated approach for reducing the build-up of arrears of public sector entities, through putting in place an Integrated Financial Management Information System and by setting up an effective system for monitoring of fiscal risks in the Ministry of Finance, including the fiscal risks stemming from SOEs and arrears.

2. Ensure timely implementation of the new Organic Budget Law (OBL) in its entirety by 2025, by adopting the necessary by-laws, in particular on budget classification and on the statement on fiscal policy; and by updating the manual on macro-fiscal projections. To improve public investment management, adopt a methodology/guidelines for appraisal of projects, in line with the recommendations of the IMF and the World Bank, and ensure sufficient training of staff in the new PIM department of the Ministry of Finance. To enhance private sector financing of public infrastructure projects based on a suitable regulatory framework, adopt the Law on Public Private Partnership.

3. Ensure a sufficiently tight monetary policy stance as long as necessary to anchor inflation expectations at levels consistent with price stability and support the peg, underpinned by a thorough assessment of potential second-round effects. Safeguard the independence of the central bank in its key statutory tasks, including in staffing and wage issues, by excluding the national bank from the scope of all related laws on administrative servants and public sector employees. Further enhance risk-based supervision in line with best international and European practices, including by operationalising the Bank Resolution Law by amending by-laws and building capacity ahead of implementation, upgrading the deposit insurance law, further implementing measures to promote the role of the domestic currency and improving data collection, notably on real estate, to enable a comprehensive assessment of financial sector risks.

ANNEX 1: OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2023

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey 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 guidance is similar to that of the country-specific recommendations usually adopted under the European Semester for EU Member States. Implementation of the guidance is evaluated by the Commission in the following year's ERP assessments.

The following table presents the Commission's assessment of the implementation of the 2023 policy guidance jointly adopted by the EU and the Western Balkans and Turkey at their Economic and Financial Dialogue at ministerial level on 16 May 2023.

Overall: Partial implementation (55.6%) ([114])	
2023 policy guidance (PG)	**Summary assessment**
PG 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.	There was **partial implementation** of PG1: 1) **Substantial implementation:** Support to mitigate high energy costs to households and companies, which implied almost universal energy subsidies in 2022 via transfers to the domestic electricity producer ESM, was restructured and made more targeted. The authorities reviewed the block tariffs for electricity to increase progressivity and better target subsidies. Subsidies to ESM still amounted to some 0.8% of projected GDP in 2023, but the government adopted measures that will likely reduce these subsidies in 2024 to 0.3% of GDP.
Use any revenue overperformance or spending under-execution compared to the 2023 budget to reduce the deficit.	2) **Limited implementation:** The government has committed, as part of new prior actions agreed with the IMF in late 2023, to use unused allocations under the *revised* budget from the 2023 to pre-fund payments for road project Corridor8/10d,or other capital expenditure, but not current expenditure. Furthermore, the authorities' policy agenda focuses on continued deficit reduction towards reaching the 3% ceiling prescribed by the OBL by 2025. However, earlier in the year (budget reallocation in July) under-execution of the large allocation for subsidies for the domestic electricity producer ESM under the *original* budget were used to pay for other current expenditure items. Untapped allocations for capital expenditure were reassigned to pay, i.a. for higher public sector wages, pensions, health fund transfer in the September reallocation.

([114]) 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.

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.	3) **Substantial implementation:** The fiscal strategy forecasts a reduction of the budget deficit from: 4.6% of GDP in 2023, 3.4% in 2024, 3.0% in 2025, 3.0% in 2026, 2.8 % in 2027 and 2.5% in 2028. The primary budget balance would also drop, yet the pre-COVID level would only just be reached in 2026: 3.2% of GDP in 2023, 1.7% in 2024, 1.0% in 2025, 0.9% in 2026, 0.6% in 2027 and 0.4% in 2028. It is also not clear which concrete revenue or expenditure measures would underpin the 2.3 pps consolidation of the primary balance between 2023 and 2026.
PG 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.	There was **substantial implementation** of PG 2: 1) **Partial implementation:** The new PIM Department at the Ministry of Finance has recruited some staff (at end-January: 6 out of 14 posts have been filled, mainly by redeployment from other departments) and has begun to develop project appraisal capabilities. The 2 draft laws have not yet been submitted to the Parliament. The Commission had sent its comments on the draft law on public-private partnership to the government in summer 2023. 2) **Full implementation:** The Parliament adopted in September 2023 the amendments to the Law on VAT, amendments to the Law on Profit Tax and the new Law on Solidarity Tax. The amended laws aim to expand the tax base and streamline tax exemptions and are in line with the principles of the Tax System Reform Strategy, adopted in December 2020. The government submitted, and the Parliament adopted in December 2023 amendments to the Law on Excise Taxes, the Decree on motor vehicle taxation, applicable as of 1 January 2024 and with the effect of broadening the tax base. No. 199/23. However, the government dropped 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. 3) **Partial implementation:** The Parliament appointed the members of the new Fiscal Council in September 2023. The Statute was adopted by the Fiscal Council on 30 January 2024. The Rulebook was adopted on 12 October 2023. The Fiscal Council also already performed a number of tasks, including issuing an opinion to the Parliament's budget committee at end-November. Yet, as of 25 January, no formal recruitment to the Secretariat of the Fiscal Council has taken place. Further operationalisation of the Fiscal Council is stalled for the moment: the Council requires approval from the Ministry of Information for starting the recruitment procedure. Ahead of the general elections, no formal employment

	can take place at the Council. However, the President plans to recruit via an alternative administrative procedure candidates already employed in the public sector. Employees of the Fiscal Council have the status of public sector employess, which limits the remuneration the Council can offer. Therefore, the President requested the Ministry of Finance to amend the respective law for Fiscal Council employees to have the same status as Central Bank employees. This procedure is ongoing.
PG 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.	There was **substantial implementation** of PG 3**.** 1) **Full implementation:** The NBRNM has carefully monitored develpments in price dynamics. To curb inflation, the NBRNM has withdrawn liquidity, increased reserve requirements, 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 peg. 2) **Substantial implementation:** Key laws and regulations improved. In January 2024 the new decision on the methodology for credit risk management started to be applied, introducing a new definition of non-performing loans in line with the EU one. A range of borrower-based macroprudential measures were introduced to curb potential risks in the real estate sector, and the counter-cyclical capital buffer was raised. Data gaps remain in the real estate sector, although the State Statistical Office is working on improving the real estate price index. The Law on the National Bank still needs to be amended to clearly establish the NBRNM's macroprudential mandate. To further align with EU regulations, a Law on bank resolution was passed in October 2023. The NBRNM adjusted reserve requirements on a differentiated basis in line with its denarisation strategy. 3) **Partial implementation:** The proposed amendments to the national bank law to exclude NBRNM staff from the status of administrative servants were adopted, but the amendments to also exclude the NBRNM from the scope of the laws on administrative servants and public sector employees are still outstanding. Passing these amendments remains important for safeguarding the NBRNM's independence, including in employment conditions.
PG 4: Adopt and commence with the implementation of the new Strategy for formalising the informal economy 2023-2025, with an action plan and	There was **partial implementation** of PG 4**.** 1) **Partial implementation:** The 2023-2025 strategy and action plan for formalisation of the informal economy were adopted in June 2023. Implementation of

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.	measures is slow. 2) **Limited implementation:** The smart specialisation strategy and action plan were adopted in December 2023. Implementation is yet to start. The export promotion strategy has been drafted, but has not yet been adopted by the government. 3) **Partial implementation:** The digitalisation of public services for businesses and citizens continues by way of further services being made available on the e-portal (www.uslugi.gov.mk). 246 services are available to citizens/businesses online**.**
PG 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.	There was **limited implementation** of PG 5. **1) Limited implementation:** The Minister of Economy adopted the Plan for Reorganisation of the Ministry of Economy No. 04-3663/1 of 29 July 2022, after holding a meeting with the Management Board for the reorganisation. The plan includes setting up a new Energy Directorate rather than reinforcing the current Energy Unit with increased staff. The Ministry of Economy can employ five additional members of staff in the Energy Department and five additional members of staff in the Energy Agency. Recruitment is ongoing. Only one person has been newly employed in the Energy Department of the Ministry of Economy. Institutional capacities in both institutions remain insufficient for carrying out their legal obligations. **2) Limited implementation:** The USAID Connect for Growth project prepared the gap analyses for the Clean Energy Package directives. Regulations have been prepared and legislation on new energy and renewable energy sources is being drafted. The public consultation on both the draft Energy Law and the draft Law on RES was launched in mid-December 2023. An EU project is under way to support the Ministry in preparing the secondary energy efficiency legislation. Work commenced on the Biofuels report in August 2023, with research undertaken and consultations with relevant stakeholders. The draft report was issued in September 2023 as a basis for discussions with the Energy Department to determine the most appropriate amendments to the current draft Biofuels Law to reflect the latest updates to the body of EU law in this area. The institutional model for the Fund has been agreed: it will be developed under the Development Bank of North Macedonia (DBNM) as a commissioned fund. The Law on DBNM was amended on 3 October 2023, providing a legal basis for setting up the Fund under the DBNM. In December 2023, the final

	version of the Fund's 10-year work strategy was prepared. The agreement on the establishment of the fund, its operational manual and a 5-year business plan are expected to be finalised in January 2024 and submitted to the government for adoption and signature.
Establish a governance mechanism for Just Transition from Coal, including an operational Inter-ministerial Committee with involvement of local actors.	**3) Partial implementation:** In line with the Just Transition roadmap, the government set up a Council for the Just Transition in October 2023. However, the Council is not yet operational. Three working groups were created on energy transition, economic transitions and skills development, with participation from the relevant ministries and state-owned enterprises.
PG 6:	There was **partial implementation** of PG 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 recomendations for a new formula for the financing of higher education.	1) **Substantial implementation:** The three laws have been finalised by the government and are in parliamentary procedure. The report of June 2022-June 2023 has been completed. A new formula for the financing of higher education is under development.
Building on the steps taken, strengthen access to active labour market policies, in particular for low-skilled unemployed and people in vulnerable situations.	2) **Partial implementation:** The government continued with the implementation of active labour market measures. The IPA funded project, carried out by the Employment Service Agency, expanded the target groups to include all vulnerable groups. Measures include a pilot of the second chance programme with more than 100 participants to date.
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.	3) **Partial implementation:** Cooperation continued to improve, as the IPA-funded project (carried out by Employment Service Agency), includes capacity-building activities for the Agency and the Social Work Centres. The project helps the beneficiaries better address the needs of low-skilled and vulnerable people, and increase their employability and employment.

ANNEX 2: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government of North Macedonia submitted the 2024-2026 ERP on 18 January 2024. 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 ERP includes an annex listing the institutions and individuals involved in its preparation. The government formally endorsed the ERP on 16 January 2024. The coordination process worked well and the attendance to technical meetings was high.

Stakeholder consultation

The ERP’s 2024-2026 draft structural reforms were posted on the Ministry of Finance’'s website on 15-29 December 2023, and interested parties were invited to send written contributions. The written comments and suggestions are set out in an annex to the ERP.

The government of North Macedonia submitted the 2024-2026 ERP on 18 January 2024. None of its components are missing.

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 reallocation and on the fiscal data available at the end of Q3. 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.

Structural reforms

The chapter on structural reforms has been prepared in line with the ERP guidance note. Reform areas that have not or have only partly been identified 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. More effort is needed to quantify the impact of each measure. The description of the implementation risks and mitigation measures continues to improve. Reform measures have been prioritised in line with the key structural challenges that have been identified. Tables 9-11 in the annex have been properly completed. The implementation reports of the 2023-2025 ERP’s policy guidance and Table 11 in the Annex are well prepared. The attributed scores largely reflect the implementation level. Contributions received by external stakeholders during the consultation process are annexed to the ERP.

8. SERBIA

8.1. EXECUTIVE SUMMARY

Serbia's economy remained resilient in 2023 and growth is forecast to accelerate slightly in 2024-2026. GDP growth picked up in the second half of 2023, reaching 2.5% ([115]) for the year as a whole, helped by decelerating inflation and strong foreign direct investment (FDI) inflows. The economic reform programme (ERP) projects economic growth to gradually pick up to 3.5% in 2024 and about 4.0% in 2025-2026, broadly returning to its potential growth rate. Consumer price inflation was on a declining trend in the second half of 2023, averaging 12.1% for the year as a whole. Inflation is expected to return to within the central bank's target band (3% ±1.5 percentage points (pps)) in mid-2024. Relatively buoyant exports and lower energy import volumes and prices contributed to the substantial reduction in the current account deficit, from 6.9% of GDP in 2022 to 2.6% in 2023. The external deficit is expected to widen again to about 4% of GDP in the coming years as imports are set to increase in line with rising private consumption and investment. The ERP projections are overall plausible, but the growth outlook is, as elsewhere, subject to a series of downside risks associated with geopolitical tensions and global trade disruptions.

The fiscal strategy projects a gradually decreasing fiscal deficit and public debt. In 2023, according to preliminary outcome data from the Ministry of Finance, general government deficit fell by about one percentage point (pp.) to 2.2% of GDP ([116]), which is better than expected despite ad hoc measures to raise pensions, social transfers and public sector wages. Revenue growth outperformed projections, and fiscal support to state-owned energy utilities was lower than planned. The 2024 budget targets a moderate further deficit reduction (compared to the ERP-estimated 2023 outcome) as taxes are boosted by robust labour income growth while expenditures are assumed to be lower than GDP growth, helped by lower energy-related subsidies. Further gradual expenditure-based fiscal consolidation is projected to bring the budget deficit down to 1.5% of GDP in 2025-2026, in compliance with the new deficit rule ([117]). The debt-to-GDP ratio decreased by 3.3 pps to 52.3% in 2023 ([118]) and the ERP projects it to moderately decline further to reach 50% of GDP in 2026. There was substantial progress on fiscal reforms in 2023, but some significant fiscal risks, including those related to state-owned enterprises (SOEs), persist.

The main challenges facing Serbia are the following:

- **Medium-term fiscal targets need to be both better anchored by a strict application of the new framework of fiscal rules and backed up by credible medium-term fiscal planning.** Serbia has been able to successfully navigate the economic challenges of recent years and is well placed to go on achieving good macro-fiscal results. The planned reduction of the fiscal deficit is in line with the new fiscal rules and is key to rebuilding fiscal buffers in the medium term. This could also be enhanced by further improvements in medium-term budgeting, including public investment planning. This is especially needed to counter the various expenditure pressures that risk emerging in the medium term, also due to very ambitious investment plans, such as those related to the 'Leap into the Future 2027' and EXPO 2027 projects. The budget also lacks a detailed overview of tax expenditures and subsidies to SOEs.

([115]) According to the Statistical Office of Serbia. ERP also projected GDP growth of 2.5% for 2023.

([116]) ERP projected a 2.8% deficit.

([117]) 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).

([118]) ERP projected 53.3% of GDP.

- **There is scope for better monitoring of fiscal risks arising from public support to state-owned enterprises (SOEs), and to address them.** Enduring fiscal risks relate particularly to SOEs, which in past years required large amounts of public fiscal support. In spite of recent progress linked to the new SOE management law, several actions are still to be completed in the coming years, such as adopting related by-laws, restructuring companies, ensuring sound corporate governance, and improving transparency. The Ministry of Finance's Department of Fiscal Risk Monitoring has an important role to play in analysing and making transparent the related fiscal risks.
- **A public sector wage reform is crucial to attract and retain talent in the public sector.** Many of the ongoing reforms are held back by a lack of staff with appropriate qualifications in the public service. This is partly due to the relatively low wage levels that can be paid for highly qualified positions, as the wage structure is very compressed.
- **Other main structural challenges lie in the areas of business environment and private sector development, the green and digital transitions, human capital, and fundamental democratic and judicial reforms**. Weaknesses in the rule of law, including the fight against corruption, and inconsistent state-aid and public procurement procedures subject to exemptions impede the business environment. The development of a strong corporate sector is also hampered by the widespread presence of inefficient SOEs in the economy and the significant informal economy. The energy sector, dominated by SOEs, remains inefficient and suffers from outdated infrastructure and over-reliance on coal. There is still scope to raise employment to EU average levels, reduce skills mismatches, improve education and training, including upskilling and reskilling, and mitigate brain drain. Serbia has made good progress on digital transformation across the economy and intends to tackle some of the remaining gaps (in areas such as digital infrastructure and cybersecurity, public sector e-services and education). These challenges are expected to be addressed through key structural reforms set out in the country's reform agenda under the New Growth Plan for the Western Balkans.

Implementation of the policy guidance set out in the conclusions of the May 2023 Economic and Financial Dialogue has been partial. The planned public deficit reduction is in line with the fiscal rule. However, the extraordinary rise in pensions contributed to pushing pension expenditure above the 10% of GDP target. An action plan for strengthening medium-term budgeting was adopted, but in practice medium-term plans still lack credibility as they are subject to frequent ad hoc changes and do not systematically cover all public investments. Even though the new electronic public wage and employment registry has progressed, the public sector wage system reform is delayed to 2025. Tax administration reform has, despite certain dealys in the past, been progressing broadly in line with the ERP 2023 timeline, but retaining and attracting qualified staff has become a persistent challenge. Fiscal risk monitoring has made steady progress but capacities need to increase further to manage the fiscal risks, especially those related to SOEs. SOE reforms made crucial progress following the September 2023 adoption of the law on management of SOEs. However, the lack of sufficient personnel within the administration to ensure the law's implementation and to draft the necessary secondary by-laws might become an obstacle for further progress. The central bank continued to tighten its monetary policy stance and the authorities have continued to enhance the banking sector's regulatory and supervisory framework. Timely consultation of businesses ahead of adopting new legislation needs further improvement. Public investment management continues to make possible numerous exemptions from the standard procedures, thereby impeding a unified, comprehensive and transparent system for investment planning and management. Issues persist in competition and State aid and in public procurement due to special laws and intergovernmental agreements. The national energy and climate plan (NECP), which should include the Energy Community Secretariat's recommendations, has yet to be adopted, while various energy infrastructure projects are ongoing including to address Serbia's over-reliance on Russian energy supply. Russia continues to control many strategic assets in the energy sector. Concerning the labour market, the adequacy of social benefits remains low and improvements in vocational education progress slowly. While the Youth Guarantee Implementation Plan has been adopted, its implementation has yet to start.

8.2. ECONOMIC OUTLOOK AND RISKS

GDP growth picked up in 2023. Preliminary outcome data indicates that GDP growth accelerated from 1.5% year-on-year (y-o-y) in the first half of the year to 3.5% in Q3 and Q4, with the total for the year at 2.5% ([119]), which is in line with the ERP scenario. Growth was driven by net exports (also helped by lower energy imports driven by base effects from 2022). Private consumption picked up gradually over the year, helped by decelerating inflation, and investments were boosted by strong FDI inflows. Inventories made a negative contribution to growth. On the supply side, the fastest growth was recorded in the construction sector, agriculture, and in information and communication. Growth in other main economic sectors was also positive, notably even accelerating in industry and mining towards the end of the year. In the ERP, the unemployment rate is projected to have remained broadly stable at 9.6% in 2023 on average, compared to 9.7% in the previous year. At the same time, the employment rate of the population aged 15 years and above was projected to have risen by 0.5 pps y-o-y to 50.7%.

The ERP's baseline scenario forecasts a gradual acceleration in GDP growth. GDP growth is expected to gradually pick up to 3.5% in 2024 and 4.0% in 2025 (similar to the projection in the previous ERP) and 4.3% in 2026, thus broadly returning to pre-2020 rates. This acceleration is expected to be mostly driven by a sharp recovery in private consumption as inflation normalises while income growth maintains its momentum. Gross fixed capital formation is set to expand further, growing on average by over 6%. Reflecting the rise in domestic demand, imports are expected to recover somewhat faster than exports, with a negative contribution to GDP growth from net exports in 2024 before it turns neutral in 2025-2026. The ERP estimates the output gap to have been slightly negative in 2023 (-0.4%), turning slowly neutral by 2026, as the economy is assumed to expand only slightly above its potential growth rate. Supported by steady economic expansion, the unemployment rate is projected to continue its gradual downward trend, reaching 9.3% of the labour force in 2024 and 8% in 2026.

The baseline scenario seems plausible, overall, with conservative growth estimates being in tune with a generally bleak global outlook subject to risks. The growth outlook continues to be subject to a degree of uncertainty about the further economic impact of Russia's full-scale war of aggression against Ukraine and global trade disruptions. Still, the macroeconomic scenario appears plausible overall. The projected 3.5% growth in 2024 appears well achievable, in particular as growth picked up already in the last quarters of 2023 and Serbia weathered well the negative global shocks over recent years. The expected moderate gradual pickup in consumption, investment, exports and imports in 2024-2025 appears reasonable, assuming inflation will slow down. The projections for potential growth also appear to be reasonable as the expected moderate growth of total factor productivity is supported by foreign direct investment (FDI) inflows, domestic innovative activity, digitalisation, and structural reforms. The specialised exhibition EXPO 2027 to be held in Belgrade implies a boost to public investment in the coming years, which is however not specifically analysed in the ERP. In addition, in January 2024 (after the ERP finalisation), Serbia's President announced a 'Leap into the Future 2027' plan, which presents major public investment programmes. While many of these investments were already previously planned and thus included in the macroeconomic scenario, some ambiguity and lack of transparency exists on the exact investment plans ahead. Overall, additional public investments might boost economic growth further, but potentially at the expense of higher public deficits (discussed in Section 3), and risks of overheating, especially in the construction sector. Furthermore, the choice of the investment areas is key to actually achieving higher economic growth potential and other aims, such as the green transition, which appears to be less prioritised in the current 'Leap Into the Future 2027' project list.

([119]) Macroeconomic and fiscal estimates and forecasts covering the period 2023-2026 have been taken from the ERPs themselves; if available, preliminary macroeconomic and fiscal out-turn data for 2023 have been taken from the relevant national sources (Statistical Office, Ministry of Finance, Central Bank).

Table II.8.1:
Serbia - comparison of macroeconomic developments and forecasts

	2022		2023		2024		2025		2026	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	2.5	**2.5**	2.2	**2.5**	3.1	**3.5**	3.7	**4.0**	n.a.	**4.3**
Contributions:										
- final domestic demand	3.1	**3.2**	1.2	**1.2**	3.2	**4.5**	3.7	**4.0**	n.a.	**4.3**
- change in inventories	0.4	**0.8**	-0.3	**-1.9**	-0.1	**-0.1**	0.0	**0.0**	n.a.	**-0.1**
- external balance of goods and services	-1.0	**-1.5**	1.3	**3.2**	0.0	**-1.0**	0.1	**0.1**	n.a.	**0.1**
Employment (% change)	2.3	**2.2**	0.3	**1.4**	0.5	**0.4**	0.6	**1.0**	n.a.	**1.2**
Unemployment rate (%)	9.4	**9.7**	9.4	**9.6**	9.0	**9.3**	8.6	**8.9**	n.a.	**8.0**
GDP deflator (% change)	10.4	**10.4**	11.4	**11.4**	3.6	**4.6**	3.9	**3.6**	n.a.	**2.9**
CPI inflation (%)	11.9	**11.7**	12.7	**12.3**	5.5	**4.6**	3.6	**3.0**	n.a.	**3.0**
Current account balance (% of GDP)	-6.9	**-6.9**	-3.3	**-2.5**	-3.5	**-3.8**	-3.3	**-4.1**	n.a.	**-4.3**
General government balance (% of GDP)	-3.2	**-3.2**	-2.8	**-2.8**	-2.2	**-2.2**	-1.5	**-1.5**	n.a.	**-1.5**
Government gross debt (% of GDP)	55.6	**55.6**	52.2	**53.3**	51.2	**51.7**	50.1	**50.7**	n.a.	**50.0**

Sources: Economic Reform Programme (ERP) 2024, Commission Autumn 2023 forecast.

The ERP's economic risk analysis sees the main downside risks from the international environment. No fundamentally domestic risks have been included in the ERP's risk analysis section (for example, higher than assumed domestic inflation pressures). Macroeconomic risks are seen to come mainly from Russia's war of aggression against Ukraine, prices of global energy products and global disruptions to supply chains. The ERP's alternative GDP scenario assumes a new shock on the energy market, higher inflation, lower real disposable income, lower economic growth in the EU, additional financial disturbances, and a deepening of uncertainty. These developments would increase production costs and reduce the potential to invest in further production capacities. As a consequence, the expected volume of foreign trade would be reduced. Economic growth in Serbia would be lower by 1.7 pps in 2024 than in the baseline scenario, largely on account of reductions in export activity, investment and private consumption. In 2025 and 2026, differences from the original expectations would be relatively smaller due to a gradual recovery of the economy from shocks.

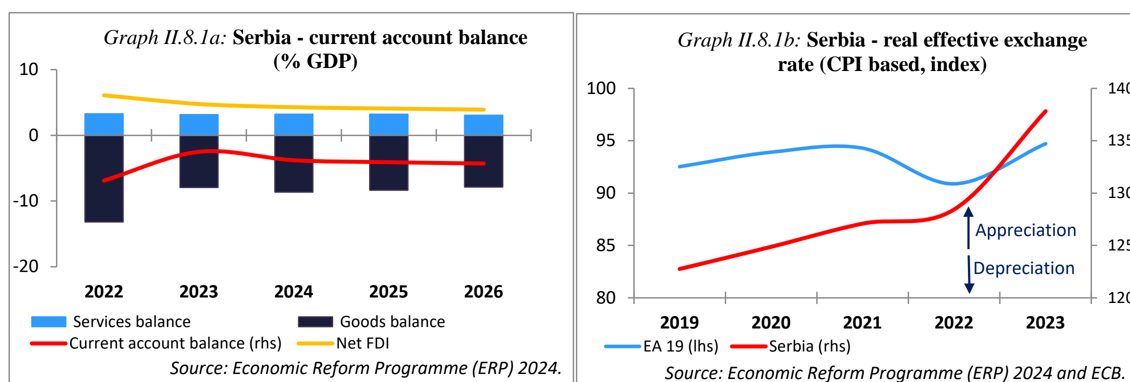
Consumer price inflation continued to abate in 2023 and is expected to return to within the central bank's target band in mid-2024. Annual consumer price inflation decelerated to 5,6% in February 2024; 2023; it was 12.1% for the year 2023 on average. Annual inflation was notably driven by food prices, but they decelerated strongly later in 2023 as global food prices eased and base effects dissipated. Rapid increases in electricity and gas tariffs (24% and 33% respectively), as included in the stand-by arrangement with the IMF, were estimated by the central bank to have directly raised inflation by 1.3 pps in 2023. There are no such extraordinary rises planned for the coming years. Core inflation (excluding energy, food, alcohol and tobacco) was lower in 2023 at 9.1%. The ERP expects inflation to decline to within the central bank's target tolerance band of 3% ±1.5 pps in mid-2024, with annual average inflation projected at 4.6% in 2024 and down to 3% in 2025-2026. The central bank expects disinflation to be supported by the effects of monetary tightening, falling inflation expectations and lower imported inflation (food and industrial products). Countering these effects, the National Bank of Serbia (NBS) expects global oil prices to still exert some inflationary pressures.

The dinar's exchange rate against the euro has remained stable, with the NBS allowing for minimal volatility and countering some appreciation pressures. NBS foreign exchange reserves increased consistently in 2023, reaching EUR 25 billion in January 2024, a surge by about 40% y-o-y, covering 6.8 months of imports of goods and services. In line with its long-standing policy of exchange rate stabilisation, the central bank continued to intervene frequently in the foreign exchange market. Dinar exchange rate appreciation pressures prevailed in 2023, with NBS buying a record amount of EUR 3.9 billion net in the domestic foreign exchange market. The dinar appreciated only marginally by 0.1% y-o-y against the euro by the end of 2023. The last time that the NBS raised its key policy rate was in July 2023, by 25 basis points to 6.5%, leaving it unchanged after. Due to high surplus dinar

liquidity in the banking sector, the required reserve ratios were raised, in September 2023, for the first time since 2015 ([120]). The aim of the required reserve increases was to support the monetary tightening and to stimulate the dinar and long-term sources of bank financing through differentiation of required reserve ratios, depending on the currency and maturity of liabilities.

The current account deficit narrowed sharply from 6.9% of GDP in 2022 to 2.6% in 2023 ([121]), reflecting the easing of the energy crisis. The current account deficit narrowed continually over the course of 2023, helped by base effects as electricity imports were extraordinarily high in 2022, due to high import prices and unexpected domestic supply disruptions, while both factors abated in 2023. Despite the slowdown in external demand, goods and services exports continued to grow in 2023, as a result of past investments made to expand production in Serbia. Merchandise trade in 2023 grew slightly in EUR value (+3.7%) while imports decreased (-4.8%) in value, which resulted in the deficit in goods trade decreasing by about one third. A surplus in the services trade balance improved very strongly by 30% y-o-y in 2023, driven by ICT, transport and business services' exports. The surplus in services covered almost half of the deficit in goods trade. The primary income deficit increased substantially by about 30% y-o-y in 2023, mainly reflecting higher dividend and interest payments. The large increase in secondary income surplus in 2022 (largely reflecting remittances) petered out in 2023 and has turned to a slight decrease y-o-y. According to the ERP's projections, the current account deficit is set to widen again to about 4% of GDP over 2024-2026 due to the projected rise in investments and consumption.

External competitiveness and current account



Inflows of FDI continue to make a major contribution to raising the economy's productive capacity and competitiveness. FDI inflows increased to record levels in absolute terms of EUR 4.5 bn in 2023 (6.1% of GDP), covering multiple times the current account deficit. Around 60% of FDI was channelled into tradable sectors: manufacturing; construction and mining industries; professional, scientific, innovation and technical activities; real estate; and trade. By country, based on data for Q1-Q3 2023, most FDI continued to originate from European countries (68%), notably those of the EU (around 53%), but the share from China has rapidly increased over recent years and is now the largest single country source of FDI (25% of the total inflow in Q1-Q3 2023). The ERP projects that strong FDI inflows will be maintained (at around 5% of GDP on average per year), driven by the EU integration process, along with bilateral and multilateral free trade agreements (Central European Free Trade Agreement, European Free Trade Association, Eurasian Economic Union, China). This is expected to drive an increasing openness of the Serbian economy and its greater integration into global trade flows. The stock of net FDI accounts for a very high share (97% in Q2-2023) of Serbia's net international investment position. The high share of FDI in net foreign liabilities, coupled with the

([120]) Required reserve ratio on foreign exchange base rose by 3 pps each, to 23% and 16%, for liabilities with agreed maturities of below and over 2 years, respectively. The percentages of dinar allocations of foreign exchange required reserve rose by 8 pps each, to 46% and 38%, depending on the maturity of liabilities. Required reserve ratios on dinar base rose by 2 pps each, to 7% and 2%, depending on the maturity of liabilities.

([121]) ERP projected 2.5% of GDP, which is very similar to the actual outcome.

relatively high level of foreign exchange reserves, reduces Serbia's vulnerability to external shocks. The ERP expects that foreign exchange reserves will cover around 6 months' worth of imports throughout the programme's duration.

Serbia's financial sector remained stable. The ratio of non-performing loans (NPLs) remained stable, near to its historic low, at 3.2% in December 2023. The capital adequacy ratio of the banking sector (regulatory capital to risk-weighted assets) stayed flat in Q3-2023 at 22.2%. As regards liquidity ratios, both the share of liquid assets to total assets (40%, +0.3 pps quarter-on-quarter) and the share of liquid assets to short-term liabilities (51.7%, +0.1 pps quarter-on-quarter) further increased marginally in Q3-2023. Higher net interest income boosted bank profitability to record highs, reaching 2.6% (for RoA) and 19.3% (for RoE) in Q3-2023. In September 2023, the NBS decided to cap interest rates for a wide range of mortgage loans with the aim of supporting people with mortgages and reducing the risk of NPLs. This is estimated by NBS to cost the banking sector about 10% of projected net profits, which they were deemed to be able to absorb given the current high level of profitability. The ERP states that this measure will be phased out at the end of 2024, but keeping this market intervention in the short-term is crucial to limit its negative spillovers.

Table II.8.2:
Serbia - financial sector indicators

	2019	2020	2021	2022	2023
Total assets of the banking system (EUR million)	45 838	50 775	56 748	61 122	67 323
Foreign ownership of banking system (%)	75.7	86.0	87.0	83.4	
Credit growth (%, average)	9.7	12.3	9.1	10.9	1.7
Deposit growth (%, average)	12.9	15.0	14.4	8.4	11.4
Loan-to-deposit ratio (end of period)	0.96	0.91	0.88	0.88	0.79
Financial soundness indicators (%, end of period)					
- non-performing loans to total loans	4.1	3.7	3.6	3.0	3.2
- regulatory capital to risk-weighted assets	23.4	22.4	20.8	20.2	21.4
- liquid assets to total assets	36.0	37.3	37.7	37.5	41.0
- return on equity	9.8	6.5	7.8	13.9	18.1
- foreign exchange loans to total loans *	67.1	64.7	63.2	65.5	59.7

* Includes both denominated and indexed positions.
Note: data for December 2023 are preliminary.
Sources: ERP 2024, National Bank of Serbia.

Driven by the higher interest rates and tighter credit standards, loan growth has slowed down. Annual lending growth in the non-financial sector slid to -0.4% in November 2023, with loans to households still growing slightly and corporate loans contracting. In Q4-2023, the interest rate on newly approved dinar household loans amounted to 12.5% (euro indexed at 6.3%) and on corporate loans 8.3% (euro indexed 7.1%). Both corporate and household deposits continued to rise, especially dinar-denominated deposits due to the interest rate differential compared to euro deposits. Looking ahead, the ERP projects annual lending growth to recover modestly to 3% in 2024, below GDP growth rates. Overall, the financial market is dominated by bank financing, with other instruments like bonds, shares and hedging instruments being less developed, which constrains the financing capacity of the economy and potentially channels more private savings towards real-estate.

8.3. PUBLIC FINANCE

In 2023, the fiscal outcome was better than expected. The ERP projects the general government deficit to have decreased from 3.2% of GDP in 2022 to 2.8% in 2023. Due to the very high nominal GDP growth, the revenue-to-GDP ratio was expected to have decreased by 1.2 pps compared to 2022, while total spending decreased by 1.7 pps. According to preliminary data from the Ministry of Finance, the general government deficit decreased even more to 2.2% of GDP in 2023. The better-than-expected outcome is explained by higher than planned revenues in 2023 (especially corporate income tax, an initially unplanned rise in excise rates, road tolls, and an overall stronger labour market) and by

lower subsidy needs to the state-owned energy companies. Compared to the original budget, the overall expenditure commitments were even raised by a late-year supplementary budget, with ad hoc measures to raise pensions, subsidies for agriculture (instead of the energy sector), one-off payments for children and additional wage rises in education and health. Capital expenditures remained relatively high, at 7.2% of GDP in 2023. The level of subsidies remained elevated at 2.7% of GDP.

Table II.8.3:
Serbia - composition of the budgetary adjustment (% of GDP)

	2022	2023	2024	2025	2026	Change: 2023-26
Revenues	43.7	42.5	42.6	42.5	42.3	-0.3
- Taxes and social security contributions	38.9	37.6	38.0	38.0	38.0	0.5
- Other (residual)	4.8	4.9	4.6	4.4	4.2	-0.7
Expenditure	46.9	45.3	44.8	44.0	43.8	-1.5
- Primary expenditure	45.4	43.5	42.7	41.8	41.4	-2.0
of which:						
Gross fixed capital formation	7.4	7.2	6.8	6.5	6.6	-0.6
Consumption	17.6	17.4	17.6	17.4	17.4	0.0
Transfers & subsidies	15.3	16.2	16.2	16.2	15.8	-0.4
Other (residual)	5.0	2.6	2.1	1.7	1.6	-1.0
- Interest payments	1.5	1.9	2.1	2.2	2.3	0.5
Budget balance	-3.2	-2.8	-2.2	-1.5	-1.5	1.3
- Cyclically adjusted	-3.4	-2.7	-2.0	-1.4	-1.5	1.2
Primary balance	-1.7	-0.9	-0.1	0.6	0.8	1.8
- Cyclically adjusted	-1.9	-0.8	0.1	0.7	0.8	1.7
Gross debt level	55.6	53.3	51.7	50.7	50.0	-3.3

Sources: Economic Reform Programme (ERP) 2024, Commission calculations.

The ERP plans to reduce the fiscal deficit to 1.5% of GDP in 2025-2026, in line with the new deficit rule. This is in line with what was planned in the previous year's ERP. It is consistent with a gradual fall in the debt-to-GDP ratio to about 50% in 2025-2026. 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 2024-2025, with no change in 2026. The ERP expects a gradual slight 0.3 pps decline in the revenue ratio over 2023-2026, explained by a decline in non-tax revenues, based on the conservative exclusion of extraordinary non-tax revenues ([122]). At the same time, tax revenues are expected to remain stable at 38% of GDP in 2025-2026. The improvement in the fiscal balance is driven by a strong decrease in the expenditure-to-GDP ratio over 2023-2026. The decreasing spending ratio (-1.5 pps between 2023 and 2026) results from the planned gradual reduction of support to the state-owned energy utilities (-0.5 pps); the decreasing share of capital expenditure from a high base (-0.6 pps); and the declining costs of energy crisis measures (-0.5 pps). Public wages are assumed to be at 10% of GDP over the coming years, in line with the maximum limit in the fiscal rules. Pension expenditure is estimated to rise sharply from 9% of GDP in 2022 to 9.6% of GDP in 2023 and further to 10.6% of GDP in 2024 and then abate slightly to 10.4% of GDP by 2026, still above the 10% of GDP target set in the fiscal rules. The extraordinary indexation of pensions (5.5%) in November 2023 is reflected in these projections. Interest expenditure is projected to rise significantly, as the effective interest rate on public debt is set to rise with the debt rollover process.

For 2024, the budget targets a deficit of 2.2% of GDP. The revenue ratio to GDP is projected to rise marginally by 0.1 pps, while the expenditure ratio is set to decline by 0.5 pps. The rise of the revenue ratio in 2024 is largely explained by social contributions revenues, reflecting the assumption

([122]) 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.

that labour income grows significantly faster than GDP. Only some relatively small gradual tax adjustments are planned to take effect in 2024, concerning income tax scales and excises, also made in previous years. A further small increase in the tax-exempt part of gross salaries is planned (costing 0.1% of GDP). This tax cut would help to lower the currently relatively high tax wedge on low-income earners ([123]). To make informal labour less attractive, there may be grounds in the coming years for raising the threshold further and above the inflation rate. The budget also envisages adjusting excises for inflation in January and a further 8% hike in October 2024, raising revenues by 0.4% of GDP. On the expenditure side, pensions are set to increase further by 14.8% as of January 2024 and public sector wages by 10%, bringing the share of the latter to 10% of GDP, the upper limit set in domestic fiscal rules. Capital investment spending is set at 6.8% of GDP, a relatively high level, as in the previous year. The expected net budget loans to the state-owned energy sector are set to decline by around 0.3% of GDP, as the energy crisis is assumed to relent.

The ERP expects the public debt ratio to continue declining gradually, due to high nominal GDP growth and an improving primary balance. The general government debt-to-GDP ratio decreased from 55.1% in 2022 to 52.3% of GDP ([124]) in 2023; in the ERP, this is expected to decline further to 50% of GDP by 2026 (about 3 pps lower than the previous year's ERP estimate, due to the expected better outcome in 2023, and carrying over to future years). The decline in the debt ratio is largely driven by the GDP growth effect and the gradually decreasing but still noticeable impact of inflation. In addition, as the primary balance is expected to turn positive in 2025, it would also contribute to the fall in the debt ratio in the later years of the ERP. These debt-reducing effects are expected to be partly offset by higher interest expenditure (rising by 0.4 pps of GDP over 2023-2026) and a large positive stock-flow adjustment (over 1 pp. of GDP in both 2025 and 2026). These stock-flow adjustments are included in the fiscal forecast as a precautionary assumption covering potential risk scenarios. Therefore, the reduction in the debt ratio could be even faster than planned in the ERP if such fiscal risks do not materialise.

([123]) The high tax wedge is explained by relatively high social taxes and little progressivity in income tax. Although Serbia's personal income tax (PIT) has a progressive rate for a higher tax bracket, most wage earners fall within the same tax bracket. Serbia levies a rate of 10% on wage income up to six times the average annual salary and 15% for income above that threshold. Serbia has one of the highest social security contributions rates in the Western Balkans region at 35.4%.

([124]) The ERP projected 53.3% of GDP.

BOX II.8.1: DEBT DYNAMICS

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

	2022	2023	2024	2025	2026
Gross debt ratio [1]	55.6	53.3	51.7	50.7	50.0
Change in the ratio	-1.5	-2.3	-1.6	-1.0	-0.7
Contributions [2]:					
1. Primary balance	**1.7**	**0.9**	**0.1**	**-0.6**	**-0.8**
2. 'Snowball effect'	**-5.0**	**-4.9**	**-1.9**	**-1.5**	**-1.0**
Of which:					
Interest expenditure	1.5	1.9	2.1	2.2	2.3
Growth effect	-1.3	-1.2	-1.7	-1.9	-2.0
Inflation effect	-5.2	-5.6	-2.3	-1.7	-1.4
3. Stock-flow adjustment	**1.8**	**1.7**	**0.1**	**1.2**	**1.1**

[1] End of period, in accordance Government debt as defined by the national methodology. This includes all government-guaranteed debt and non-guaranteed local government debt. It differs from government debt according to the national methodology (set out in the 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) 2024, Commission calculations.

The large proportion of foreign currency-denominated debt (about 80% of the debt stock in Q3-2023) exposes government debt to exchange rate risks. The ERP presents a debt sensitivity analysis, which shows debt trends under different exchange rate scenarios. Broadly, a 10% appreciation or depreciation would result in the debt ratio at 45% or 53% of GDP, respectively. 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 would also play an important role in reinforcing medium-term debt sustainability. Overall, the ERP sets an aim to reduce the exposure to variable interest obligations, where possible. In mid-2023, fixed interest debt made up about 70% of the total. Debt management aims to develop flexibility in terms of market choice (domestic or international), debt currency and financing instruments. The most recent debt issuance is geared towards covering the EXPO 2027 financing needs, raising 150 bn dinars, or EUR 1.3 bn, representing 1.8% of GDP. The 8-year dinar-denominated bonds were issued in several smaller batches, with yield rates declining in each new issuance, from 6.39% in October 2023 to 6.12% in February 2024.

The short-term fiscal risks appear balanced, while structural downside fiscal risks are likely to persist in the medium term. In the short term, the fiscal projection appears to face balanced risks. While some uncertainty surrounds the GDP outlook, mostly due to global factors, this risk is balanced by economic activity already picking up speed in late 2023 and its strong carry-over effect to 2024. Revenue projections remain plausible, with the elasticity of revenues to tax bases assumed to be neutral and the revenue forecast not relying on one-off revenue items or shrinking of the grey economy. Both the new electronic fiscalisation model and the transition to electronic invoicing have been completed and constitute an upside risk due to their expected impact on shrinking the grey economy, increasing VAT collection, and improving the tax control process. On the expenditure side, as

in previous years, new non-budgeted ad hoc expenditure measures could be announced. Keeping expenditure growth below the nominal growth of GDP might be challenging. Public investments, already relatively large, might turn out even higher than planned in the ERP for the coming years. The investments needed for the specialised EXPO 2027 and the 'Leap into the Future 2027' programme ([125]) (announced after the ERP was finalised) imply large public capital spending in the coming years. Most of the announced investment projects were already previously planned, but there is nevertheless some uncertainty if the new plans would necessitate additional spending. Further substantial public investments can lead to unforeseen expenditure rises, as construction prices could also rise in an already tight market. The investment-led boost to the economy (resulting in higher GDP) might actually create additional public expenditure pressures in other areas as well, like social spending, via risks of higher inflation. This was the case in 2023, when additional social support was given to vulnerable groups whose incomes failed to keep up with inflation.

The weak governance of SOEs and their strong presence in the economy remains a major fiscal risk, but some progress has been made. The fiscal support needs were unexpectedly high in 2022 due to the energy crisis but fiscal transfers were significantly lower in 2023, notably also helped by the IMF programme-mandated energy tariff increases. There remains a need to to establish an automatic tariff adjustment system. Overall, many SOEs in Serbia (not only energy related) do not achieve significant profitability and therefore pose a fiscal risk if market conditions deteriorate. A major achievement was the adoption in September 2023 of the new law on SOE governance, which will enter into force in September 2024. A number of by-laws have yet to be adopted. However, there is still a lack of capacity within the national administration to ensure full implementation of the law and to draft the necessary secondary by-laws. Technical assistance in the drafting process of some of the by-laws is ongoing and provided by the EBRD. It is important to focus on implementing structural reforms across all SOEs and not just the most problematic ones like Elektroprivreda Srbije (EPS) and Srbijagas ([126]).

The Ministry of Finance has a leading role in monitoring fiscal risks, making steady progress in its work. The main task of the Department for Monitoring of Fiscal Risks is the strengthening of both legislation and the methodological framework, capacity building, and development of technical tools and models necessary for monitoring and assessment of fiscal risks. The purpose is that these activities result in risk identification and assessment and lead to proposals for exit strategies. Further progress in its capacities is important with a view to better analysing and managing fiscal risks, especially related to SOEs, and to make the work transparent by publishing its reports. Further immediate plans include developing a more structured analysis (with World Bank methodology) in the form of a 'fiscal risk statement'.

Serbia has issued relatively large guarantees over the past decades, linked to SOEs. The issued guarantees in their total amount are included in the public debt. They have reduced gradually from 9.5% of debt stock in 2015 to 5.2% by September 2023. The activated guarantees, with a deficit effect on the budget, are estimated in the budget bill to amount to 0.3% of GDP in 2023. Recognising the risks from guarantees, the government has taken steps to limit the issuance of new guarantees. Amendments to the Law on Public Debt prohibit the issuance of new guarantees for loans for the purposes of liquidity. Amendments to the Law on the Development Fund of the Republic of Serbia disallowed any further issuance of a counter-guarantee for guarantees issued by the Development Fund. A large number of SOEs, which are the biggest beneficiaries of guarantees, are planned to undergo a restructuring process in collaboration with international financial institutions.

The ERP also acknowledges substantial fiscal risks arising from court decisions, which result in fines and damages payable by government bodies. In 2022, these expenses amounted

([125]) The 'Leap into the Future 2027' plan technically also includes the EXPO 2027 investments, but the two were announced at different times.

([126]) 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 recent increases in electricity and gas prices.

to RSD 26.8 billion (0.4% of GDP), and they reached RSD 18.9 billion (0.2% of GDP) over January to September 2023. Potential obligations may also arise from the legacy of the Socialist Federal Republic of Yugoslavia (e.g. from ongoing complaints by employees of former socially-owned enterprises, or unpaid wages). 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).

Serbia has relatively high public investments, at 7.2% of GDP in 2023, which underscores the importance of public investment management and public procurement. Major investment needs relate to the green transition, including energy infrastructure, and to transport. In September 2023, the government adopted a new Decree on capital projects, which makes some steps in the direction of a single and clear overall view of the current and planned investments in Serbia. However, the Decree falls short of developing a genuine single system for public investment management and foresees important exemptions. Discussions are to be launched between Serbia and the European Commission to establish a time-bound action plan to remedy this. 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 thorugh intragovernmental agreements. 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. 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.

Reform of the tax administration progressed well in 2023, but staffing issues remain. The implementation of of the tax administration reform has continued. In May 2022, a new fiscalisation model (e-fiscalisation) was introduced. The system is expected to contribute to the reduction of discrepancy with taxpayers and to a lower number of negative audit opinions. The system for an electronic exchange of invoices (e-invoices) was implemented in early 2023. Procurement of an information system is still to be conducted. An ongoing project analyses the VAT gap, with preliminary results showing that it was considerably reduced compared to 2018. Work is ongoing for a cross-analysis of personal property and income. The development plan of the tax administration itself envisages the hiring of more staff with higher qualifications, which is currently hindered by inadequate salaries for some categories of employees, relative to the private sector. The independence and transparency of the tax administration also has to be strengthened. While the tax administration has a distinct legal status and its own operating budget, it has yet to establish an independent management board.

The current public sector wage system does not in practice make it possible to effectively attract higher paid categories of employees, given the built-in strong wage compression. The wage scales are firmly set by law, while being very compressed with about a 1 to 4 ratio from the lowest to the highest wage band. The public sector wage system reform has been repeatedly postponed and is now scheduled for 2025. Some progress was made in preparatory steps as the new central electronic public wage and employment registry (Iskra) became operational for some sectors in 2022 and was rolled out to most of the public sector (except military, security and higher education institutions) by the end of 2023. Iskra would make it possible to analyse different reform scenarios and identify the most problematic areas, which could be the basis for specific reform steps.

The newly instituted domestic fiscal rules ([127]) constitute well designed anchors for fiscal policy, but some challenges have emerged in their interpretation and implementation,

([127]) Fiscal rules were adopted 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

specifically regarding the target on pension expenditure. One of the fiscal rules targets pension expenditure at 10% of GDP as an equilibrium point, and envisages an adjustment mechanism if this is exceeded due to indexation rules or other economic factors. In 2023, pension expenditure was projected to reach only 9.6% of GDP. However, the automatic indexation of pensions was set to increase the ratio to above 10% in 2024 and 2025 (when GDP growth is projected to abate while the pension index has a lagged impact from the previous very inflationary years). This would then in turn trigger a lower indexation as a corrective measure. Nevertheless, the government decided to give an additional ad hoc rise in pensions with the end-2023 supplementary budget, which further pushed the pensions-to-GDP ratio above the 10% boundary in the coming years. This is estimated in the ERP to reach 10.6% of GDP in 2024 and 10.8% in 2025 before coming down to 10.4% in 2026. The discretionary rise of pensions in 2023 can be seen to go against the spirit of the fiscal rules; avoiding deviations in the future would help increase the credibility of the new system of fiscal rules. It would also seem appropriate to improve the medium-term perspective for implementing fiscal rules by strengthening medium-term budgeting. Also, should the rules be deemed to have been breached, there is currently no enforcement mechanism provided for in the fiscal rules.

The parliamentary and public vetting of the state budget is occasionally lacking transparency. While the annual budgets are adopted broadly in line with the normal legislative procedure, the mid-year amending budgets are often adopted using the urgent procedure. The share of non-assigned expenditures that are allocated in the budget to reserves is relatively high, limited by law at 4% of total spending. This makes possible the taking of substantial ad hoc spending decisions during the fiscal year. Typically, the unused budgetary funds are also reassigned towards the end of the year and spent in an untransparent way. Neither the 2023 amending budget nor the 2024 budget provide a sufficient level of transparency regarding the breakdown of capital transfers and guarantees to SOEs, in particular to EPS and Srbijagas. The budget is also lacking a detailed overview of tax expenditures, which complicates understanding of how government spending through the tax code affects overall revenue and the distribution of related benefits. On the positive side, there was a meaningful parliamentary debate on the 2024 budget and the government also submitted to parliament the final annual budget execution report for 2022. The well-established Fiscal Council has continued to function properly and produce independent fiscal assessments and recommendations. However, the mandate of some Fiscal Council members expired in mid-2023 and has not been officially renewed.

8.4. MAIN MACRO-RELEVANT STRUCTURAL CHALLENGES

In November 2023, the Commission proposed a New Growth Plan for the Western Balkans ([128]) with the aim of supporting the region's economic convergence and accelerating the accession process. The plan involves a Reform and Growth Facility (EUR 2 billion in grants, EUR 4 billion in loans) that is to be disbursed in 2024-2027 as investment ([129]) and budget support in exchange for implementing reforms that are to be set out in reform agendas prepared by the Western Balkan partners. The New Growth Plan is therefore an important tool to increase reform incentives to

enter into force in 2025 because specific deficit targets for 2023 and 2024 had already been agreed in the stand-by arrangement 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. 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.

([128]) https://neighbourhood-enlargement.ec.europa.eu/enlargement-policy/new-growth-plan-western-balkans_en.

([129]) Infrastructure investments need to comply with the EU environmental acquis, national and international nature protection and water management obligations, ensure public participation and consultation, and guarantee high quality environmental impact assessment reports that include cumulative impacts on nature and biodiversity.

boost growth and convergence. In this context, with a view to ensuring an integrated surveillance of Serbia's economy, this chapter briefly outlines the main structural challenges facing the country.

Serbia's business environment has seen positive developments with the regulatory administrative burden easing, yet substantial structural challenges persist. Exports have been a major driver of growth, both manufacturing and services (ICT, transport). Manufacturing has modernised and diversified in recent years, but traditional industry, notably the energy sector, has not undergone sufficient opening or restructuring. The underperformance of these sectors continues to hinder Serbia's competitiveness and economic growth potential, a vulnerability accentuated during the recent energy crisis. To achieve sustained higher growth rates, Serbia should capitalise on opportunities within the single market while ensuring a level playing field for all companies. Long-term economic growth and improved living standards, approaching those of the EU, hinge on the consistent implementation of structural reforms across multiple areas.

Fundamental areas such as rule of law, the fight against corruption, and improving the functioning of democratic institutions are key foundations for the business environment. The Serbian legal framework is prone to unexpected and non-transparent changes, frequently without consultation procedures, which can be detrimental to business. Shortcomings are noted in 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. Businesses also raise the issue of the lack of both reliability in contract enforcement and expertise among judges, particularly in complex areas of law such as competition, intellectual property, or taxation, which leads to inconsistency in rulings. Moreover, the business environment remains hampered by red tape, political interference and limited public administration efficiency. Serbia's legal framework for fighting corruption and dealing with economic crime and abuse of office is largely in place, but its implementation is lacking, also due to understaffing. A particularly critical area is public procurement where the level of competition in the public procurement process remains limited. Serbia ranked 104th out of 180 countries in the 2023 corruption perception index compiled by Transparency International, thus continuing the negative trend of rankings that have been steadily deteriorating since 2018, when Serbia ranked 87th. In its annual country report under the enlargement package, the Commission closely monitors the issues of strengthening the rule of law and fighting corruption.

Economic growth and the development of a strong corporate sector is hampered by the widespread informal economy and the significant share of inefficient SOEs in the economy. Driving forces behind the informal economy include high taxes and high social 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. To address the problem, Serbia adopted its "Programme for combating the grey economy 2023-25" along with an Action Plan in 2023. As noted above in Section 3, Serbia somewhat lowered income taxation in 2023 and 2024, which also lowered the tax wedge somewhat. E-fiscalisation and e-invoicing systems, which were rolled out in 2022-2023, provide for real-time tracking of the issuance of fiscal receipts, enabling the tax office to better monitor and counter tax evasion. The role of the State in the economy remains significant with large and inefficient SOEs dominating many sectors, including energy, transport, utilities, telecommunications, infrastructure, mining, and extraction of natural resources, and distorting competition also in sectors like manufacturing, tourism, retail trade. Many of Serbia's SOEs do not apply corporate governance rules and operate with low efficiency and high costs. Serbia's new Law on SOEs can be an considered as an important first step to improve the management of the SOE sector but it needs to be fully implemented to have the desired effects. Improving the efficiency of SOEs would give a boost to the economy, and reduce the strain on public finances. Structural challenges also remain for state aid, competition and public procurement, where legislative frameworks are often implemented inconsistently or with exceptions, negatively impacting competition.

The energy sector remains inefficient and suffers from outdated infrastructure and over-reliance on coal. Most energy companies are state-owned and have relied to a varying degree on state budget subsidies. The Serbian energy market is not fully compliant with the Energy Community Treaty or the EU *acquis* and continues to hamper competitiveness and Serbia's ability to attract much-

needed private investment, in particular in the renewables sector. Energy infrastructure is largely outdated and the energy supply continues to rely mostly on coal with high carbon intensity and pollution ([130]). This constrains Serbia's economic growth potential as EU Member States move towards greener economies and the carbon border adjustment mechanism (CBAM) is being implemented. The Energy Community's Decarbonisation Roadmap is still to be fully implemented in Serbia, to comply with the Energy Community climate and energy targets, and Serbia should strive towards establishing a carbon pricing instrument compatible with the EU Emissions Trading System. Furthermore, Serbia's dependence on Russia in the energy sector is the highest in the Western Balkans with Russia having majority control of Serbia's gas infrastructure and oil industry. However, in order to reduce the dependence on Russian gas, the gas interconnector between Serbia and Bulgaria was finalised in late 2023 and construction of an interconnector with North Macedonia is in preparation. The ERP rightly recognises the importance of greening Serbia's energy sector and fully opening the energy market. A notable achievement was the establishment of an intraday electricity market in July 2023 (the first in the Western Balkans). Serbia has launched a housing renovation programme to increase energy efficiency in residency buildings, which has however seen a slow start. Electricity and gas prices in Serbia were raised substantially in 2023, which has also likely negated the need for state subsidies in those sectors in the short term. Work to promote a just transition is in its infancy and proceeding too cautiously.

Serbia has made substantial progress on digital transformation across the economy. Digitalisation remains a key priority for the government and will be given a further boost also via the Reform Agenda. The action plan under the 2023-2025 e-government development programme was adopted in April 2023, with the objective to improve the quality of public services by ensuring interoperability, efficient coordination, project management and legal certainty over e-government use, and to foster the use of open data. The e-government national portal is continuously upgraded with new services, serving as a one-stop shop for e-government services and as a central point of access for businesses and the general public. Serbia's communications infrastructure still requires systematic improvement of both regulation and investment. Broadband roll-out is too slow, preventing the uptake of e-government and business services, and slowing down the digital transformation of the economy. The lack of comprehensive legal and regulatory reforms hinders private sector investments in high-speed communications networks. There was, however, some progress with the connection of public institutions and 150 000 households to fast broadband and speeds of 100Mbps. Supported by the inflow to Serbia of Russian citizens with related skills, the robust growth of the information and communication sector continued, with exports of ICT services one of the main export drivers.

While the labour market has improved markedly over the past decade, there is still room to raise employment to EU average levels. The current Serbian employment rate of 69.3% of the population aged 20-64 is substantially below the average of 74.6% in the EU. Serbia has a high prevalence of long-term unemployment. Compared to the EU average, a higher share of young people are neither in employment nor in education or training ([131]). Outmigration represents a considerable challenge for the labour market. Despite wide-ranging reforms in the past, the quality of education and training is still weak; enhancing and reorienting them to better match market needs would improve the employability of the workforce and Serbia's potential to attract higher value-added investments. A lower share of the Serbian population has basic or above-basic overall digital skills compared to EU average, which can impact individuals' employability as the labour market places an increasing emphasis on these skills. According to the results of the OECD's 2022 Programme for International Student Assessment (PISA) tests, students in Serbia scored less than the OECD average in mathematics, reading and science, but were the top performer among the Western Balkan 6. Compared to 2012 and 2018 PISA testing, the scores have not changed significantly.

([130]) Energy is the main source of pollution in Serbia. Annual average concentrations of PM2.5 reached 20.5 µg/m3 in 2021, one of the highest levels in Europe and more than four times higher than WHO recommended levels of 5 µg/m3.

([131]) 11.2% in EU vs 15.3% in Serbia of the population aged 15-29.

8.5. THE POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS PARTNERS, TÜRKIYE, GEORGIA, REPUBLIC OF MOLDOVA AND UKRAINE

The Economic and Financial Dialogue between the EU and the Western Balkans Partners, Türkiye, Georgia, Republic of Moldova and Ukraine

Brussels, 14 May 2024

[...]

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

1. Keep an appropriately tight fiscal stance in 2024 to help disinflation and strictly adhere to the new fiscal rules in order to enhance their credibility. Implement the action plan for 2023-2026 to strengthen medium-term budgeting, inter alia by developing tools and methodology for a stable strategic fiscal planning. Appoint members of the Fiscal Council following the recent expiry of some of their mandates.

2. Adopt the necessary by-laws to fully implement the new SOE law and strengthen SOE governance, reducing the associated fiscal risks. Reinforce fiscal risk analysis and management capacity, fully implement the risk methodology and publish comprehensive fiscal risk reports. Building on progress with the electronic public wage and employment registry, implement the preparatory steps towards an appropriately designed public sector wage system reform.

3. Ensure a sufficiently tight monetary policy stance as long as necessary to anchor inflation expectations at levels consistent with price stability, underpinned by a thorough assessment of possible second-round effects. Further enhance risk-based supervision in line with best international and European practices, including by further strengthening the reporting framework across the banking system, phase out temporary measures affecting market mechanisms in setting mortgage interest rates and foster NPL resolution including by further developing the secondary market for NPLs. 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.

ANNEX 1: OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2023

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey 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 guidance is similar to that of the country-specific recommendations usually adopted under the European Semester for EU Member States. Implementation of the guidance is evaluated by the Commission in the following year's ERP assessments.

The following table presents the Commission's assessment of the implementation of the 2023 policy guidance jointly adopted by the EU and the Western Balkans and Turkey at their Economic and Financial Dialogue at ministerial level on 16 May 2023.

Overall: Partial implementation (51.4%) ([132])	
2023 policy guidance (PG)	**Summary assessment**
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 stand-by arrangement commitments and the new fiscal rules.	There was **substantial implementation** of PG 1: 1) **Substantial implementation**: The planned deficit reduction conforms with the stand-by arrangement concluded with the IMF and the domestic fiscal rule deficit target. Fiscal support to energy SOEs was reduced in 2023. The 2023 fiscal deficit outcome was better than expected. However, the ad hoc supplementary budget in November 2023 provided for a fiscal stimulus, which goes against the policy of helping disinflation. Also, the extraordinary rise in pensions contributed to further pushing pension expenditure above 10% of GDP, set in the fiscal rules as an equilibrium target.
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.	2) **Substantial implementation**: Overall spending on wages as a percentage of GDP is projected to remain stable at 10% in 2024-2026, in line with the fiscal rules. The public sector wage system reform is delayed, postponed to 2025. On the positive side, the new central electronic public wage and employment registry (Iskra) was rolled out to most of the public sector (except military, security and higher education institutions) at the end of 2023. This is as an important step in preparing the delayed wage system reform.
Strengthen medium-term budgeting via the development of a corresponding time-bound action plan and the implementation of its first	

([132]) 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.

steps.	3) **Partial implementation**: An action plan for strengthening the medium-term expenditure framework for the period 2023-2026 was prepared and adopted with the aim of introducing more efficient medium-term budgeting. In 2023, fiscal limits were defined in strategic documents, in accordance with Article 50 of the Budget Law for 2024. However, the role of medium-term planning is undermined by frequent ad hoc changes to spending and a limited political commitment to medium-term strategic fiscal planningplanning.
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.	There was **substantial implementation** of PG 2: 1) **Substantial implementation**: The implementation of the tax administration reform continued in the framework of the "Transformation Programme of the Tax Administration" for the period 2021-25, including. This included efforts toward improvement of business processes, improved risk assessment practices and capacity building of existing staff. However, the implementation of the new integrated information system (COTS) planned for 2023-2024, has not started yet. Attracting and retaining qualified personnel remains a challenge. 2) **Partial implementation**: The Ministry of Finance's Department for Monitoring of Fiscal Risks has made steady progress in its work. Its main task is the strengthening of the legislation and the methodological framework, capacity building, and development of technical tools and models necessary for monitoring and assessment of fiscal risks. The department's work is based on the Uniform Methodology, adopted in 2021, prepared with the assistance of the World Bank. Further expanding the capacities of the department is still needed to analyse and manage fiscal risks, especially related to state-owned enterprises (SOEs), and to make the work transparent by publishing its reports, including a stand-alone and comprehensive fiscal risk statement. 3) **Substantial implementation:** The government adopted a new SOE Governance Law developed together with the IMF, based on OECD principles. The new law applies as of September 2024, and work is underway on the remaining by-laws required to enact the new

	law, with the support of the European Bank for Reconstruction and Development and the IMF. Reformative actions started, including the transformation of several SOEs into joint stock companies. Reforms in EPS are under way; a new supervisory board has been appointed but a transformation plan has yet to be adopted. Other SOEs have so far seen far less or no reformative action, including Srbijagas, EDS, Posta Srbije and others. The remaining steps of the time-bound action plan 2021-2023 were rolled over to the action plan 2024-2025, which remains to be adopted.
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.	There was **substantial implementation** of PG3**:** 1) **Full implementation:** The central bank continued to tighten its monetary policy stance, increasing the policy rate further in several steps. In addition, to support the tightening and increase efficiency of the transmission mechanism – particularly to absorb some of the excess liquidity – required reserve rates were raised. These measures have contributed to bringing inflation on a steep downward path and to keeping inflation expectations anchored. 2) **Substantial implementation:** The authorities have continued to enhance the regulatory and supervisory framework. Following a gap analysis of the Serbian legal framework for banks relative to the EU, the regulatory framework for liquidity coverage has been aligned. This is to be followed by the introduction of a regulatory limit for the leverage ratio and requirements for prudential reserves. There was no progress on reducing remaining obstacles to non-performing loan (NPL) resolution, such as further facilitating the sale of retail NPLs or improving judiciary processes, but asset quality continued to improve. The authorities have strengthened the database on mortgaged real estate valuations. 3) **Substantial implementation:** The authorities continued fostering the development of local bond markets and encouraged dinar-denominated deposit and loan growth. Nevertheless, currency substitution remains high. Measures put in place include: i) lower reserve requirements on dinar sources while remunerating reserves in dinars; ii) mandatory down-payment ratios for FX loans, iii) systemic risk buffers and iv) higher capital requirements

	on banks' new FX lending to corporates. In addition, the legal framework for auctioning dinar-denominated securities through Euroclear has been finalised. The first auction through this system is to be launched in 2024.
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 ensure a consistent and transparent track record demonstrating the operational independence of the Commission for State Aid Control.	There was **limited implementation** of PG4: 1) **Limited implementation:** While an increase in the percentage of legislation undergoing consultations has occurred, the overall level remains low and timely consultation is not applied systematically. Certain secondary legislation affecting daily operations of companies continue to be adopted hastily with no consultations and with very short implementation deadlines. Despite the legal obligation to provide information on the results of public consultations, reports are not systematically published, nor are explanations systematically provided on the acceptance or not of comments received. CSOs continue to report that the time given for public consultations is not sufficient, and that their comments on draft laws of public interest are not considered. Furthermore, the practice of the Parliament in 2023 to adopt huge number of laws in one session with almost no time for substantive debate of MPs about the substance and the impact of the proposed drafts is another very problematic dimension in the process of adoption of laws. 2) **No implementation:** In September 2023, the Government adopted a new decree on capital projects. However, it does not sufficiently address long-standing concerns and recommendations, as it continues to allow for numerous exemptions. As such, it does not provide for the establishment of a unified, comprehensive and transparent system for capital investment planning and management, in line with international standards and best practices. A regulation adopted in October 2023 on projects of special importance, continues to allow for ambiguity regarding the selection criteria, economic justification and prioritisation of public investments. The "projects of special importance" are one of the exemptions foreseen by the decree on capital projects. 3) **No implementation:** The law on special procedures for linear infrastructure projects was repealed in July 2023. However, in October

	2023, a new special law was adopted, with a similar approach, for the preparation of EXPO 2027 in Belgrade, containing an exemption from public procurement legislation. On the basis of this law, in February 2024, the government adopted a decree setting the public procurement rules for EXPO 2027 that is not aligned with the EU *acquis* and thus raises serious concerns. In addition, the law on the use of renewable energy sources introduces derogations from legislation pertaining to public procurement and public-private partnerships and concessions; the law was used as a basis to adopt a decree on the selection of a strategic partner for the construction of large-scale solar power plants. 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.
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 overdependence 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.	There was **partial implementation** of PG5: 1) **Partial implementation:** The NECP is to be adopted by the Ministry of Mining and Energy before June 2024, with the final approval of the government. The Energy Community Secretariat published its comments on Serbia's draft NECP in November 2023, stressing the need for more ambitious targets for renewables and energy efficiency. The gas interconnector between Serbia and Bulgaria (IBS) was completed in December 2023, and the permitting procedure is ongoing. The IBS pipeline would provide diversification of gas sources. Increased use of natural gas should lower carbon emission by reduced use of coal in electricity production. Regarding the Trans-Balkan Electricity Corridor, section III construction permits were obtained and the preparation of technical documentation was completed. The start of the construction of section III is expected in 2024, following the completion of preparatory steps, and, whereas the construction permit was obtained for Section IV. Work is ongoing to finalise the Just Transition Diagnostics Study and action plan financed by the EBRD. 2) **Substantial implementation:** Serbia successfully launched the first round of auctions in June 2023 (wind 400 MW and solar 50 MW), and the connection agreements with networks have been signed. The government has also chosen the strategic partnerpartners

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.	(UGT Renewables and Hyundai Engineering) to develop 1 GW of solar power plant by 2028. The gas interconnector between Serbia and Bulgaria (IBS) was completed in December and is expected to contribute to reducing Serbia's dependence on Russia in this area. In 2023, the price of electricity and gas was increased three times in line with Serbia's commitments under the stand-by arrangement. A new energy pricing mechanism is under development as agreed with the IMF. The restructuring of EPS continued while assistance to other SOEs from the energy sector was delayed. fullFull implementation of the EPS restructuring plan is still pending. The financing mechanism for Energy energy efficiency measures as well as human capacities for the management of national funds remain weak. The legislative gap related to the energy efficiency of buildings needs to be completed in order to accelerate implementation of the long-term building renovation strategy. 3) **Partial implementation:** Amendments to the Law on Energy were adopted in July 2023 in line with the provisions from the EU Third Energy Package, and among others, the provisions of Directive 2009/72 from the common rules for the internal electricity market and common rules for the internal market of natural gas. The law establishes the Commission for Energy Networks as an independent and autonomous body of the Republic of Serbia that is responsible for controlling the operation of electricity transmission system operators and natural gas transmission system operators founded by the Republic of Serbia, or in majority ownership. The Commission started its activity in November 2023 but has yet to become fully operational. The final certification of Transportgas Srbija and Yugorosgaz is still pending as well as certification of storage operators.
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.	There was **limited implementation** of PG 6: 1) **No implementation:** There were no substantial increases in 2023, only inflation adjustments FSA was increased by 323 RSD and child allowance by 61 RSD. 2) **Limited implementation:** The number of

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.	developed qualification standards in secondary vocational education and training (VET) has slowly increased, while higher education is yet to see the development of qualification standards and to be linked with quality assurance procedures in higher education. However, in order to have a meaningful impact on student skills development, this is still to be followed by the development of modernised curricula, teacher training and delivery in classrooms. Despite some increased focus on the set-up of regional VET training centres, the VET curriculum generally remains outdated. A major advance toward improving VET governance was the opening of the Office for Dual Education and the National Qualifications Framework (ODENQF) in November 2022.
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:** The Youth Guarantee Implementation Plan was adopted in December 2023, which a piloting of the Youth Guarantee from 2024 to 2026. The implementation of the Youth Guarantee has yet to start.

ANNEX 2: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government adopted the Economic Reform Programme on 28 December 2023 and formally submitted it to the Commission on 15 January 2024. The programme is in line with the medium-term fiscal strategy and the 2024 budget and covers 2024-2026.

Inter-ministerial coordination

Preparation of the 2024-2026 ERP was coordinated by the Ministry of Finance (the Minister of Finance was appointed as national coordinator). 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 macro-fiscal part) and various line ministries (for the part on structural reform measures). Several training courses for those involved in preparing the document were organised. As a novelty in these years' ERP cycle, the preparation process for Chapters 2 and 5, Tables 10a, 10b and 11, and Addendum 2 benefited from greater digitalisation through the ERP portal. ERP drafting benefited from financial and technical support from the governments of Switzerland and Germany, through the German Agency for International Cooperation (GIZ).

Stakeholder consultation

The national authorities involved stakeholders in the preparation of the document and from September to December 2023 held several rounds of consultation on the draft ERPSepember. Stakeholders were invited to provide comments through an online e-consultation portal. 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. A large number of suggestions and comments of interested parties from the previous cycle were taken into account in the current ERP cycle.

Macroeconomic framework

The programme presents a clear and concise picture of past developments. It also covers all relevant data at the time of drafting. The macroeconomic framework is sufficiently comprehensive and coherent. The baseline macroeconomic scenario is broadly plausible and major uncertainties and risks are clearly outlined and recognised. The programme presents an alternative macro-fiscal scenario 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 high global uncertainty.

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 budgetary 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 the European System of Accounts 2010.]

Structural reforms

Reporting on implementation of the 2023-2025 structural reform measures is detailed and up to date. The ERP presents six broad reform areas broken down into various specific activities. The annexed tables have been filled in correctly.

9. TÜRKIYE

9.1. EXECUTIVE SUMMARY

The ERP projects a soft-landing scenario for Türkiye, with economic growth slowing down temporarily and imbalances declining on the back of a welcome macroeconomic policy normalisation. The Turkish economy continued expanding in 2023, with real GDP growth at 4.5%, slightly above the ERP projection but somewhat lower than in the previous year. Domestic demand was still very strong, fuelled by expansionary policies implemented before the May 2023 parliamentary and presidential elections. Economic growth is projected to slow to 4.0% in 2024, before rebounding to 5.0% in 2026 as domestic demand growth cools down to more sustainable levels. The macroeconomic scenario appears more plausible than last year, although it remains somewhat optimistic about the prospects for growth in the medium term. The projected economic rebalancing will be helped by the ongoing policy normalisation that saw a very substantial monetary tightening: the Turkish central bank raised its key policy rate between June 2023 and March 2024 from 8.5% to 50.0% and has taken steps to gradually unwind some of the many distortive macroprudential measures that were introduced to sustain the previous policy regime of extremely low real interest rates. Tighter economic policies are helping to curb external imbalances and capital inflows have trickled back. This has supported the exchange rate and boosted foreign-exchange reserves. However, attracting long-term capital remains a challenge. As inflation still remains very high (standing at close to 70% year-on-year in early 2024), maintaining a tight monetary policy stance remains key to firmly consolidating the disinflation process and anchoring inflation expectations. The banking sector so far has adapted relatively smoothly to the changed policy environment.

Corrective measures helped contain the 2023 budget deficit, and the ERP projects an expenditure-based fiscal consolidation in the medium term. The central government budget deficit is estimated to have increased to 5.2% of GDP in 2023, below the revised target of 6.4% of GDP. Nevertheless, the deficit was much higher than in the previous year and in the original budget because of large earthquake-related costs and pre-election spending in 2023. The ERP optimistically expects the primary balance to improve significantly (by 5.1 percentage points between 2023 and 2026) and to reach a surplus of 1.2% of GDP by 2026. The fiscal adjustment relies heavily on the expiration of earthquake-related expenditure (around 3% of GDP), while increasing tax revenue and current spending at the expense of more productive capital expenditure. On current projections, the 2024 central government budget deficit is likely to be significantly below the target of 6.4% of GDP due to better revenue performance and under-execution of expenditure (mostly of earthquake-related spending). The ERP projects that the government debt ratio will hover at or below 35% of GDP in 2024-2026, helped by still-high inflation, strong economic growth, and a projected primary surplus. Fiscal risks have declined, in particular due to steps taken to unwind the FX-protected lira deposits scheme. At the same time, the weak institutional underpinnings of the budgetary framework and a lack of fiscal anchors have been evident in the series of decisions that substantially increased non-discretionary government expenditure.

The main challenges facing Türkiye are the following:

- **Sustaining a sufficiently tight monetary policy until it consolidates the ongoing disinflation process and durably reduces external imbalances, while managing a projected steep deceleration in domestic demand.** Although monthly inflation has subsided strongly since last summer, inflation remains very high and the ERP forecasts that annual inflation will fall below 10% only in 2026. Monetary policy will therefore need to remain tight for the foreseeable future and to continue gradually unwinding the distortive macroprudential measures. Policy credibility should be further underpinned by strengthening central bank independence.

- **Reducing the budget deficit and improving the quality of public finance.** Pre-election expenditure and earthquake-related spending have strained the budget and worsened its structure. The authorities already took some measures in 2023 to correct the deficit, and they expect a sizeable improvement in the budget balance over the 3 three years, which would support the disinflation process. However, the budget deficit is still very high, while the quality and composition of expenditure could be made more growth friendly. Both the medium-term budgetary framework and the budget process are weak and prone to revisions.
- **Raising the skills level to increase employment, in particular of women and young people.** The employment rate (for those aged 15+) slightly increased to 48.3% in 2023, from 47.5% in 2022. However, the significant gap between male and female rates of employment persists. In 2023, the employment rate for men was 65.7% against only 31.3% for women, leading to a wide gender-employment gap of 34.4 pps. To further facilitate the entrance and re-entrance of women into the labour market, Türkiye needs to both actively encourage women's participation in on-the-job training and step up the provision of childcare facilities. Similarly, young people still face difficulties entering the formal labour market despite the significant decrease in the youth unemployment rate (15-24) from 19.4% in 2022 to 17.4% in 2023. The rate of young people not in employment, education or training (NEET) slightly improved, but remains high at 29.8% in 2023. Overall, there is a need to facilitate the swift entrance of workers to the labour market and reduce the skills gap as the economy develops, especially in the green and digital sectors.
- **Improving transparency and predictability in the regulatory and institutional environment affecting businesses.** Türkiye has been making progress in digitalising government services for businesses, and has taken steps to develop alternative dispute-settlement mechanisms. However, improvement is still needed in key aspects of the business environment such as: (i) introducing effective measures to strengthen the rule of law; (ii) ensuring appropriate and timely contract enforcement; and (iii) improving the availability and functioning of dispute-settlement mechanisms. Strengthening the legal framework for state intervention by making it more transparent, accountable, and predictable is also a crucial requirement for creating a more favourable business environment. The persistent and serious backsliding in the judicial system continues to undermine business trust in judicial efficiency and independence. Legislation to implement State-aid rules is long overdue, and its absence hinders enforcement and transparency. Türkiye still lacks preventive and anti-corruption bodies, and serious deficiencies in the anti-corruption legal framework have allowed undue political influence in public resource allocation. Due to several exceptions permitted under the law, public procurement remains especially prone to corruption. The enforcement of intellectual property rights continues to be very weak. Access to long-term finance for small and medium-sized enterprises (SMEs) remains limited, especially in local currency.
- **Pursuing climate neutrality, energy security and the economy's green transition, in particular by boosting energy efficiency.** The adoption of a new Climate Law and subsequent establishment of a national emissions trading system (ETS) aligned with the EU ETS with a sufficient level of ambition remain crucial for the economy's cost-effective decarbonisation and competitiveness. To support the objectives set out in Türkiye's national energy plan (2023-2035), 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 the context of 'Climate Change Mitigation Strategy and Action Plan (2024-2030)' and 'Climate Change Adaptation Strategy and Action Plan (2024-2030)', Türkiye should effectively implement a long-term low-emission development strategy and address the energy-intensive and hard-to-abate sectors also using alternative fuels such as renewable hydrogen. Türkiye continues to turn to Russia for fossil-fuel imports and nuclear energy. An increased use of renewable-energy sources and greater energy efficiency are essential for both transitioning to energy that is sustainable and secure and dealing with the risks posed by the changing international energy market. Türkiye could help to lower energy dependency and create new opportunities for businesses by further encouraging the development of renewable-energy

installations, in full compliance with its obligations under the Customs Union with the EU. Overall, much more ambitious climate and environment policies need to be established and implemented to create the necessary enabling environment for the transition to a more modern and competitive economy.

Notwithstanding a welcome macroeconomic policy normalisation, the implementation of the policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2023 has overall been limited. Monetary and fiscal policy tightened after the May 2023 elections. The government continued providing subsidies to state-owned enterprises in the energy sector, and took measures to support citizens and businesses affected by the earthquakes. The medium-term fiscal consolidation strategy relies largely on the expiration of one-off policy-support measures. Contrary to policy commitments, there are still many tax exemptions and tax-reduction schemes in place. The authorities have taken steps to gradually exit the FX-protected deposits scheme. Recent policy documents have set a target of amending the public procurement law by the end of the second quarter of 2024. No progress was made towards adopting a fiscal rule and the setting up of an independent body to monitor its implementation. The central bank took steps to simplify the micro- and macro-prudential framework, providing more guidance and reinforcing its communication. The recommendation on carbon pricing has not materialised into concrete legislative changes to date due to the significant delay in the adoption of the Climate Law. This delay has impacted the implementation of an ETS system. Limited reform measures have been announced on the business regulatory environment, once again falling short of addressing key challenges. Some steps have been undertaken to streamline commercial disputes. Similarly, limited measures have been adopted for NEETs to improve the quality and access to vocational education and training (VET). As regards support investments for care in the earthquake-affected regions, the need for healthcare services including mental health and psychosocial services remains unmet. Additionally, active labour market policies aimed at faciliating women's entrance to the labour market have had little structural impact thus far.

9.2. ECONOMIC OUTLOOK AND RISKS

Economic growth and domestic demand remained robust in most of 2023, but high-frequency indicators point to a slowdown of economic activity at the end of the year ([133]). Türkiye's economic growth was strong but unbalanced last year, with a very strong domestic demand contribution fuelled by expansionary policies (strong consumer lending and wage increases) implemented before the May parliamentary and presidential elections. Real GDP growth was 4.5% in 2023, slightly above the ERP projection but somewhat lower than the 5.5% expansion recorded in 2022. Growth in household consumption decelerated in the second half of 2023 but remained very strong, despite the tightening of monetary and fiscal policy. Trade sales growth decelerated further in the second half of 2023, and industry also showed signs of weakening output, after reaching record-high levels of production in the previous year. Nevertheless, investment activity picked up in 2023, with buoyant machinery and equipment investment. The contribution of net exports to economic growth was negative, both because of the high real growth of imports and because of declining exports, which were held back by subdued foreign demand despite a modest recovery in the second half of the year.

The ERP forecasts a 'soft-landing' scenario and a rebalancing of the Turkish economy, with domestic demand growth slowing down to more sustainable levels. Economic growth is projected to moderate to 4.0% in 2024, before rebounding to 5.0% in 2026, slightly below the estimates of last year's programme. The strong deceleration in household consumption growth is seen as the main driver of economic rebalancing and the main check on excess demand. Public consumption

([133]) Macroeconomic and fiscal estimates and forecasts covering the period 2023-2026 have been taken from the ERPs themselves. If available, preliminary macroeconomic and fiscal outturn data for 2023 have been taken from the relevant national sources (Turkish Statistical Institute, Ministry of Treasury and Finance, Central Bank of the Republic of Türkiye).

and investment are also expected to support this rebalancing, albeit to a lesser extent. As a result, the contribution of net exports to growth is forecast to turn slightly positive in 2024-2026, as the recovery in exports consolidates and import growth moderates. The reliability of estimates of the cyclical position of the economy continues to be affected by high domestic economic volatility and the large external shocks of recent years. Nonetheless, the ERP estimates that the output gap will turn negative as soon as 2024 and widen further in the following years. Potential growth is projected to be in the range of 4.8-5.0% in 2024-2026. By factors of production, capital (2.0 pps per year on average) is forecast to remain the main growth driver, followed by employment (1.7 pps per year on average) and total factor productivity (TFP) (0.8 pps per year on average). However, the programme expects the contribution of capital to decline at the expense of rising shares of employment and TFP.

Table II.9.1:
Türkiye - comparison of macroeconomic developments and forecasts

	2022		2023		2024		2025		2026	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	5.5	**5.5**	4.2	**4.4**	3.5	**4.0**	4.0	**4.5**	n.a.	**5.0**
Contributions:										
- final domestic demand	11.3	**12.5**	8.5	**9.9**	3.1	**4.0**	3.5	**4.6**	n.a.	**4.9**
- change in inventories	-7.0	**-7.7**	1.4	**-2.5**	0.0	**-0.5**	0.0	**-0.3**	n.a.	**-0.2**
- external balance of goods and services	0.5	**0.7**	-5.7	**-2.9**	0.5	**0.4**	0.5	**0.2**	n.a.	**0.3**
Employment (% change)	6.6	**6.8**	3.0	**2.9**	2.4	**2.4**	2.7	**2.8**	n.a.	**3.1**
Unemployment rate (%)	10.5	**10.4**	10.0	**10.1**	10.2	**10.3**	9.8	**9.9**	n.a.	**9.3**
GDP deflator (% change)	96.0	**96.0**	63.7	**62.6**	58.6	**55.3**	24.3	**23.1**	n.a.	**13.4**
CPI inflation (%)	72.3	**64.3**	55.4	**65.0**	53.6	**33.0**	22.9	**15.2**	n.a.	**8.5**
Current account balance (% of GDP)	-5.4	**-5.4**	-4.0	**-4.0**	-2.9	**-3.1**	-2.7	**-2.6**	n.a.	**-2.3**
General government balance (% of GDP)	-2.3	**-0.8**	-6.0	**-6.5**	-6.0	**-6.0**	-3.5	**-3.0**	n.a.	**-2.5**
Government gross debt (% of GDP)	31.7	**30.8**	32.0	**33.3**	33.0	**35.2**	32.8	**34.6**	n.a.	**33.2**

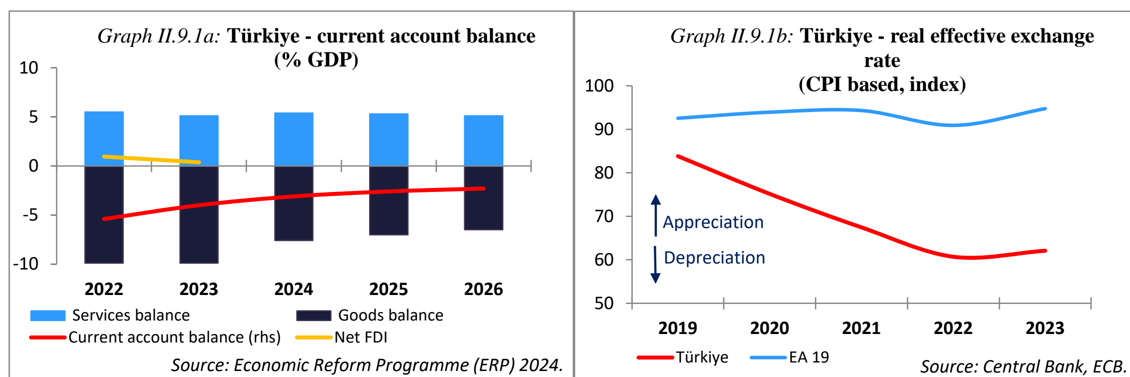
Sources: Economic Reform Programme (ERP) 2024, Commission Autumn 2023 forecast.

The ERP's macroeconomic scenario for 2024-2026 appears more plausible than the scenario that Türkiye set out in the previous ERP, although its projected growth path remains somewhat optimistic. The main economic policy challenge is to sustain the current tight economic policy until it consolidates the ongoing disinflation process and durably reduces external imbalances, while managing the ongoing steep deceleration of domestic demand to avoid a 'hard landing'. Given the highly uncertain global environment and the need for a tight policy stance, the ERP's growth assumptions may easily be tested, calling for a more prudent baseline scenario. The forecast export profile looks plausible, although it is subject to risks related to the growth performance of major trading partners in the EU. The macroeconomic outlook continues to be affected by a high degree of uncertainty related to the economic fallout from geopolitical conflicts in the region, in particular the effects that these conflicts might have on energy supply and inflation. With the balance of risks tilted to the downside, the repeated failure to present an alternative scenario in the ERP remains a drawback of the programme.

Decisive policy action has brought some results, but inflation remains very high and the disinflation process will be lengthy. Under new leadership, the central bank raised its key policy rate between June 2023 and March 2024 from 8.5% to 50.0%, to positive territory in ex-ante real terms. It has also taken steps to unwind some of the many distortive macroprudential measures that were introduced to sustain the previous policy regime of extremely low real interest rates. The new policies were instrumental in improving inflation expectations and external financing conditions, while strengthening foreign-exchange reserves and exchange-rate stability. Monthly inflation has decelerated strongly to 2.9% month-on-month in December 2023 (with core inflation falling below the headline rate), although due to base effects inflation accelerated in year-on-year terms to 64.8%. Inflation increased in early 2024, as expected, but remained within the 'expectations corridor' of the central bank. The ERP forecasts that annual inflation will peak by mid-2024, before declining rapidly to 33% (an ambitious target) at the end of the year, and to fall below 10% only in 2026. The authorities

are aware that they need to maintain a tight monetary policy stance until they have firmly consolidated the disinflation process and anchored inflation expectations. Although monetary policy transmission has improved significantly since summer 2024, restoring policy credibility in a sustainable manner would need to be further complemented and better underpinned by strengthening central bank independence.

External competitiveness and current account



A tighter policy stance would help curb external imbalances. The current account deficit fell to 4.1% of GDP in 2023. The ERP forecasts a steady decline in the deficit to 2.3% of GDP in 2026, as lower domestic demand crimps import growth and economic stability reduces non-monetary gold imports, which are considered a safe asset in times of heightened volatility. Energy-efficiency measures and lower international energy prices are also expected to reduce the energy import bill. After steady gains in price competitiveness for about a decade, the average CPI-based real effective exchange rate has remained broadly stable since early 2022, while the producer-price-based exchange rate has appreciated. Türkiye's tradable sector has expanded to new markets and products in recent years. Although it went through a year of sluggish performance since the end of 2022, due to weak external demand, goods exports rebounded in the last quarter of 2023, while exports of travel services reached historic highs in the summer. The ERP projects moderate export growth in the coming years, boosted by efforts to further develop Türkiye as an energy, financial, and logistics centre.

Capital inflows have trickled back since the 2023 elections, but attracting long-term capital remains a challenge. The balance of payments faces relatively low financing risks, and access to foreign finance has been uninterrupted even in times of economic stress, albeit at elevated costs. Portfolio and other investment inflows have increased recently, attracted by the progress of economic policy normalisation since the 2023 elections. Short-term financial inflows have surged from a very low level, making it possible to replenish foreign-exchange reserves, which reached a historically high level in 2023, although net reserves remained very low. The external debt roll-over ratio picked up to above 100% for both the banking and the non-banking sectors by the end of 2023. The open net foreign-exchange position of non-financial companies improved further in 2023, while their short-term position remained in surplus. External debt declined to around 46% of GDP in 2023. The authorities are committed to reducing Türkiye's reliance on volatile short-term capital inflows over the medium term. However, FDI inflows (at 1% of GDP in 2023) remain significantly below the economy's potential. Türkiye will need to ramp up structural reforms and improve policy credibility if it wants to rely more on FDI to underpin a sustainable expansion, modernisation, and the long-term financing of its economy.

The banking sector has adapted relatively smoothly to the changed policy environment. Since mid-2023, the central bank introduced new selective tightening measures to supress consumer lending and support lending for exports, investment, and SMEs. As a result, real lending declined, although corporate lending in lira picked up. However, the pace of growth in credit-card debt has remained very high. The quality of the loan portfolio held by Turkish banks has remained satisfactory. The non-performing loan ratio fell to 1.5% in 2023 (although this percentage was still affected by forbearance measures). Loan-loss provisioning remained high, and the collection of impaired loans

improved, helped by the high inflation. As economic activity is set to cool down in 2024, credit risk is likely to increase, especially for credit-card and SME loans which require close monitoring. Commercial banks have remained stable and well capitalised, although the 19.1% capital adequacy ratio in 2023 is also affected by forbearance measures and capitalisation of state-owned banks remained in general lower. Turkish banks had shortened the average duration of their lira loans long before the central bank increased interest rates, which helped their adjustment to the tighter monetary policy stance. However, net interest margins fell, while profitability and returns on both assets and equity declined in 2023.

The central bank has taken steps to gradually simplify the macroprudential framework. Since June 2023, there has been a new period of tight monetary policy and Türkiye has begun to address negative repercussions from earlier macroprudential measures on the financial sector. Given this situation, the authorities proceeded with a gradual unwinding of some of these measures. The securities-maintenance requirements were partially removed and targets to convert FX-protected deposits to ordinary lira deposits were abolished. The authorities also announced their intention to end in 2024 the FX-protected deposit scheme. This scheme had long had a direct and sizeable impact on the budget and remains a significant source of (contingent) budget liabilities, after it was fully transferred (deposits that were originally in turkish lira) to the central bank in July 2023. As a result of these steps, the share of lira deposits has increased markedly since September (when it was at 34.4%) to 42.2% in December, mainly due to a fall in FX-protected deposits. The central bank also took steps to sterilise the excess lira liquidity. Commercial banks continued to have high exposure to the central bank, due to significant FX swaps with it.

Table II.9.2:
Türkiye - financial sector indicators

	2019	2020	2021	2022	2023
Total assets of the banking system (EUR million)	676	678	628	724	742
Foreign ownership of banking system (%)	26.0	25.0	25.9	24.9	25.0
Credit growth (%, average)	6.5	28.4	22.7	56.0	55.7
Deposit growth (%, average)	18.8	36.4	28.0	78.3	65.4
Loan-to-deposit ratio (end of period)	1.03	1.04	0.85	0.79	0.77
Financial soundness indicators (%, end of period)					
- non-performing loans to total loans *	5.4	4.1	3.2	2.1	1.6
- regulatory capital to risk-weighted assets	18.4	18.8	18.4	19.4	18.9
- liquid assets to total assets	10.0	9.4	13.3	11.6	14.2
- return on equity	11.5	11.4	15.5	49.9	41.5
- foreign exchange loans to total loans	38.0	34.0	42.2	32.6	32.0**

* including the impact of write-offs.
** Q3.
Sources: Central Bank of Türkiye, IHS Markit.

9.3. PUBLIC FINANCE

Corrective measures adopted in July 2023 have helped contain the increase in the budget deficit. Preliminary estimates show there was a significant increase in the general government and central government deficits in 2023, both to around 5.2% of GDP. The central government deficit was 1.2 pps. lower than the revised target, butwas much higher than both its level in 2022 (when it was only 1.0% of GDP) and the original budget target (3.5% of GDP). This was because of the large earthquake-related costs (3.7% of GDP) following the earthquakes in February 2023 (affecting more than 16% of the population) and pre-election spending on higher salaries and pensions in 2023. However, more than half of the recorded earthquake-related expenditure has not yet been effectively spent. The removal of the age requirement for early retirement added nearly 1% of GDP to budget expenditure in 2023, challenging the sustainability of the social security system. In July 2023, the

authorities adopted a revised 2023 budget, including sizeable tax increases (on VAT, corporate income, special consumption, motor vehicle taxes, etc.) to cover some of the additional expenditure and limit the impact of this additional expenditure on the deficit. They have also transferred to the central bank the obligation to pay the guarantee on the FX-protected deposits that were originally in turkish lira.

The fiscal scenario of the ERP targets an expenditure-based consolidation in the medium-term. The ERP expects the primary balance to improve significantly, by 5.1 pps between 2023 and 2026, allowing it to reach a surplus of 1.2% of GDP by 2026. After the strong fiscal expansion in 2023, the programme projects that budget revenue will stabilise at a higher level, while primary expenditure is set to decline steeply from 2025 as earthquake-related spending falls. Subsidies are also projected to come down, in particular to state-owned enterprises in the energy sector. Total expenditure is set to fall by 3 pps in 2024-2026, but remain elevated, significantly above its pre-earthquake level, due to a significant rise in interest payments (1.1 pps) and social transfers (2.1 pps) to cover higher pension expenditure related to the decision on early retirement. After peaking in 2023, government investment is forecast to gradually decline to 2.5% of GDP in 2025. Overall, the back-loaded fiscal adjustment relies heavily on the expiration of the earthquake-related expenditure (around 3 pps), while a significant rise in current spending is set to be compensated by both a greater tax-revenue ratio and lower capital expenditure. The authorities plan to support fiscal consolidation by pursuing ‘soft’ fiscal measures, like rationalising public expenditure, systematising spending reviews, broadening the tax base, and fighting the informal economy. Given the negative and growing output gap projected by the ERP, the forecast fiscal tightening would be pro-cyclical. The quality and credibility of the medium-term fiscal consolidation plan continues to be affected by a failure to present sufficiently detailed policy measures in the ERP.

Table II.9.3:

Türkiye - composition of the budgetary adjustment (% of GDP)

	2022	2023	2024	2025	2026	Change: 2023-26
Revenues	27.8	30.2	31.2	31.2	31.2	1.0
- Taxes and social security contributions	22.3	24.5	26.2	26.0	26.0	1.5
- Other (residual)	5.6	5.7	5.1	5.2	5.1	-0.5
Expenditure	28.6	36.7	37.2	34.2	33.7	-3.0
- Primary expenditure	26.5	34.1	34.2	30.7	30.0	-4.1
of which:						
Gross fixed capital formation	2.9	3.1	2.7	2.6	2.5	-0.6
Consumption	12.2	14.5	14.8	14.4	14.2	-0.3
Transfers & subsidies	5.2	7.6	8.4	7.2	7.2	-0.4
Other (residual)	6.3	9.0	8.3	6.6	6.1	-2.8
- Interest payments	2.2	2.6	3.1	3.5	3.7	1.1
Budget balance	-0.8	-6.5	-6.0	-3.0	-2.5	4.0
- Cyclically adjusted	-0.3	-5.6	-5.5	-2.8	-2.5	3.1
Primary balance	1.4	-3.9	-2.9	0.4	1.2	5.1
- Cyclically adjusted	1.9	-3.0	-2.4	0.6	1.2	4.2
Gross debt level	30.8	33.3	35.2	34.6	33.2	-0.1

Sources: Economic Reform Programme (ERP) 2024, Commission calculations.

The 2024 budget is conservative and based on more realistic macroeconomic assumptions than in the previous ERP, but addresses macroeconomic imbalances to a limited extent. The parliament approved the 2024 central government budget on 25 December 2023, planning a deficit for 2024 of 6.4% of GDP, which corresponds to a widening of the deficit by around 1 pp. compared to the 2023 outturn estimate. The budget is based on 4% real GDP growth and a GDP deflator of 55.3%. Total revenue is forecast to increase by 71.1% and expenditure by 69.0% in comparison to the estimated 2023 budget outturn. Around 3% of GDP is allocated to earthquake-recovery measures, which is somewhat lower than was allocated in in 2023. Government revenue and expenditure are both projected to increase, with higher tax revenue, public consumption, social transfers, and interest

payments. Overall, the planned budgetary stance and structure in 2024 is not sufficiently tight or sufficiently supportive of the stated objective of macroeconomic policy to reduce inflation and macroeconomic imbalances. However, given that the actual 2023 budget deficit and revenue outcome was better than the ERP estimate, the 2024 budget deficit could also turn out significantly below the target of 6.4% of GDP due to better-than-planned revenue performance and under-execution of expenditure (mostly of earthquake-related spending).

The 2024 budget is largely an extension of previous policies, and fiscal planning continues to be marred by ad-hoc measures. The key revenue and expenditure items mostly reflect policies adopted in July 2023 and before the May 2023 elections. However, the ERP does not present either detailed estimates of the budgetary effects of these measures or information on new policies. In addition, some of the one-off measures adopted in 2023 to finance recovery and reconstruction efforts (such as attracting donations from the central bank, state-owned banks, and state-owned enterprises) are also not mentioned, although they should reduce 2024 revenue. Details are missing on the major decision taken in early 2023 to remove the age requirement for early retirement, which has profound long-term implications for social transfers and the sustainability of the pension system. In a continuation of previous practice, new ad hoc measures affecting the budget (like a higher indexation of some pensions in January 2024) were adopted after the formal adoption of the budget.

BOX II.9.1: DEBT DYNAMICS

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

	2022	2023	2024	2025	2026
Gross debt ratio [1]	30.8	33.3	35.2	34.6	33.2
Change in the ratio	-10.9	2.5	1.9	-0.6	-1.4
Contributions [2]:					
1. Primary balance	**-1.4**	**3.9**	**2.9**	**-0.4**	**-1.2**
2. 'Snowball effect'	**-18.3**	**-9.6**	**-9.1**	**-4.1**	**-1.6**
Of which:					
Interest expenditure	2.2	2.6	3.1	3.5	3.7
Growth effect	-1.1	-0.8	-0.8	-1.2	-1.5
Inflation effect	-19.4	-11.4	-11.4	-6.3	-3.9
3. Stock-flow adjustment	**8.8**	**8.2**	**8.1**	**3.9**	**1.4**

[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) 2024, Commission calculations.

The ERP forecasts that government debt will remain broadly unchanged. In 2023, the government debt ratio declined slightly in comparison to the previous year to 29.5% of GDP (the outcome was below the ERP estimate), helped by the strong denominator effect from the very high inflation and the better budget deficit outturn. Nevertheless, net government debt increased to 21.2% of GDP from 16.8% in 2022, as falling net assets of the central bank drove total public sector net assets down to their lowest level in decades. High inflation is expected to remain the main debt-reducing factor in the coming years, but as inflation declines, its contribution is set to decrease substantially. The move to a primary surplus from 2025, and the projected real economic growth, are key factors supporting debt sustainability over the medium term, even if their combined debt-reducing effect is projected to be lower than that of inflation. Interest payments are forecast to increase

substantially and reach 3.7% of GDP in 2026, but these are likely overestimated in view of the underlying assumption in the ERP of a steady and significant rise in the implicit interest rate on government debt. The main debt-increasing contribution until 2025 will continue to come from the stock-flow adjustments, driven by the depreciation of the lira, although the new policy stance and lower rate of inflation are expected to lead to both a markedly slower rate of lira depreciation and much smaller stock-flow adjustments.

Debt metrics have improved but vulnerabilities remain. The authorities have taken measures to normalise the functioning of the government securities market by reducing regulatory interventions that had previously forced commercial banks to hold government debt denominated in lira ([134]). As a result, yields on government bonds, especially at the short end of the yield curve have increased markedly since mid-2023. On the other hand, Türkiye's 5-year credit default swap spread has declined steadily since May 2023, from above 700 bps to under 300 bps at the end of 2023, although it is still above pre-2018 levels and that of peer countries. Reflecting continued liraisation efforts, the share of new domestic borrowing in lira remained very high at 86% in 2023, and the lira's share in the stock of government debt went up marginally to 35.8%. The average time to maturity of the domestic central government debt stock increased to 3.8 years in 2023, while the average time to maturity for the total debt stock fell to 5.3 years, driven by a further decline in the maturity profile of the external debt stock to 6.6 years, its lowest level since 2005. The banking sector's share in domestic debt holdings increased to a new high of 79%, and although non-resident investors have started to slowly return to the domestic government debt market, their share increased only marginally to 1.9% in 2023. Türkiye's sovereign credit-rating outlook improved as rating agencies noted the resolute steps taken by the government to normalise monetary policy.

Fiscal risks have declined but remain non-negligible. Some of these risks stem from the macroeconomic environment and the growth assumption, both of which may be challenged by: (i) external geopolitical and economic developments; and (ii) the possibility that the intended tight policy stance cools down the economy faster or more than expected. On the positive side, the steps taken to unwind and completely terminate the FX-protected lira deposits scheme in 2024 will likely remove one of the biggest sources of fiscal risk. However, until the scheme expires fully, its significant costs will be borne by the central bank, which will have indirect budgetary implications via its reduced profit. The monetary policy normalisation process will also bring additional costs related to the need to sterilise excessive lira liquidity. Although in the short-term there could be further delays in post-earthquake reconstruction efforts, over the medium-term the risk is that recovery costs may exceed budget estimates. Other risks stemming from contingent liabilities (like public-private partnerships and credit-guarantee schemes) seem manageable. The budget also contains some buffers, like the relatively large reserve appropriations (0.5% of GDP) and a generally prudent revenue and expenditure estimates. In addition, the government's liquidity preference has remained high, with public sector deposits and other financial assets at around 6% of GDP at end-2023.

The quality of public finance faces challenges. The tax increases in the summer of 2023 have reestablished the authorities' commitment to fiscal discipline, which had been challenged by the pre-election fiscal largesse in 2023. The ERP has maintained this commitment, although the marked rise in non-discretionary expenditure has not only strained public finance management, but undermined efforts to reduce macroeconomic imbalances and will likely require years to reverse. The budget process weakened in 2023, as important decisions with significant budget implications were taken without proper preparation and discussion, outside of the regular budget process. Public investment in human and physical capital is low and is expected to decline further. The many tax exemptions and reductions undermine the tax base. The consolidated framework for all public-private partnerships has yet to be adopted. It is expected that this framework will 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 in 2023, which makes it possible for contracting

([134]) Terminating the securities maintenance practice linked to the FX-protected deposit scheme and lira deposits; reducing the securities maintenance ratio for foreign exchange liabilities from 5% to 4%; but also extending the securities maintenance based on loan growth for another 6 months until mid-2024.

authorities to limit competition and transparency by referring to discretionary criteria that cannot be objectively measured. Further steps were taken in 2023 to strengthen the system of public internal financial control and improve administrative capacity.

The fiscal framework is weak and lacks anchors. The weak institutional underpinnings of the budgetary framework were evident in the series of decisions taken in 2023 that substantially increased non-discretionary government expenditure. The relatively limited budget deficits (net of earthquake-related effects) thus hide a fundamental policy weakness. It remains a weakness in the Turkish fiscal framework that there is a lack of national fiscal rules or independent fiscal institutions to: (i) monitor fiscal performance; (ii) review forecasts; and (iii) advise the government on fiscal policy matters. In addition, the medium-term budget framework is subject to frequent changes and is not sufficiently credible and binding. Macroeconomic forecasts underpinning budgetary planning have become more realistic but would benefit from more transparency about the estimated effects of various policy measures.

9.4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

The Commission has conducted an independent analysis of the Turkish economy to identify the key structural challenges the country faces in its drive to boost competitiveness and inclusive growth. In addition to the need to secure long-lasting macroeconomic stability and the ongoing post-earthquake recovery efforts, the Commission considers that the key structural challenges in relation to advancing competitiveness and long-term inclusive growth in Türkiye are:

raising the skills level to increase employment, in particular of women and young people;

improving transparency and predictability in the regulatory and institutional environment affecting businesses; and

pursuing climate neutrality, energy security and the economy's green transition, in particular by boosting energy efficiency.

Türkiye needs to improve the rule of law and judicial independence and strengthen its institutions to promote competitiveness and attract foreign investments. Addressing these fundamental concerns is a prerequisite for successfully transforming the economy. Furthermore, the country should urgently adopt a Climate Law, notably to establish a domestic ETS aligned with the EU's.

Key structural challenge 1: Raising the skills level to increase employment, in particular of women and young people

Türkiye's labour market indicators have remained on a positive upward trend in recent years with an increased employment rate (among those aged 15+) from 47.5% in 2022 to 48.3% in 2023. The unemployment rate (15+) decreased from 10.4% in 2022 to 9.4% in 2023. The unemployment rate for women decreased from 13.4% in 2022 to 12.6% in 2023. However, the composite measure of labour underutilisation increased to 22.8% in 2023 (31.0% for women) due to higher time-related underemployment.

Despite the overall economic upturn, the significant gap between male and female employment persists. In 2023, the employment rate for men was 65.7% against only 31.3% for women, leading to a wide gender-employment gap of 34.4 pps. Female labour-force participation recorded a slight increase in 2023 but remained low at 35.8%. Barriers in certain occupations, traditional gender roles, and a lack of skills continue to restrict female labour force participation. In particular, limited childcare facilities remain a crucial challenge, and there are no dedicated measures to step up their provision. The disadvantaged position of young women in the labour market has become entrenched, resulting in their lack of participation in on-the-job training to upgrade their professional skills. Policies aimed at the activation of women in the labour market have been too limited in scope and budget, yielding only limited results.

The youth unemployment rate (aged 15-24) significantly decreased from 19.4% in 2022 to 17.4% in 2023, but young people still have difficulties entering the labour market. While the rate of young people who are not in education, employment or training (NEET) decreased from 32.3% in 2022 to 29.8% in 2023, it remains structurally high, especially for women (36.4%). The implementation of National Youth Employment Strategy and Action Plan (2021-2023), including activities to promote career guidance and vocational training, was completed by the end of 2023. No official announcement has been made yet for the extension or the new version of the strategy and action plan. Türkiye must upgrade its school, tertiary, and vocational training system to provide its young people with good employment opportunities and bring its NEET rate closer to the EU average of 11.7% (2022). To provide more economic opportunities for young people in Türkiye, especially young women, active labour market policies and activation schemes inspired by the EU Youth Guarantee are still needed.

In the ERP (2024-2026), Türkiye introduced reform measure 6 on 'Enhancing and improving the employment services in line with the needs of the labour market'. This reform measure seeks to bring together a variety of activities and targets to ensure that the Turkish Employment Agency (İŞKUR) provides better employment services. The measure is very appropriate considering the need to improve employment services in line with the needs of the labour market. The measure's prioritisation of women, young people and people with disabilities is also highly appreciated. However, the planned activities were already deployed in previous years and suffer from a lack of strategic and innovative measures beyond the already established virtual employment fairs. Considering the advantages they provide, especially in reaching a high number of people, the organisation of virtual fairs is a relevant and feasible activity. The 'Future Professions' measure in the previous ERP (2023-2025), could have been incorporated under this measure considering the importance of digital skill development.

Vocational education and training (VET) have the potential to facilitate swift entrances to the labour market and reduce the skills gap as the economy develops, in particular in the green and digital sectors. The labour market uptake is better for VET-trained students than students with traditional tertiary-level education. In the secondary, technical and vocational schools, and in the vocational training centres of the Ministry of National Education, curricula are being updated. These curricula are being updated according to the occupational standards and qualifications developed by Türkiye's Vocational Qualifications Authority for all occupations related to the green and digital transformation. Recognition of Prior Learning (RPL) is also partly implemented in the Vocational Training Centres. However, for a full implementation of the RPL, this practice needs to be applied to all levels of occupations and needs to also be recognised by the formal VET institutions. More work-based learning, such as dual education, and a focus on practical skills, would help make VET education more practically relevant and would facilitate school-to-work transitions. Businesses in Türkiye struggle to find staff with the right skills, leading to labour shortages, in particular in manufacturing and logistics, thus hampering the further growth prospects of the economy. By progressively applying EU quality frameworks for traineeships ([135]) and apprenticeships ([136]), Türkiye could improve the quality and relevance of work-based learning opportunities and thus make VET more attractive to students.

Türkiye consistently aligns its VET policy with the EU Skills Agenda and the Osnabrück Declaration (2020), while leveraging EU technical and financial support to enhance VET provisions. 'Improving the Quality of Vocational Education and Training Through Establishment of Sectoral Centres of Excellence Operation' has played an important role in Türkiye's progress towards achieving policy goals. In addition, Türkiye's ongoing collaboration with the European Training Foundation (ETF), most recently through the ETF's Network for Excellence, is instrumental in advancing VET excellence in line with EU initiatives. Türkiye also participated in the European Year of Skills, which is commendable.

Reform measure 5 on 'Skill-based updating of curriculum at all levels within the scope of green and digital transformation and developing a system for recognising previous learning by strengthening vocational training centres' was introduced in the 2024 ERP. This is a very welcome reform step on the

([135]) Council recommendation of 10 March 2014 on a European Quality Framework for Traineeships.

([136]) Council recommendation of 15 March 2018 on a European Framework for Quality and Effective Apprenticeships.

country's path towards the digital and green economy. However, it needs to be closely followed up by relevant authorities, especially in terms of updating of the curricula for all levels of education as part of the twin transition and aligning skills with the needs of the green and digital sectors. In addition, the measure comprises updates of curricula from pre-school to 8th grade, which is a running exercise that was already initiated under the Education Vision 2023 programme of the Turkish government.

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

Despite the shift towards more conventional economic policies in the second half of 2023, several structural barriers remain, as the institutional and regulatory environment lacks predictability and transparency. The size of the informal economy still accounts for a significant share of economic activity, and the government has therefore underlined the fight against the informal economy as a key priority in its 2024 budget. The persistent serious backsliding regarding the judicial system continues to undermine business trust in judicial efficiency and independence. The enforcement of intellectual property rights also continues to be very weak. Furthermore, the reform of the bankruptcy system has yet to bring results, while procedures are still costly and slow, with a low recovery rate. Türkiye has made progress in digitalising government services for businesses, and has also taken steps to develop alternative dispute-settlement mechanisms. Nevertheless, effective measures to strengthen the rule of law, ensure appropriate and timely contract enforcement, and improve the availability and functioning of dispute-settlement mechanisms remain key actions that must be implemented to improve the business environment.

Strengthening the legal framework for state intervention by making this framework more transparent, accountable, and predictable is also a key requirement for a more favourable business environment. The Customs Union with the EU requires Türkiye to set an independent and effective framework for state aid control. Increased state interference in the economy and the failure to monitor state aid prevents the market-based consolidation of a level playing field for businesses. 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, and Türkiye has not yet formally set up a comprehensive and transparent state inventory of all aid schemes, despite the obligations stemming from the Customs Union.

It is of concern that the Türkiye Wealth Fund (TWF) and the Savings Deposits Insurance Fund (SDIF) remain largely exempt from fiscal discipline, transparency requirements, accountability and competition. These shortcomings contribute towards the disruption the smooth functioning of the market. Another factor causing disruption to Turkish financial markets is widespread distortion in the allocation of government contracts and assets. Türkiye still lacks preventive and anti-corruption bodies, and serious deficiencies in the anti-corruption legal framework have allowed undue political influence in public resource allocation. Due to several exceptions permitted under public procurement law, public procurement remains especially prone to corruption. Predictability in the institutional and regulatory environment is crucial to attracting foreign investment. Nevertheless, major obstacles discouraging potential investors remain unaddressed. These obstacles include difficulties in getting approvals, weak enforcement of industrial and property rights, and hidden market restrictions.

Despite strong economic growth in 2023 (4.5%), access to long-term finance for SMEs remains limited. SMEs are mostly financed through short-term loans in a highly inflationary environment. Türkiye has taken further steps to provide equity-based finance opportunities for early-stage companies and via capital markets. However, microfinancing systems (non-bank financing) are not widespread, and the current macroeconomic situation with high inflation rates and high interest rates make access to long-term finance difficult for SMEs.

Regarding measure 2 on 'Promoting Sustainable Tourism and Branding', the tourism sector is considered as one of Türkiye's globally competitive sectors, and tourism revenues contribute significantly to the development of the economy, the improvement of the trade balance and thus to the reduction of the current account deficit. However, this sector is highly vulnerable to pandemics,

global economic and political developments, natural disasters, and rapidly changing consumer preferences. In this respect, the continuation and further development of this measure from previous ERPs is welcomed. For further improvements, sustainable tourism activities and infrastructure should be improved in the regions with important natural, historical and cultural assets (such as the Black Sea, and Eastern and Southeastern Anatolia).

Key structural challenge 3: Pursuing climate neutrality, energy security and the economy's green transition, in particular by boosting energy efficiency

Türkiye faces critical environmental and climate challenges, both in terms of mitigation and adaptation to climate change. In the recent years, a number of documents ([137]) have been adopted to comply with the policies of combating global climate change and to support green transformation in line with the European Green Deal. However, Türkiye urgently needs to adopt a new Climate Law, in particular to establish a domestic ETS aligned with the EU's. The environment-related government R&D budget, as a percentage of total government R&D, has been gradually decreasing since 2010.

On energy, Türkiye announced ambitious goals when it published its national energy plan (2023-2035) in January 2023. The declared goal is to increase the share of renewable energy in primary energy consumption from 16.7% currently to 23.7% in 2035, and the share of nuclear energy from zero to 5.9% in 2035. To support these objectives, it will be vital to continue coordination between energy subsidies, taxation and overall green policies, in particular a phase-out of fossil fuel subsidies and increased taxation weighing on fossil energy compared to renewablesIn the context of 'Climate Change Mitigation Strategy and Action Plan (2024-2030)' and 'Climate Change Adaptation Strategy and Action Plan (2024-2030)', Türkiye should effectively implement a long-term low-emission development strategy and address the energy-intensive and hard-to-abate sectors also using alternative fuels such as renewable hydrogen. Another key success factor for rapid decarbonisation consists in redirecting domestic financial flows towards sustainable investment. Türkiye has taken initial steps towards establishing a national sustainable finance taxonomy. This is an encouraging first step that should help mainstream sustainability across the entire Turkish financial sector.

Türkiye continues to be an important transit country for the EU but continues to turn to Russia for fossil-fuel imports and nuclear energy. 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 continues to invest in becoming a natural gas hub thanks to the country's existing infrastructure of pipelines, LNG terminals, gas-storage facilities, a gas exchange, and a balancing system. Achieving a balance between energy security, growing demand and decarbonisation can only be achieved through ensuring affordable, green and stable energy supplies for sustainable economic development. Increased use of renewable-energy sources and greater energy efficiency are essential for transitioning to an energy system that is sustainable and secure, and for dealing with the risks posed by the changing international energy market. Therefore, much more ambitious climate and environment policies need to be established and implemented to create the necessary enabling environment for the transition to a more modern and competitive economy ([138]). 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 reduce energy dependency and create new opportunities for businesses. Additionally, as Türkiye outlined in the ERP (2024-2026), green and circular economy goals, including new laws, must be addressed.

([137]) They include: Türkiye's Green Deal Action Plan of 2021, the 2021 Green Growth Technology Roadmap, the Türkīye Solar Energy Technologies Strategy and Roadmap of 2022, and the Türkīye Hydrogen Technologies Strategy and Roadmap of 2023. For the green and digital transitions, TÜBİTAK's Priority R&D and Innovation Areas Study (2022-2023) includes priority topics focusing on digitalisation and green technologies.

([138]) Infrastructure investments need to comply with the EU environmental acquis, national and international nature protection, and water management obligations, ensure public participation and consultation, and guarantee high quality environmental impact assessment reports that include cumulative impacts on nature and biodiversity.

In measure 3 on ‘Accelerating green transformation’, there are clear action points related to legislative steps to develop the green taxonomy, and to start a pilot implementation of the ETS. However, in the absence of the expected Climate Law, the timelines for these action points presented are not realistic without a clear supportive regulatory framework. The ETS should be compatible with the EU. Measure 1 on ‘Supporting the modernisation of SMEs and increasing their efficiency and competitiveness through digital transformation and green transformation in the manufacturing industry’ is a positive and welcome reform measure. All related actions under this measure should follow an integrated and coordinated approach towards the green and digital transformation of industry, including the establishment of clear climate policies. To facilitate this transformation, the preparation of a National Circular Economy Action Plan in Türkiye is encouraged, as the circular economy can also strengthen the industrial base and foster business creation and entrepreneurship among SMEs. Overall, an improvement in the design of this measure can be observed compared with previous years.

9.5. THE POLICY GUIDANCE

JOINT CONCLUSIONS OF THE ECONOMIC AND FINANCIAL DIALOGUE BETWEEN THE EU AND THE WESTERN BALKANS PARTNERS, TÜRKIYE, GEORGIA, REPUBLIC OF MOLDOVA AND UKRAINE

The Economic and Financial Dialogue between the EU and the Western Balkans Partners, Türkiye, Georgia, Republic of Moldova and Ukraine

Brussels, 14 May 2024

[…]

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

1. Maintain a tight macroeconomic policy mix until the disinflation process is firmly established. Use any revenue overperformance as well as fiscal buffers on the expenditure side to lower the 2024 budget deficit compared to the ERP target. Present a medium-term fiscal strategy that includes specific consolidation measures to support the envisaged gradual return to a primary surplus of at least 1% of GDP.
2. Reduce fiscal risks by – inter alia – gradually phasing out the FX value guarantees on lira time deposits. Expand the tax base by streamlining tax exemptions and reductions and reducing informality. Take gradual steps to phase out subsidies on fossil fuels.
3. Ensure a sufficiently tight monetary policy stance to entrench further disinflation and anchor inflation expectations, continue the simplification of the complex macroprudential measures and the regulatory framework to strengthen monetary transmission while maintaining financial stability. Underline central bank independence as the institutional basis for sustainably achieving price stability and underpinning monetary policy credibility. Enhance risk-based supervision in line with best international and European practices, including by further improving the transparency and efficiency of the regulatory framework by removing regulations that hamper market-based credit allocation and loan pricing, and enhance confidence by conducting transparent asset quality reviews and publish its methodology and outcomes.
4. Implement legislation and enhance transparency, accountability, and predictability 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. Adopt effective measures to further strengthen the rule of law, ensure adequate and timely contract enforcement and improve the availability and functioning of dispute settlement mechanisms. Track the implementation process of the action plan for the fight against the informal economy (2023-2025).
5. Adopt the Climate Law focusing on enhancing climate governance, fair transition and the establishment of an Emission Trading System (ETS) aligned with the EU ETS. In the context of "Climate Change Mitigation Strategy and Action Plan (2024-2030)" and "Climate Change Adaptation Strategy and Action Plan (2024-2030)", effectively implement a long-term low-emission development strategy and address the energy-intensive and hard-to-abate sectors also using alternative fuels such as renewable hydrogen. Increase the resilience against

climate change and disaster-related risks, including to ensure sustainable urban development.

6. Facilitate school-to-work transitions for young people who are not in education, employment or training (NEET) by ensuring the quality and inclusivity of the school, tertiary, and vocational training system. Address the labour market gender gap – the difference between men and women – through the establishment of affordable childcare infrastructure beyond the big urban centres of Türkiye, and through raising the level of skills for women by facilitating their participation in on- the-job training. Continue increasing the participation of adults in lifelong learning, aimed at the development of a skilled labour force fit for the green and digital transitions.

ANNEX 1: OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2023

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey 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 guidance is similar to that of the country-specific recommendations usually adopted under the European Semester for EU Member States. Implementation of the guidance is evaluated by the Commission in the following year's ERP assessments.

The following table presents the Commission's assessment of the implementation of the 2023 policy guidance jointly adopted by the EU and the Western Balkans and Turkey at their Economic and Financial Dialogue at ministerial level on 16 May 2023.

Overall: Limited implementation (36.1%) ([139])	
2023 policy guidance	**Summary assessment**
PG 1:	There was **limited implementation** of PG 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.	1) **Partial implementation**: Fiscal policy was expansionary in 2023, driven by earthquake- and pre-electoral-related expenditure. However, in July, the 2023 budget was revised, including with sizeable tax increases to cover some of the additional expenditure and limit their impact on the deficit. The 2023 budget deficit was 5.2% of GDP, higher than in 2022 but lower than the revised target of 6.4% of GDP. Net of earthquake-related expenditure, the deficit was 1.7% of GDP. Subsidies to state-owned enterprises in the energy sector have declined in 2023 but remained substantial (the state-owned Petroleum Pipeline Corporation BOTAŞ received TRY 74 billion through current transfers). A number of timely and transparent fiscal measures were taken to support citizens and businesses affected by the February 2023 earthquakes (these measures include postponement of loan instalments and tax liabilities, and an increase in current and capital transfers). A total of TRY 950 billion was allocated in 2023 for the recovery and reconstruction of earthquake-damaged regions and the remediation of the effects of the February earthquake, exceeding the estimated TRY 762 billion.
Present a credible medium-term strategy to support the envisaged gradual return to a primary surplus of	2) **Limited implementation**: The ERP projects a general government primary surplus of 1.2% of GDP in 2026, which would be a 3.9 pp. improvement on the 2023

([139]) 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.

at least 1% of GDP.	outcome. In addition to the expiration of the earthquake-related expenditure, the authorities plan to pursue 'soft' fiscal measures, like rationalising public expenditure, systematising spending reviews, broadening the tax base, and fighting the informal economy. Although the envisaged total fiscal adjustment seems plausible, the adjustment path is likely to be smoother than currently planned.
Expand the tax base by streamlining tax exemptions and reductions.	3) **No implementation:** In recent years, Türkiye has implemented temporary tax cuts, debt restructuring, and amnesty programmes. Contrary to commitments made in Turkish policy documents, tax restructuring and capital repatriation, which have negative consequences for long-term voluntary tax collection, have become established practices. The government also passed a new tax-restructuring bill shortly before the May 2023 elections. The new policy documents (i.e. the Medium-Term Programme for 2024-2026 and the 12th Development Plan for 2024-2028) seek to ensure revenue continuity by: (i) strengthening tax justice; (ii) broadening the tax base; (iii) increasing tax collection; (iv) eliminating inactive exceptions, exemptions and discounts; and (v) updating laes on income, corporate, and value-added tax to increase the share of direct taxes in the medium term.
PG 2: Reduce fiscal risks by – *inter alia* – gradually phasing out the FX value guarantees on lira time deposits.	There was **limited implementation** of PG 2: 1) **Substantial implementation:** The authorities have taken a series of measures to ensure the gradual wind-down of the FX-protected deposits scheme (through amendments in the security maintenance facility and reserve requirements, new incentives to switch from FX deposits to TRY deposits, etc.). They have also announced that the scheme will come to a complete end in 2024. The volume of FX-protected deposits under the scheme has been following a downward trend since mid-August 2023, falling from TRY 3.4 trillion down to TRY 2.5 trillion as of end-January 2024.
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.	2) **Limited implementation:** The law on public procurement contains many exemptions that undermine the transparency and accountability of public expenditure. Furthermore, Türkiye continues to overuse negotiated procedures, which allow contracting authorities to limit competition and transparency (regardless of any threshold) by referring to subjective criteria that cannot be objectively measured. However, recent policy documents (i.e. the Medium-Term Programme for 2024-2026 and the 12th Development Plan for 2024-2028) have set a target of amending the public procurement law by the end of the second quarter of 2024 in order to: (i) digitalise the legislation according to international norms and standards; (ii) update it with a purchasing approach that supports and

	prioritises innovation and sustainability; and (iii) implement sectoral public procurement regulation.
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) **No implementation:** The government has not disclosed any official option paper for the possible adoption of a fiscal rule and the setting up of an independent body to monitor its implementation.
PG 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.	There was **partial implementation** of PG 3: 1) **Partial implementation:** Interest rates have been increased substantially and the monetary policy stance has been tightened on account of various metrics, with important steps taken to strengthen monetary transmission and reinstating the policy rate as the primary instrument of monetary policy. However, no improvements have been made to strengthen central bank independence.
Provide more guidance and efficient communication with regards policy tools as well as the evaluations of their potential effects and increase the efficiency of the operational framework.	2) **Substantial implementation**: The effectiveness and consistency of the central bank's policy and communication tools have improved since the policy shift as of June 2023. The complex system of macroprudential and regulatory measures adopted in recent years, which hampered operational efficiency and distorted price signals, has started to be unwound and simplified, albeit gradually in the face of high risks to macro-financial stability.
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.	3) **Partial implementation**: Progress has been made in simplifying the macroprudential regulatory framework and improving predictability, although some regulations constraining market-based asset and loan pricing and credit allocation remain in place. Legislative work on compliance with the final elements of Basel III regulations has been completed, with full implementation planned for 2025 in line with the implementation schedule announced by the EU. There are no plans to conduct independent asset quality reviews and publish its methodology and outcomes.
PG 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.	There was **limited implementation** of PG 4: 1) **Limited implementation:** The 12th Development Plan (2024-2028) was published in November 2023. Launched in December 2022, the preparation for this new Plan involved the contribution in total of 60 special expert commissions and 27 working groups with the participation of representatives from public institutions, academia, private sector, social partners and civil society. Yet, the results of these consultations and expert commission reports are not publicly available. The Coordination Board for the Improvement of Investment Environment (YOIKK) continued its meetings with private sector and public sector stakeholders, with its last meeting held in December 2023.

	The action plans of the Board and meeting conclusions are, however, not publicly available. Meanwhile, there has not been any significant improvement in the use of social dialogue mechanisms to develop relevant 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.	2) **No implementation:** Since the enactment of Law No. 6015 on Monitoring and Supervision of State Aids, Türkiye has actively avoided implementing state aid control by failing to establish a functional organisational structure and refusing to pass the necessary implementing legislation. Instead of enforcing Law No. 6015 through secondary legislation, Türkiye established a new legislative structure aimed at the effective implementation, coordination, monitoring and evaluation of state aid. This new system does not aim to align with the EU acquis. The lack of independence in enforcing state aid legislation and the lack of transparency regarding the actual amount of state aid provided remain a source of concern. Yet, recent policy documents (i.e. the Medium-Term Programme 2024-2026 and the 12th Development Plan for 2024-2028) set targets for establishing a state aid monitoring system in 2028 to simplify state aid, ensure coordination among public institutions, prevent duplication, and measure the impact of state aid in order to prioritise new areas of aid.
Increase the number and improve the efficiency of specialised courts for business, with a view of streamlining commercial disputes.	3) **Limited implementation:** Regarding specialised courts, Türkiye indicated in bilateral technical meetings (at the last Sub-Committee meeting No.3) that capacity-building programmes are in place for specialised courts, while the assignment of judges and prosecutors to these courts continued. Yet, no data on implementation was provided. The Medium-Term Programme (2024-2026) and the 12th Development Plan (2024-2028) indicate the Government's intention to strengthen the specialised courts. In this respect, it is foreseen in 2024 to conduct impact assessments of the specialised courts to determine new areas of needs, to reinforce these courts in view of improving the effectiveness of the investigations as well as to provide trainings for the judges and prosecutors involved in these specialised courts. A Judicial Reform Strategy is under preparation, with a view of improving the accessibility and effectiveness of the overall judicial system. Türkiye has made wider use of alternative dispute settlement mechanisms over the last years in an attempt to reduce the workload of the judiciary and increase its efficiency (increase from 1,160 voluntary arbitration files settled in 2015 to 469,829 files already in 2022 according to Ministry of Justice's data). Yet, no data on the implementation was provided in the ERP.
PG 5: Take further steps to implement the	There was **partial implementation** of PG 5: 1) **Limited implementation**: The adoption of a Turkish Climate Law is critical for establishment and

ETS carbon pricing mechanism.	implementation of ETS carbon pricing mechanism. A draft law has been prepared but has not been submitted yet to the Parliament. Efforts are ongoing for the development of the ETS system. Meanwhile, Türkiye seems to be focused primarily on EU CBAM effect on Turkish exports and minimising/ mitigating its cost.
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.	2) **Partial implementation**: Türkiye announced ambitious goals on renewable energy generation in its latest National Energy Plan (2023-2035). The plan envisages maximising solar and wind energy to achieve the country's greenhouse gas emission targets. The declared goal is to increase the share of renewable energy in primary energy consumption from 16.7% to 23.7% and the share of nuclear energy from zero to 5.9% by 2035. Türkiye also published a hydrogen technologies strategy and roadmap strategic document, highlighting the role for green hydrogen on the road to achieve net-zero emission targets by 2053.
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.	3) **Substantial implementation**: Türkiye has tightened its energy efficiency and renewable energy standards in buildings in the context of its 2053 climate targets. The second National Energy Efficiency Action Plan for the period 2024-2030 was agreed at the end of 2023. In the buildings sector, Türkiye plans to achieve energy savings by at least 30% by 2030 for public buildings, including hospitals and schools. Some national funding mechanisms are already initiated. This goal albeit ambitious was set not only in view of achieving the country's 2053 climate targets but also in the light of the enormous reconstruction efforts following the February earthquakes.
PG 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.	There was **limited implementation** of PG 6: 1) **Limited implementation**: Young people, especially women, still have difficulties in entering the labour market. While the NEET rate in the 3rd quarter of 2023 decreased to 24.7% from 27.1% in the same quarter of 2022, it remains high, especially for women (32.9% in the 3rd quarter of 2023). The incentives for additional employment continued in 2023; however no additional legislative and fiscal measures have been introduced in 2023. The implementation of National Youth Employment Strategy and Action Plan (2021-2023) including active labour market activities on career guidance and vocational trainings was completed by the end of 2023. An assessment of the action plan is expected to be done before the end of the 1st half of 2024. No official announcement has made yet for the extension or the new version of the strategy and action plan. The limited care services is still a major challenge for female labour force participation.

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.	2) **Limited implementation:** The Ministry of Health provided healthcare services through undamaged hospitals, hospital stations, emergency units and primary health care units and also established field hospitals in the earthquake region. Vaccination and reproductive health services were conducted to avoid health risks, whilst mobilised psychosocial teams provided psychosocial support to individuals in the region. Though a rotational system where volunteer-based public health workers were deployed to the highly affected areas in shifts to combat public health threats, the health workers assigned had generally obtained limited trainings and experience in responding to outbreaks, disasters and public health emergencies. The need for healthcare services including mental health and psychosocial services remain unmet. Progress is overall limited in terms of strengthening the national capacity starting from earthquake affected provinces to all provinces and ensure health security. A number of measures were introduced in the aftermath of the earthquakes in the region, such as community benefit programs, short-term work benefits and cash wage support. Implementing employment incentive programs in the earthquake region has been identified as policy recommendations in “Türkiye Earthquakes Recovery and Reconstruction Assessment”, however, the progress is limited.
Continue increasing the participation of adults in lifelong learning, in particular to reinforce green and digital skills, in order to ensure just transition.	3) **Partial implementation**: According to the most recent data published by Turkish Statistical Institute, the Lifelong Learning participation rate in Türkiye increased from 2% in 2006 to 6.7% in 2022, yet it is still below the EU target of 15%. The recent official documents such as the Medium Term Programme (2024-2028) and the 12th Development Plan (2024-2028) reflect the Government’s plan to strengthen education and training capacity of the relevant centres, especially as regards green and digital skills. In this respect, it is foreseen to adopt measures to increase the participation in lifelong learning and adapt skills to the needs arising with the green and digital transformation.

ANNEX 2: COMPLIANCE WITH PROGRAMME REQUIREMENTS

Türkiye's 2024-2026 ERP was submitted to the Commission on 15 January 2024. Overall, it has followed the Commission's guidance note.

Inter-ministerial coordination

Türkiye's 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 for the sections of the ERP dealing with the macroeconomic outlook and public finance and with all other line ministries and institutions for the sections of the ERP dealing with structural reforms.

Each line ministry has designated a coordinator for the ERP, which has helped to ensure a smooth inter-ministerial ERP coordination process. The proposed measures for the new ERP were discussed in a workshop held in July and December 2023 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 Long-Term Development Strategy (2024-2053) and 12th Development Plan (2024-2028), Medium Term Program (MTP, 2024-2026) and 2024 Presidential Annual Program. The 12th 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). On 31 October 2023, the 12th Development Plan was approved by the General Assembly of the TGNA. During one-year period, 87 different ad-hoc committees and working groups were set up to obtain opinions and suggestions from various parts of society. Approximately 8,500 representatives from the public sector, private sector, academia and non-governmental organisations participated in these meetings and contributed to the ongoing studies. In addition, high-level participatory meetings were held with relevant public institutions, academia, civil society organisations, professional associations and the business community. An online citizens' survey was conducted with the participation of some 43,000 citizens. After all these inputs, the development plan was prepared and ERP (2024-2026) is fully aligned with these policy objectives and actions.

As part of the preparations for structural reforms, workshops were held in July 2023 and December 2023 with the participation of all relevant public institutions and organisations in cooperation with Connecting Europe Facility. Suggestions on the scope of the reform measures and their compliance were made with the current guidelines in mind. In the process that followed the meeting, the institutions' work on improving the measures in the ERP was conducted in communication with the strategy and budget experts. The updated contributions were finalised as of January 2024.

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. No training programmes were organised this year. 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 in the ERP 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 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 largely follows the outline provided in the guidance note. It covers all major elements and provides information on the 2024 budget, although without presenting information on the main discretionary fiscal measures (equal to or above 0.1% of GDP). The chapter also 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 most of the implementation of the policy guidance is sufficient. However, in some instances, outcome indicators such as total factor productivity, increase in value added, share of high technology products in exports, and so on, were not included to assess whether the reform measures met their objectives. Furthermore, the assessment of full implementation was delivered to some reform measures which did not reach the outlined initial targets. To improve future reporting, impact-related and outcome indicators should be utilised. The maximum number of reforms (20) is respected; the current ERP (2024-2026) presents a total of 6 measures. However, the page limit (50) is not respected, as the section on the structural reform stretches to 74 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'*. The ERP document also includes *'Table 11: Reporting on the implementation of the structural reform measures of the ERP 2023-2025'*, which is presented as *'Table 10'*.

Regarding Annex 2 table, *'links between reform areas and relevant policy documents',* 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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