European Commission

ISSN 2443-8014 (online)

2017 Economic Reform Programmes of Albania, the former Yugoslav Republic of Macedonia, Montenegro, Serbia, Turkey, Bosnia and Herzegovina and Kosovo*

The Commission's Overview and Country Assessments

INSTITUTIONAL PAPER 055 | JUNE 2017

EUROPEAN ECONOMY

Economic and Financial Affairs

Neighbourhood and Enlargement Negotiations

Employment, Social Affairs and Inclusion

European Economy Institutional Papers are important reports analysing the economic situation and economic developments prepared by the European Commission's Directorate-General for Economic and Financial Affairs, which serve to underpin economic policy-making by the European Commission, the Council of the European Union and the European Parliament.

Views expressed in unofficial documents do not necessarily represent the views of the European Commission.

This paper exists in English only and can be downloaded from https://ec.europa.eu/info/publications/economic-and-financial-affairs-publications_en.

Europe Direct is a service to help you find answers to your questions about the European Union.

Freephone number (*):

00 800 6 7 8 9 10 11

(*) The information given is free, as are most calls (though some operators, phone boxes or hotels may charge you).

More information on the European Union is available on http://europa.eu.

Luxembourg: Publications Office of the European Union, 2017

KC-BC-17-055-EN-N (online)
ISBN 978-92-79-64694-2 (online)
doi:10.2765/795229 (online)

KC-BC-17-055-EN-C (print)
ISBN 978-92-79-64693-5 (print)
doi:10.2765/15536 (print)

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

2017 Economic Reform Programmes of Albania, The former Yugoslav Republic of Macedonia, Montenegro, Serbia, Turkey, Bosnia and Herzegovina and Kosovo*:

The Commission's Overview and Country Assessments

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

EUROPEAN ECONOMY Institutional Paper 055

CONTENTS

INTRODUCTION

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

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

In 2017, enlargement countries submitted their third annual Economic Reform Programmes covering the period 2017-2019[1]. They have been assessed by the European Commission and the European Central Bank. Based on these assessments, Joint Conclusions with country-specific policy guidance[2] were agreed and adopted at the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey. The dialogue was held in the margins of the Economic and Financial Affairs Council meeting of 23 May 2017.

This paper contains the Commission staff's assessment of the ERPs for 2017-2019 submitted by Albania, Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia, Kosovo[*], Montenegro, Serbia and Turkey. The assessment also takes stock of the implementation of the country-specific policy guidance adopted last year. The cut-off date for the assessment was 12 April 2017.

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

Comments would be gratefully received and should be sent to:

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

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

---

1 Albania: http://www.ekonomia.gov.al/files/userfiles/ERP_2017-2019_en.pdf;
Bosnia and Herzegovina: http://www.dep.gov.ba/naslovna/?id=1810;
Kosovo: http://mf.rks-gov.net/desk/inc/media/57179C7A-9531-4E3D-AEDE-ECC703B75D55.pdf;
the former Yugoslav Republic of Macedonia: http://www.finance.gov.mk/en/node/4832;
Montenegro: http://www.gov.me/ResourceManager/FileDownload.aspx?rId=264373&rType=2;
Serbia: http://www.mfin.gov.rs/UserFiles/File/strategije/ERP%202017%20-%202019%20final_Eng.pdf;
Turkey: http://www.mod.gov.tr/Lists/RecentPublications/Attachments/127/Pre-Accession%20Economic%20Reform%20Programme%202017.pdf

2 This paper includes at the end of each country assessment the country-specific policy guidance adopted in May 2017.

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

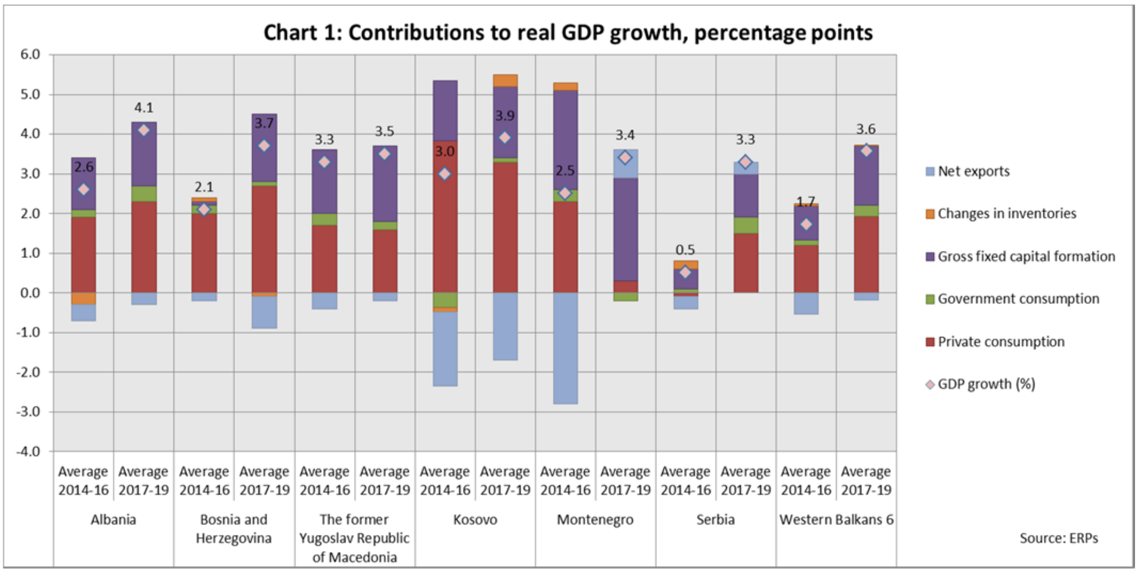
Part I

Overview

1. Overview of the 2017 programmes

1.1. ECONOMIC OUTLOOK AND CONTEXT

The Western Balkan countries and Turkey are benefiting from the global economic upturn and the economic opportunities their proximity to the EU offers. The continuing economic recovery in the EU will especially benefit these 'enlargement countries', given that the EU is their main trading and investment partner. In addition to absorbing about half of their exports, the EU also offers these countries the best opportunity to integrate into global value chains. Most of the trade involving international production chains in the Western Balkans and Turkey is with the EU. GDP per capita in these countries, adjusted for purchasing power differences, ranged from one quarter (Kosovo) to slightly more than half (Turkey) of the EU average in 2015, which means that the potential for catch-up growth is significant. However, convergence has ground to a halt since the onset of the global financial crisis[1]. The improving external environment now creates better conditions for renewed convergence towards EU living standards, but how quickly this will happen ultimately depends on how these countries implement wide-ranging reforms domestically.



Economic growth is expected to strengthen in the Western Balkans and Turkey, offering opportunities to advance much-needed reforms while times are good. All **Western Balkan** countries expect to improve their economic performance in the 2017-2019 period, compared to 2014-2016 (see chart 1). Private consumption and investment have been driving economic activity in the last three years and are forecast to contribute most to the acceleration of growth[2], although with some differences between countries. Net exports are expected to be a drag on GDP growth in 2017-2019 in all but two countries: Serbia, which has recently expanded its export capacities thanks to foreign direct investment (FDI) inflows into the tradable sector; and Montenegro, where the economic reform programme (ERP)

[1] In the five Western Balkan countries excluding Kosovo (for which data are less readily available) average GDP per capita in purchasing power standards (PPS) was 27 % of the EU-28 average in 2004. It rose to 33 % of the EU-28 average in 2009, but remained virtually the same in 2015 (34 %). In Turkey, convergence was rapid between 2004 and 2011 (with GDP per capita in PPS increasing from 39 % to 53 % of the EU-28 average) but then stopped (the figure was 52 % in 2015). The figures for Turkey come from the national accounts data published before the change in methodology.

[2] Investment is expected to contribute 1.5 percentage points (pps) annually to GDP growth across the six Western Balkan countries from 2017 to 2019 (up from 0.8 pps annually from 2014 to 2016); private consumption is also forecast to strengthen on the back of rising employment and income (1.9 pps growth contribution annually from 2017 to 2019, compared to 1.2 pps from 2014 to 2016).

projects, optimistically, a sharp slowdown in imports. Investment is expected to contribute very strongly to growth in Montenegro over the period 2017-2019, due to the construction of a major highway, together with investment in tourism and energy. The contribution to growth from private consumption is forecast to be largest in Kosovo, underpinned by increasing lending, rising employment and stable growth in remittances. In **Turkey**, growth is expected to recover slowly from the rapid slowdown in 2016. Along with fiscal stimulus, net trade is forecast to kick-start economic growth, helped by the sharp depreciation of the lira, with private domestic demand likely to strengthen during 2017 on the back of a continuing improvement in confidence indicators first seen in early 2017.

The expected growth acceleration faces some downside risks. In some countries, such as Albania and to a certain extent Montenegro, the projected investment surge relies on ongoing FDI-financed projects. In others it is seen as the consequence of expected improvements in the business environment (Bosnia and Herzegovina), ramped-up public capital expenditure (Kosovo, partly Montenegro), a return to political stability (Turkey, the former Yugoslav Republic of Macedonia), or the continuation of a recent reform drive (Serbia). These factors all carry various degrees of uncertainty and, therefore, downside risks. On the external side, there is a risk that global economic developments may unfold unfavourably. In particular, rising oil prices and greater risk aversion among foreign investors could weigh on disposable incomes and investment flows into the region.

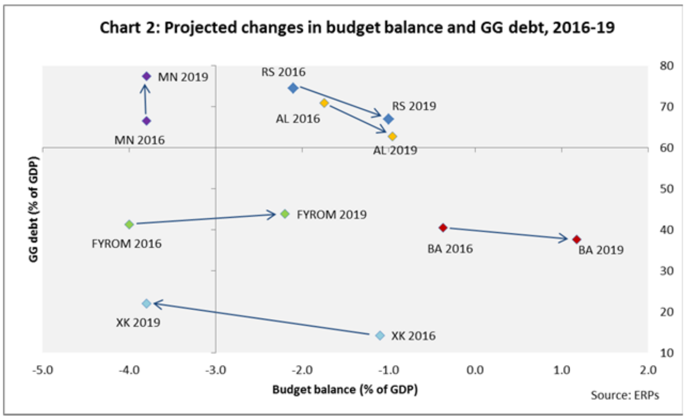
The projections for narrower current account deficits appear somewhat optimistic. In many Western Balkan countries current account deficits increased further in 2016, often from an already high level. These increases stemmed from a number of factors, which varied from country to country, such as investment-related imports, lower commodity prices or declining private and public transfers from abroad. Some of these factors will continue to impact external balances going forward. In particular, more robust household consumption, stronger private investment and large-scale ongoing public infrastructure works will continue to boost imports. Export growth is also expected to gather pace, benefiting from a more benign external environment and stronger external demand. However, trade deficits will remain high as structural weaknesses and a narrow production base continue to limit the export potential in most countries in the region over the medium term. In Turkey, in addition to stronger foreign demand, exports will also benefit from the strong depreciation of the lira; but any reversal in the recent poor performance of tourism and related services will hinge on the stabilisation of the country’s political and security situation.

Price developments have diverged in the Western Balkans and Turkey; going forward, inflation is projected to pick up to moderate levels in the former group of countries, while Turkey aims to address entrenched high inflation. The countries of the Western Balkans have experienced low inflation rates, or even decreases in overall price levels, as a consequence of low global food and energy prices, combined with limited domestic price pressures. In Turkey the strong depreciation of the lira, a jump in the statutory minimum wage and entrenched inflation expectations have combined to keep inflation stubbornly high and above-target. The Western Balkan countries rightly project a moderate increase in inflation consistent with faster economic growth, falling unemployment and recovering global commodity prices. Turkey expects, rather optimistically, the inflation rate to gradually converge to the central bank’s policy target towards the end of the ERP’s horizon.

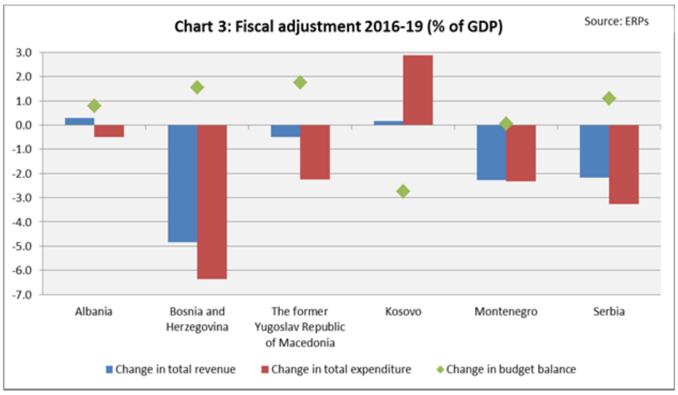
1.2. MAIN CHALLENGES

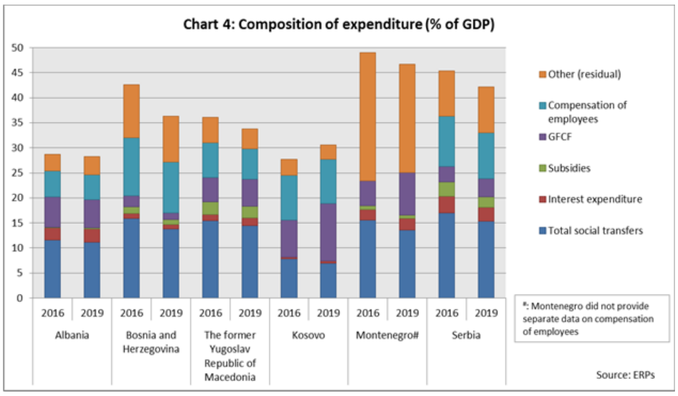
The Western Balkans and Turkey face several challenges with both internal and external imbalances and the structural reform agenda. The economic reform programmes cover the key areas that should strengthen macroeconomic stability and remove major bottlenecks to growth. In some countries, such as Serbia and Albania, significant reforms have taken place or started in the past few years. Still, major challenges remain and reform efforts need to be sustained. In other countries the reform agenda should receive new impetus and policy plans should be followed by determined implementation. The major challenges facing the countries are set out below.

First, fiscal policy should aim at reinforcing consolidation and safeguarding debt sustainability while creating space for much-needed capital spending. The countries with the highest debt ratios, Serbia and Albania, have implemented significant fiscal adjustments in recent years and achieved debt stabilisation. Going forward, fiscal policy in these countries aims to lock in consolidation gains and further decrease public debt as a share of GDP, but efforts could be more ambitious (see chart 2). Montenegro, on the other hand, has embarked on a public investment spree by constructing a highway section costing as much as 20 % of GDP. This, together, with unsustainable pre-election increases in current spending, will continue to push up public debt to close to 80 % of GDP by 2019, the highest in the region. Although Montenegro's ERP recognises the associated risks (linked also to elevated rollover needs in 2019 and 2020) and the 2017 budget has taken some steps in the right direction, a comprehensive fiscal consolidation strategy has yet to be adopted. The former Yugoslav Republic of Macedonia is also characterised by unfavourable debt dynamics, as well as frequent cuts to capital spending to compensate for disappointing revenue. Its ERP envisages medium-term fiscal consolidation, but the measures to achieve that remain unspecified or unclear. Kosovo has a favourable debt ratio and a high share of public capital spending which it plans to increase further, increasing the deficit in the process. Bosnia and Herzegovina has low deficit and debt ratios, but its capital spending is very compressed, and with limited access to international markets it needs to create space for growth-enhancing public investment. Turkey's fiscal sustainability is not in doubt and it has been able to use its fiscal space to counteract the economic slowdown. However, given the recent preference for extra-budgetary measures such as the scaled-up loan guarantee fund, the sovereign wealth fund and the increasing reliance on public-private partnerships, risks stemming from non-transparent public liabilities have risen.



The expenditure-based consolidation paths generally envisaged in the ERPs are welcome, but there is an overall need to better set out the underlying measures. All Western Balkan countries except Kosovo and Montenegro expect an improvement in their general government budget balance between 2016 and 2019. Adjustment strategies are mostly expenditure-based (see chart 3). However, the fiscal measures are often unspecified, lack concrete supporting policies, and in some countries (particularly the former Yugoslav Republic of Macedonia and Montenegro) the medium-term consolidation strategy is still to be developed. The composition of expenditure is still very much tilted towards social transfers, public wages and subsidies across the region, in particular in Bosnia and Herzegovina, Montenegro, Serbia and the former Yugoslav Republic of Macedonia (see chart 4). Therefore, there is large scope for shifting spending towards a more growth-enhancing pattern.





The credibility and sustainability of public finances would greatly benefit from effective fiscal rules and stronger medium-term fiscal frameworks. Well-designed fiscal rules could help firmly anchor fiscal policies, familiarise countries with the constraints of a rules-based framework and foster public debate about budget priorities and policies. In countries that already have fiscal rules[3], their impact would be helped if they were applied more robustly (Serbia) or if an independent oversight body was in place (Montenegro, Albania and Kosovo). However, the latter cannot properly function unless there is sufficient expertise in the country. Other countries without a fiscal rule could also consider adopting one to help anchor fiscal expectations. Medium-term budget planning, fiscal reporting and transparency also need to be improved substantially across the region.

Second, Western Balkan countries and Turkey continue to face considerable external imbalances and rely on external financing, exposing them to sudden changes in investor sentiment. Current account deficits have been sizeable – and, in quite a few instances, very sizeable – in recent years. These have translated into a dependence on foreign investment, as the large negative net international investment position in most countries shows. At the same time, the financing of the current account deficits has been relatively stable and has taken the form mainly of direct investment everywhere except in Turkey, where foreign financing relies to a large extent on more volatile types of capital flows, including short-term loans. A high share of foreign direct investment generally occurs in non-tradable sectors (construction, retail, real estate and financial services). This is not conducive to economic competitiveness and the prospective reduction of external imbalances. The former Yugoslav Republic of Macedonia is an example of how foreign investors can help diversify the export base. Here, foreign companies have helped increase the share of higher value-added products in recent years, although challenges remain to better embed these companies into the local economy. As of late, macroeconomic stabilisation and reform efforts have also made Serbia more attractive to foreign investors, boosting the country's export performance.

Third, despite some improvement in 2016, non-performing loan (NPL) ratios remain high (except for in Turkey and Kosovo) and pose significant risks to financial stability and economic growth, prompting the need for comprehensive strategies. In most countries, the legacy of non-performing loans is hitting bank profitability and still restraining lending, even if interest rates have trended downwards and the banking sectors remain generally sound. Some Western Balkan economies have recorded stronger growth in credit for the private sector. However, generally speaking, lending to corporates has often remained sluggish, while lending to households has been growing at a much faster pace. In Turkey lending growth, including to the corporate sector, has been strong, but the same is true of growth in non-performing loans. Albania and Serbia have adopted NPL resolution strategies and their implementation has been encouraging, while other countries have taken selective measures, facilitating write-offs, the sale of bad loans or out-of-court workouts. Pursuing NPL resolution should remain a priority for policy-makers in the region. This will involve addressing underlying legal and institutional bottlenecks such as weak property rights, insufficient contract enforcement and ambiguous tax regulations.

Fourth, a cumbersome and unpredictable regulatory environment, weak access to finance, government interference and unclear property rights hamper private-sector development and

3 See table 3 at the end of this section.

investment. Numerous para-fiscal charges and state aid given to uncompetitive publicly owned enterprises pose a problem in some economies, such as Serbia and Bosnia and Herzegovina. Others, such as the former Yugoslav Republic of Macedonia, hinder businesses with frequent legal changes without prior consultation. The regulatory burden is generally high. The access to commercial finance is hampered by a broad mix of issues, which include inadequate financial literacy among SMEs, unclear property rights and lengthy judicial proceedings to enforce collateral. Fragmented land plots hinder economies of scale in the agricultural sector and outdated production methods negatively affect both agriculture and industry. Unclear property rights are another substantial obstacle to agricultural development, not least because they weaken access to finance.

Uncompetitive and rigid markets for network industries continue to pose a problem for competitiveness in the energy sector. This is especially true in Serbia, Bosnia and Herzegovina and Albania. The Western Balkan economies are small and therefore face a difficult trade-off between achieving economies of scale and providing the necessary competition on domestic markets for energy and transport that calls for deeper regional integration. Energy, transport and telecommunications infrastructure needs to be upgraded in the context of sound management of public finances and sector-wide reforms that include energy efficiency measures and IT skills development.

Low public and private spending on research and development is not conducive to innovation. Weak cooperation between universities, research facilities, R&D-related public entities and the private sector continues to be problematic. Mobilising investment in research and innovative solutions requires a comprehensive approach that covers several areas (research policy, regional policy, education, private sector) and addresses the regulatory framework.

The large informal sector reduces tax revenues, leads to unfair competition and negatively affects workers' skills and the quality of jobs. The informal sector can account for as much as 30 % to 50 % of GDP in the Western Balkans and Turkey. Improving tax administrations can broaden the tax base and boost revenues. National strategies to formalise the informal economy need to address the root causes of informal employment, such as the high labour tax wedge.

Fifth, labour market performance is weak overall, albeit with marked differences across countries. Despite some recent improvements and an expected further decline in unemployment, structural challenges persist. Unemployment is in double figures while employment rates are low, particularly among women. Youth unemployment is especially high. Active labour market policies need to be scaled up and better target vulnerable groups; disincentives to work should be removed. All countries need to improve their education systems, and providing skills through vocational education and training should be aligned to labour market needs.

Sixth, despite some slight improvements, economic governance frameworks remain weak and slow down the implementation of much-needed structural reforms. Policy planning is often done on an ad hoc basis and inter-ministerial cooperation tends to be weak. Evidence-based policy-making and proper monitoring of reforms are not widespread. Public financial management (PFM) still has several shortcomings, as is evident from recent PEFA and SIGMA assessments. The PFM reform programmes in place in Albania, Kosovo, Montenegro and Serbia will help with this, just as the single project pipelines and national investment committees will help make public investment choices more transparent if used properly. Corruption is still widespread, making the investment climate and attracting foreign direct investment more difficult. Reforming public procurement systems to encourage greater transparency and eProcurement should therefore be at the top of policy agendas.

Seventh, trade barriers in the Western Balkans impede trade exchanges beyond low-skill, low-tech and natural resource-intensive products. On the regulatory side, trade is still hampered by non-performing logistics, lack of mutual recognition of certificates and licences, lengthy customs procedures and limited use of risk-based controls in many border agencies. Overcoming these non-tariff barriers is key to facilitating trade in goods and services and unleashing the region's trade potential. Another structural issue is the low level of regional economic integration, which means that national economies remain relatively small in scale.

1.3. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED IN 2016

Although jointly adopting targeted policy guidance is still relatively new for enlargement countries, there is a clear need to substantially step up its implementation. This would go a long way towards addressing the macro-fiscal vulnerabilities and structural obstacles that these countries face.

How effective the policy guidance is in strengthening macro-fiscal stability and prioritising structural reforms to boost competitiveness depends hugely on how it is implemented. This, in turn, is in the hands of the enlargement countries. Since 2016 the Commission's assessment of the Economic Reform Programmes has included information on the degree of implementation of the jointly adopted policy guidance. Nevertheless, building on the practice followed under the European Semester for Member States, it is possible and desirable to monitor more closely how the policy guidance is implemented.

Overall, applying the methodology used in the European Semester[4] points to limited implementation of the policy guidance adopted in 2016. The situation varies greatly from country to country, with Serbia having the highest score but remaining in the 'partial implementation' category, and the former Yugoslav Republic of Macedonia and Turkey lagging behind (see chart 5).

Almost 15% of all policy guidance items[5] have not been implemented, with a further 39% having seen only a limited degree of implementation. At the other end of the spectrum, only two policy guidance items (or 4.8% of the total) have been substantially or fully implemented (see chart 6).

Chart 5: 2016 country scores

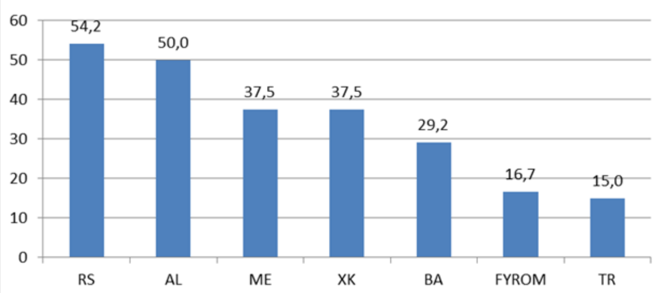
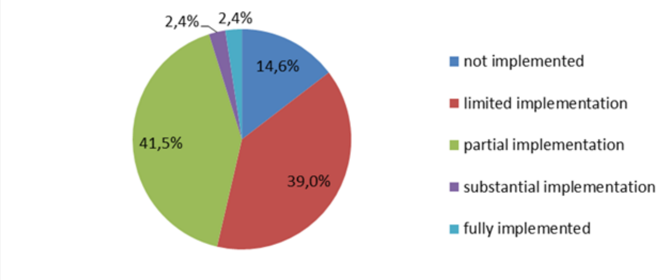


Chart 6: Overall implementation of the policy guidance from 2016



[4] See the Box for a detailed description of the methodology.
[5] In all, 41 policy guidance items were adopted for the Western Balkan countries and Turkey in 2016.

BOX: MEASURING THE IMPLEMENTATION OF THE COUNTRY-SPECIFIC POLICY GUIDANCE ADOPTED IN 2016

As of this year, for each policy guidance item (PG) implementation is assessed and put in one of five categories, namely, 'not implemented', 'limited implementation', 'partial implementation', 'substantial implementation' and 'fully implemented'.[6] The qualitative assessment draws on information from:

a) the ERP itself,

b) fact-finding missions to enlargement countries, and

c) other available sources.

These five assessment categories correspond to the following states of implementation:

Table B1: **Definition of assessment categories**

Assessment category	Definition
Not implemented	The enlargement country has neither announced nor adopted any measures to address the PG.
Limited implementation	The enlargement country has announced some measures to address the PG, but they appear insufficient and/or their adoption/implementation is at risk.
Partial implementation	The enlargement country has announced or adopted measures to address the PG. These measures are promising, but not all of them have been implemented yet and implementation is not certain in all cases.
Substantial implementation	The enlargement country has adopted measures, most of which have been implemented. These measures go a long way towards addressing the PG.
Fully implemented	The enlargement country has adopted and implemented measures that address the PG appropriately.

The progress that an enlargement country has made with PG implementation can be summarised using a synthetic indicator. For this, the qualitative assessment of each PG based on the five categories above is translated into a quantified synthetic indicator using cardinal numbers from 0 to 100: 0 for 'not implemented', 25 for 'limited implementation', 50 for 'partial implementation', 75 for 'substantial implementation', and 100 for 'fully implemented'. The indicator takes the aggregate of the individual PG scores and divides that by the number of PGs to give the country-level score. This simple calculation method aims to translate qualitative information into a numerical assessment. It does not use weightings, as they may carry a degree of judgment and risk being less transparent.

Once calculated, the country's implementation score can be used to assess the overall progress achieved in implementing the policy guidance. Indeed, table 2 below shows how the scores match the assessment categories. For instance, a score of 38 would fall into the lower range of 'partial implementation'.

[6] This is different from the European Semester, where the country-specific recommendations are first broken down into subparts to assess implementation.

Table B2: **Synthetic indicator scores and corresponding assessment categories**

Assessment category	Definition
[0]	Not implemented
]0; 37.5[	Limited implementation
[37.5; 62.5[	Partial implementation
[62.5; 87.5[	Substantial implementation
[87.5; 100]	Fully implemented

Importantly, as the nature and size of the economic challenges facing enlargement countries vary, so the degree of implementation of their PGs may differ as well. This, in turn, will impact the progress with PG implementation in a specific enlargement country, and ultimately its ranking when compared to the others. Moreover, a lower PG implementation score may also stem from the fact that implementing that particular PG proves objectively more difficult than implementing others[7].

Table B3: **Country-level assessment of the implementation of the PG adopted in 2016**

Country	2016 scores	Assessment category
Serbia	54.2	Partial implementation
Albania	50.0	Partial implementation
Montenegro	37.5	Partial implementation
Kosovo	37.5	Partial implementation
Bosnia and Herzegovina	29.2	Limited implementation
The former Yugoslav Republic of Macedonia	16.7	Limited implementation
Turkey	15.0	Limited implementation

[7] The applied methodology has other limitations as well. For a fuller picture, see the ECFIN Economic Brief *Implementing economic reforms – are EU Member States responding to European Semester recommendations?* by S. Deroose and J. Griesse (http://ec.europa.eu/economy_finance/publications/economic_briefs/2014/eb37_en.htm).

Table 1:

Economic Reform Programmes 2017
Key indicators

	2013	2014	2015	2016e	2017	2018	2019
Real GDP growth (% change)							
Albania	1.0	1.8	2.6	3.4	3.8	4.1	4.2
The former Yugoslav Republic of Macedonia	2.7	3.5	3.8	2.3	3.0	3.5	4.0
Montenegro	3.5	1.8	3.4	2.4	3.2	4.4	2.6
Serbia	2.6	-1.8	0.8	2.7	3.0	3.5	3.5
Turkey	8.5	5.2	4.0	3.2	4.4	5.0	5.0
Bosnia and Herzegovina	2.4	1.4	3.0	3.1	3.4	3.8	4.0
Kosovo	3.4	1.2	4.0	3.8	4.5	3.3	3.8
Unemployment rate (%, LFS)							
Albania	16.4	17.9	17.5	15.7	14.4	13.3	12.5
The former Yugoslav Republic of Macedonia	29.0	28.0	26.1	23.9	23.0	22.1	21.1
Montenegro	19.5	18.0	17.5	19.4	17.8	17.0	16.6
Serbia	22.1	19.2	18.2	17.0	16.0	14.7	13.2
Turkey	8.9	10.1	10.3	10.5	10.2	10.1	9.8
Bosnia and Herzegovina	27.5	27.5	27.7	25.4	24.7	24.0	23.2
Kosovo	30.0	35.3	32.9	:	:	:	:
Current account balance (% of GDP)							
Albania	-10.9	-12.9	-11.2	-12.1	-12.6	-12.0	-10.7
The former Yugoslav Republic of Macedonia	-1.6	-0.5	-2.1	-2.1	-2.3	-2.6	-2.5
Montenegro	-14.5	-15.2	-13.3	-21.0	-20.8	-18.8	-16.9
Serbia	-6.1	-6.0	-4.7	-4.1	-4.1	-3.9	-3.9
Turkey	-7.8	-5.0	-4.5	-4.3	-4.2	-3.9	-3.5
Bosnia and Herzegovina	-5.3	-7.4	-5.6	-2.9	-5.3	-5.8	-6.5
Kosovo	-6.4	-7.8	-8.9	-11.0	-11.6	-11.4	-11.4
Inflation (CPI, annual % change)							
Albania	1.9	1.6	0.2	1.3	2.3	2.8	3.0
The former Yugoslav Republic of Macedonia	2.8	-0.3	-0.3	0.0	1.3	2.0	2.0
Montenegro	1.8	-0.5	1.4	0.4	2.2	2.0	1.7
Serbia	7.9	2.1	1.4	1.1	2.4	3.0	3.0
Turkey	7.5	8.9	7.7	7.8	7.0	5.6	5.0
Bosnia and Herzegovina	-0.1	-0.9	-1.0	-1.0	0.5	1.0	1.2
Kosovo	1.8	0.4	-0.5	0.0	0.9	0.6	0.7

Sources: Economic Reform Programme (ERP) 2017 for 2015-2019, CCEQ for 2013 and 2014.

Table 2:

Economic Reform Programmes 2017
Fiscal indicators

	2013	2014	2015	2016e	2017	2018	2019
Total revenue* (% of GDP)							
Albania	24.0	26.2	26.4	27.0	27.3	27.3	27.3
The former Yugoslav Republic of Macedonia	30.2	29.8	31.0	32.1	32.7	32.4	31.6
Montenegro	43.4	44.8	42.1	45.1	44.8	43.9	42.9
Serbia	39.7	41.5	41.9	43.3	42.4	41.6	41.1
Turkey	40.0	39.6	40.9	41.9	41.4	40.3	39.7
Bosnia and Herzegovina	40.8	41.2	40.9	42.3	40.1	38.8	37.5
Kosovo	24.7	23.9	25.5	26.6	26.9	26.7	26.8
Total expenditure* (% of GDP)							
Albania	28.9	31.3	30.5	28.7	29.3	29.1	28.2
The former Yugoslav Republic of Macedonia	34.2	34.0	34.4	36.1	35.7	35.1	33.8
Montenegro	47.7	47.9	50.4	49.0	50.8	49.4	46.7
Serbia	45.0	48.1	45.6	45.4	44.1	42.9	42.1
Turkey	40.7	40.2	41.0	43.7	43.0	42.0	40.6
Bosnia and Herzegovina	42.3	43.1	42.0	42.7	40.4	37.9	36.3
Kosovo	27.8	26.5	27.1	27.7	31.2	30.7	30.6
General government balance (% of GDP)							
Albania	-5.0	-5.2	-4.1	-1.7	-2.0	-1.8	-0.9
The former Yugoslav Republic of Macedonia	-3.8	-4.2	-3.4	-4.0	-3.0	-2.6	-2.2
Montenegro	-5.2	-3.1	-8.3	-3.9	-6.1	-5.5	-3.8
Serbia	-5.5	-6.6	-3.7	-1.9	-1.6	-1.4	-1.1
Turkey	-1.3	-1.2	-0.1	-1.9	-1.7	-1.6	-1.0
Bosnia and Herzegovina	-2.2	-2.0	-1.1	-0.4	-0.3	0.9	1.2
Kosovo	-3.1	-2.2	-1.6	-1.2	-4.3	-4.0	-3.8
General government debt (% of GDP)							
Albania	65.6	70.1	72.7	71.0	68.9	66.3	62.8
The former Yugoslav Republic of Macedonia	34.0	38.1	38.1	41.3	42.7	43.0	43.9
Montenegro	57.6	54.8	65.7	66.6	71.6	74.9	77.5
Serbia	58.8	68.3	76.0	74.6	73.9	70.7	67.0
Turkey	36.1	33.5	32.9	32.8	31.9	31.0	29.9
Bosnia and Herzegovina	37.7	41.7	40.6	40.5	40.3	39.7	37.6
Kosovo	9.1	10.6	13.0	14.2	17.9	20.4	22.0

Sources: Economic Reform Programme (ERP) 2017 for 2015-2019, CCEQ for 2013 and 2014.
*2013 data from PEP/EFP 2015, 2014 data from PEP/EFP 2016. Kosovo data from CCEQ.

Notes:

2016e: *At the time of reception of the programmes, data for 2016 was still estimated*
CCEQ: *DG ECFIN publication 'EU Candidate and Potential Candidate Countries' Economic Quarterly'*
EFP: *Economic and Fiscal Programme*
LFS: *Labour Force Survey*
PEP: *Pre-accession Economic Programme*

Table 3: **Fiscal rules in the Western Balkans and Turkey**

Country	Main elements of the fiscal rule	Year of adoption	Main shortcomings
Serbia	The general government debt limit is set at 45 % of GDP. There is an augmented deficit rule taking into account deviations from the long term growth rate and from the medium term deficit target of 1 % of GDP. In addition, there are limits on government spending on wages and pensions. There is an independent body (Fiscal Council) to monitor implementation.	2010	No sanctions are provided for in the event of non-compliance, and implementation has so far been weak.
Kosovo	The deficit rule stipulates that the deficit cannot exceed 2 % of GDP; under the debt rule public and publicly guaranteed debt cannot surpass 40 % of GDP. There are exemptions to the deficit rule (recession, natural disaster, etc.). Capital investment financed from privatisation proceeds is exempt from the headline deficit, provided that government deposits amount to at least 4.5 % of GDP. New donor-financed capital projects are excluded from the headline deficit as long as the debt level remains below 30 % of GDP for a period of 10 years (starting in 2016). There is a spending limit of 0.7% of GDP on the war veteran pension programme. Starting in 2018, rises in the overall public wage bill will be tied to nominal GDP growth.	2013 and 2015	There is no independent body to monitor compliance.
Montenegro	The fiscal rule adopts the Maastricht limits – i.e. it caps the general government cash deficit at 3 % and public debt at 60 % of GDP. Growth in central government spending must be less than the forecast for real GDP growth. State guarantees should not exceed 15 % of GDP. If public debt exceeds 60 % of GDP the government is obliged to propose a debt stabilisation strategy with a five-year implementation period.	2014	There is no independent body to monitor compliance. There are no automatic spending caps and no deadlines for implementing fiscal measures.
Albania	The rule lays down a long-term debt ceiling of 45 % of GDP and budget balances that ensure a falling debt ratio until the target is reached. A 'buffer' clause ensures that 0.7 % of GDP is set aside as a budgetary reserve that can be used to compensate for forecasting errors and unforeseen changes in macroeconomic variables (lower growth than expected, changes in exchange rates, etc.). Macroeconomic assumptions used for budgeting purposes are drawn from the IMF's *World Economic Outlook*.	2016	There is neither a target deadline nor an independent body to monitor compliance. In economic upturns the rule does not provide a strong anchor for fiscal policy.
Bosnia and Herzegovina	There is no fiscal rule for the consolidated general government. Fiscal rules are in place for the two constitutional and legal entities.		
The former Yugoslav Republic of Macedonia	No fiscal rule is in place yet. The authorities intended to introduce one in early 2017 that would limit the general government fiscal deficit to 3 % and the public debt level to 60 % of GDP. But this has been postponed due to the political crisis.		
Turkey	There is no fiscal rule in place.		

Part II

Country analysis

1. ALBANIA

1.1. EXECUTIVE SUMMARY

Albania is experiencing a gradual economic upturn that is expected to continue in 2017-2019. The economic reform programme (ERP) projects GDP growth to strengthen to more than 4 % in 2018 on the back of rising domestic demand and improving net exports. Two large foreign direct investments in the energy sector are major drivers for expansion in the near term. Consumer spending is also expected to pick up further supported by rising employment, higher wages and record-low interest rates. Robust export growth is expected, based on the assumption that the oil price will stabilise and last year's growth in foreign tourism will continue. Stronger-than-projected import growth seems to be the main downside risk to the programme's forecast of real GDP growth.

Sustaining the ongoing economic recovery requires further reform efforts and the tackling of macroeconomic weaknesses in relation to public finances and the financial sector. Under its three-year International Monetary Fund (IMF) programme, completed in February, the country has made great strides in consolidating its public finances, while an accommodative monetary policy has supported the economy's cyclical recovery. Albania has also started to implement substantial business-relevant reforms, such as the comprehensive overhaul of the justice system. Nevertheless, enduring macroeconomic weaknesses and structural obstacles to growth call for sustained efforts to address the following main challenges:

- **While debt stabilisation has been achieved, high public debt remains a major source of macroeconomic vulnerability.** Public debt (including guarantees) still exceeds 70 % of GDP, and is associated with significant rollover and exchange rate risks. The country's fiscal adjustment plans are markedly less ambitious than in last year's programme and aim mainly at locking-in the recently achieved consolidation gains. The expected continuing fall of the debt ratio relies mainly on improving growth prospects and on modest expenditure restraint. While the pace of debt reduction envisaged is appropriate, there are non-negligible downside risks to it, mainly from lower-than-expected nominal GDP growth and from contingent liabilities. There is significant scope for raising more revenue by improving tax compliance and enlarging the tax base.

- **The overhang of non-performing loans still burdens banks' balance sheets and impedes credit recovery.** Banks are well capitalised and highly liquid, and household credit has been rising. However, despite multi-pronged efforts to address the problem, the non-performing loan ratio remains high and constrains business-sector lending. Furthermore, despite an ongoing gradual shift towards lending in lek, the proportion of loans issued in euros remains high and poses challenges both to the stability of the banking system and to the conduct of monetary policy.

- **Inefficiencies in the energy sector, including insufficient security of supply, continue to weigh on Albania's competitiveness.** The ERP recognises this and includes measures to further unbundle and liberalise the energy market following the adoption of the required legal base. Albania has started to diversify its energy sources through its gasification project. In terms of improving the sustainability of the energy sector, some progress has been made in bills collection, but tariff reforms are still awaited.

- **The lack of clarity around land ownership is among the key constraints on Albania's economic development, affecting a number of sectors including infrastructure and industrial development, agriculture, the property market and access to finance.** Progress towards establishing a comprehensive cadastre has been slow. The ERP maintains a narrow view of the issue, prioritising only agricultural land. An agricultural land consolidation strategy was adopted at the end of 2016, but implementation has yet to begin. There has been limited progress in establishing the legal basis for the creation of the much-needed e-cadastre. However, an e-procedure for buildings permits has been introduced.

- **High structural unemployment and inactivity and a widespread skills mismatch are the main challenges for the labour market.** Low quality of education at all levels is a general concern, and education outcomes do not meet labour market needs. Modernisation of curricula focuses on vocational education, but is progressing slowly and with insufficient involvement of the employers. While spending on active labour market policies (ALMPs) has increased, their effectiveness and coverage remain very low. Widespread engagement in informal work remains a challenge and there is no strategic approach to increasing formal employment. Ongoing activities to improve financial social assistance need to be complemented by strengthening the links between social assistance and measures to find work. Inability to address these challenges affects people's employment and social prospects of the population, in particular young people, women and the unemployed.

The policy guidance jointly adopted at the Economic and Financial Dialogue of 25 May 2016 has been partially implemented. Fiscal consolidation has advanced with the deficit narrowing more than planned. The fiscal framework has improved with the adoption of a fiscal rule, even though it does not provide a particularly strong anchor. Important steps have been taken towards liberalising the energy market, but the unbundling of state owned transmission and distribution companies has not been finalised. No progress has been made on setting up the e-cadastre, but steps have been taken to improve property registration. An e-procedure for building permits has become operational. Budgetary allocations for active labour market measures have increased, but the coverage of such measures remains very low and work on linking them with social protection support has not yet started. No progress has been made in reducing undeclared work or setting up a comprehensive approach to do so. The structural reform measures planned to be completed in 2016 in last year's ERP were only partially implemented.

Overall, the programme's macro-fiscal framework is plausible even though on the optimistic side, while the reconfirmed commitment to lowering debt-related vulnerabilities is in line with the priorities identified by the Commission in previous years. The fiscal framework also allocates resources to the implementation of important reform priorities, such as those related to the justice system, public administration and local governments. Structural obstacles to competitiveness and the reform measures, as presented in the ERP, largely match bottlenecks and reform needs identified by the Commission. However, the quality of the analysis varies largely among sectors. It focuses on relevant issues related to access to finance, contract enforcement, the informal economy, business regulation, the skills gap and the overall quality of education. The mix of structural reform measures is overall relevant, while the focus of some measures, especially in the field of employment, skills and social inclusion, is not clear.

1.2. ECONOMIC OUTLOOK AND RISKS

Albania's economic reform programme (ERP) projects an acceleration of economic activity based on continuing expansion of domestic demand and improving net exports. Private investment is set to be the main driver of growth in the near term fuelled by strong foreign direct investment planned in the energy sector. Consumer spending has strengthened recently in the context of record-low interest rates and an improving labour market. A steady increase in employment and wages is expected to continue supporting private consumption. Government consumption is projected to increase at a robust rate before being reined in in the last year of the programme period. In spite of relatively strong export growth, overall foreign trade (net exports) is still expected to subtract from GDP growth in 2017 due to large import-intensive investments. In subsequent years, however, import growth is projected to slow, while export growth is projected to remain robust. As a result, net exports are set to move gradually towards contributing positively to GDP growth. Seen from the production side, the ERP projects all economic sectors to contribute positively to growth in 2017-2019. The largest contributions are expected to come from agriculture, mining and quarrying, manufacturing, construction, and wholesale and retail trade. The highest growth rates are expected for mining and quarrying, as the industry is seen as recovering from the severe contraction linked to weak commodity prices. All in all, the ERP projects that economic growth will accelerate from 3.4 % in 2016 to 4.2 % in 2019.

Table 1:

Macroeconomic developments and forecasts

	2015		2016		2017		2018		2019	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	2.6	**2.6**	3.3	**3.4**	3.5	**3.8**	3.6	**4.1**	n.a.	**4.2**
Contributions:										
- Final domestic demand	3.2	**3.2**	4.5	**4.8**	5.2	**5.3**	4.2	**4.1**	n.a.	**3.6**
- Change in inventories	0.2	**0.2**	0.0	**0.0**	0.0	**0.0**	0.0	**0.0**	n.a.	**0.0**
- External balance of goods and services	1.8	**1.8**	-1.4	**-1.4**	-1.7	**-1.5**	-0.7	**0.0**	n.a.	**0.7**
Employment (% change)	4.9	**4.9**	4.4	**3.7**	2.6	**3.9**	2.7	**3.0**	n.a.	**2.6**
Unemployment rate (%)	17.5	**17.5**	15.3	**15.7**	14.5	**14.4**	13.4	**13.3**	n.a.	**12.5**
GDP deflator (% change)	0.3	**0.3**	0.4	**1.3**	1.7	**2.4**	2.3	**2.7**	n.a.	**3.0**
CPI inflation (%)	0.2	**0.2**	1.3	**1.3**	2.2	**2.3**	2.6	**2.8**	n.a.	**3.0**
Current account balance (% of GDP)	-11.2	**-11.2**	-11.8	**-12.1**	-13.1	**-12.6**	-12.8	**-12.0**	n.a.	**-10.7**

Sources: Economic Reform Programme (ERP) 2017, Commission 2017 winter Forecast (COM).

The ERP's projected trajectory for GDP growth appears somewhat optimistic and exceeds the Commission's winter forecast. In the ERP, private consumption is expected to accelerate gradually from 2.3 % growth in 2017 to 3.4 % in 2019, supported by a steady rise in employment, wages and household borrowing. Public consumption is expected to surge in 2017 following a decline in 2016. The estimate for 2016 appears unrealistic considering that the actual growth rate of public consumption in the first three quarters of the year amounted to 1.4 % year-on-year. Growth in capital formation is projected to slow (from 9.9 % in 2017 to 2.6 % in 2019), which appears plausible in view of the implementation schedule for the two large investment projects in the energy sector[1]. Exports are forecast to expand at an average annual rate of close to 6 % over the programme period, based on the assumption that the oil price will stabilise and then edge upwards. The export of tourism services expanded significantly in 2016 from a relatively low base and is expected to continue performing well. Imports are projected to slow from 6.1 % in 2017 to 2.3 % in 2019. As with investment, some decline in import growth is likely as a consequence

[1] The Trans-Adriatic Pipeline (TAP) and the Statkraft/Devoll hydropower project.

of the planned schedule for the energy projects, which entail large imports of capital goods. The magnitude of the decline may, however, be smaller than projected in the ERP considering the robust rise in both private consumption and exports. Given the projected divergence for export and import growth in the ERP, net exports' contribution to GDP growth is expected to turn from negative (-1.5 pps.) in 2017 to neutral in 2018 and positive (+0.7 pp.) in 2019. This is the main difference between the ERP's macroeconomic scenario and the Commission's February 2017 forecast, in which the drag on growth from net exports is projected to decline more moderately, i.e. from -1.7 pps. in 2017 to -0.7 pp. in 2018. Overall, the ERP's macroeconomic scenario is relatively plausible although somewhat optimistic. The major risk to projected GDP growth in the baseline scenario is that import growth will exert a stronger-than-expected drag.

Inflation remains below target and the central bank intends to keep monetary policy on an accommodative course. The annual average of the consumer price index rose by 1.3 % in 2016. Annual inflation has now run at below the central bank's 3 % target for four consecutive years, which reflects the absence of upward price pressures from a domestic economy that is still operating below potential in combination with disinflationary impacts from the external environment. In this context, the central bank reduced its key policy rate by half a percentage points in two instalments in April and May 2016, to a new historic low of 1.25 %. The central bank expects average inflation to rise to 2.3 % in 2017 and to return to target in 2018 as economic growth strengthens further. In this scenario, the central bank intends to maintain an accommodative monetary policy stance, but to remain flexible regarding the intensity of monetary stimulus. Specifically, it has signaled that it will not reduce the monetary stimulus before the fourth quarter of 2017. The recent monetary easing has reduced interest rates for private borrowers, thereby supporting consumer spending and private investment. Despite the narrowing of the lek-euro interest-rate differential, the lek appreciated 1.7 % against the euro in 2016 (average annual value) within Albania's floating exchange rate system. The lek's nominal and real effective exchange rates were up by 3.2 % and 4.1 % respectively year-on-year in the fourth quarter of 2016. For 2017-2019, the ERP assumes a constant nominal exchange rate against the euro.

The current account deficit is expected to widen in 2017 as a result of strong growth in import-intensive investments, before declining in the following two years. Albania has a relatively narrow production base resulting in a large structural deficit in the balance of trade for goods. This is partially offset by revenues from foreign tourism and the export of manufacturing services for foreign-owned products. In addition to the surplus on the balance of trade for services, the current account benefits from a large volume of remittances sent by Albanians abroad. Nevertheless, the current account has shown a deficit in excess of 10 % of GDP in each year between 2007 and 2015. In 2016 however, it narrowed by 1.2 pps. to 9.6 % of GDP mainly due to a rising surplus on the balance of primary incomes and current transfers. Goods imports are projected to increase relatively strongly during the final phase of TAP construction in 2017, and expanding domestic demand will be accompanied by rising imports throughout the programme period. Therefore, the import slowdown projected for 2018-2019 is less plausible than the projected rise in exports. The latter is seen to be based on slightly rising commodity prices, relatively low unit labour costs, and continued growth of tourism, even though growth in Albania's main export markets is expected to be tepid. Overall, the ERP projects that the current account deficit will widen to 12.6 % of GDP in 2017 before import deceleration reduces it by about 2 pps. over the following two years. In terms of the saving-investment balance, rising investment relative to GDP is projected to outstrip the expected increase in the domestic saving rate in 2017. This development is expected to be reversed in the next two years mainly as a result of strong growth in the ratio of domestic saving to GDP, while investment as a proportion of GDP is projected to fall slightly in the period 2017-2019. Overall, the assumed path for the current account balance appears somewhat optimistic.

Foreign direct investment is expected to remain the largest source for financing the current account deficit. In the past 10 years, net inflows of foreign direct investment (FDI) have financed close to two-thirds of the current account deficit. Net FDI inflows are projected to rise gradually to cover more than

80 % of the current account deficit by 2019. However, renewed decline in international commodity prices is a downside risk to this outlook since it would dampen FDI in the extractive industries. Albania's relative success in attracting foreign investment in recent years has been heavily concentrated in non-tradable and natural resource-based industries. Attracting FDI to higher value-added activities would integrate the economy better into global supply chains, boost productivity and create more and better jobs throughout the economy. This, however, would require wide-ranging structural reform to bring about substantial improvements in the investment environment. Gross external debt stood at 71.8 % of GDP at the end of 2016, down by 1.5 pps. from the preceding year. About 80% of the external debt is long-term. More than half of the long-term debt is owed by the government and most of the rest consists of intercompany lending between direct investors and subsidiaries. Although sizeable, the composition of the external debt means that it does not give rise to immediate concerns. Foreign exchange reserves totalled EUR 2.9 billion (26.3 % of GDP) at the end of 2016 and are expected to rise by more than 20 % over the next three years. Currently, the reserves cover about 7 months' worth of imports of goods and services, providing an adequate safeguard against adverse shocks.

Non-performing loans continue to impair bank balance sheets and hamper a revival in lending, even though banks are well capitalised and highly liquid. The ratio of non-performing loans (NPL) to total gross loans trended higher for most of 2016 before reversing and finishing at 18.3 % in December. The central bank attributes the declining NPL ratio in the final months of 2016 to the improving economic situation, credit restructuring and loan write-offs. It is still difficult to assess the effectiveness of the NPL action plan of September 2015, which involves legislative and regulatory measures and was expected to speed up NPL resolution and credit recovery. The high NPL ratio is a major factor behind strict lending standards which, in turn, explains much of the weak lending growth to the business sector. Private credit in Albania grew by only 2.8 % in 2016 (adjusted for the impact of loan write-offs). Monetary easing has led to a decrease in the lek-euro interest rate spread and has supported a gradual shift towards lending in lek. As a result, the share of foreign exchange loans in total loans fell by 2.2 percentage points to 58.6 % in 2016. Unhedged foreign exchange loans, which are associated with the risk of lek depreciation, constituted about 26 % of total private-sector credit in mid-2016. Overall, the banking system maintains adequate buffers to absorb shocks as capital adequacy and liquidity ratios exceed regulatory requirements and profitability has been improving. Banks are also not reliant on foreign-based parent banks for funding because the loan-deposit ratio is low (51.8 % at the end of 2016). However, the preponderance of short-term deposits among funding sources leads to maturity mismatches and hinders long-term financing by banks. On the asset side, government securities account for around 25 %, exposing banks to sovereign risk. The banking sector is relatively concentrated and two of the major banks do not have overseas parents and are therefore not covered by an international supervisor.

Table 2:
Financial sector indicators

	2012	2013	2014	2015	2016
Total assets of the banking system, mEUR	8,503	8,803	9,234	9,773	10,407
Foreign ownership of banking system by asset, %	89.8	88.6	87.1	84.1	82.6
Private credit growth*, %	1.4	-1.4	2.0	2.2	2.8
Deposit growth, %	9.4	3.7	1.5	1.9	5.0
Loan to deposit ratio	60.7	58.4	57.7	56.8	51.8
Financial soundness indicators, %					
- non-performing loans to total loans	22.8	23.2	22.8	17.7	18.3
- core capital to risk weighted assets	14.6	14.9	13.8	13.5	13.8
- liquid to total assets	29.4	27.6	31.9	32.3	31.3
- return on equity	3.8	6.4	10.5	13.2	7.2
- forex loans to total loans	64.5	63.0	62.4	60.8	58.6

**: Adjusted for loan write-offs*
Sources: Economic Reform Programme (ERP) 2017, Bank of Albania, ECFIN CCEQ.

1.3. PUBLIC FINANCE

In 2016, the fiscal deficit was significantly smaller than planned due to broad-based under-execution of expenditure. Total revenue increased by 6.8 % year-on-year driven by higher tax revenue in most categories. The ratio of revenue to GDP increased from 26.4 % in 2015 to 27.0 % in 2016, which was less than the planned increase to 27.4 %. Compared to the budget as revised in December 2016, total revenue was 2.3 % below target. This was caused by lower-than-expected prices for oil and minerals, lower inflation, higher-than-expected value-added-tax (VAT) refunds and a shortfall of dividends from state-owned companies. These factors were partly offset by higher revenue from profit taxes which, according to the ERP, was a result of the government's campaign to reduce informal economic activity. Total expenditure fell by 1.4 % year-on-year, much helped by the end of payments to clear central government arrears in 2016[2]. The ratio of expenditure to GDP fell from 30.5 % in 2015 to 28.7 % in 2016, which is significantly more than the planned decrease to 29.6 %. Compared to the budget as revised in December 2016, total expenditure was 4.2 % below target. Although the under-execution of expenditure was broad-based, it particularly reflected: (1) lower-than-expected inflation reducing social insurance outlays; (2) lower interest rates reducing interest payments; and (3) the recent reorganisation of local government units, which caused delays in local spending. Public-sector investment, as defined in the ERP[3], surged by 23 % year-on-year, much more than projected in last year's ERP. While public investment is crucial to address large gaps in infrastructure, a recurrent failure to adhere to spending targets (which more often takes the form of serious under-execution of the capital budget) indicates ongoing weaknesses in public investment management. All in all, the headline budget deficit narrowed from 4.1 % of GDP in 2015 to 1.7 % in 2016[4], which is significantly lower than in the original budget (2.2 %) and in the revised budget (2.4 %). The primary balance of general government moved from a deficit of 1.4 % of GDP in 2015 to a surplus of 0.7 % in 2016.

For the programme period, the ERP projects budgetary stabilisation and a gradually declining debt-to-GDP ratio. The overall fiscal deficit is projected to rise to 2.0 % of GDP in 2017 before

[2] Excluding the clearance of arrears, expenditure increased by 2.7 % in 2016, which is still less than nominal GDP growth of 3.2 % (GDP data released on 3 April 2017).
[3] Including grants to the Regional Development Fund administered by local governments, amounting to about 0.6 % of GDP.
[4] On the basis of GDP data released on 3 April 2017, the budget deficit amounted to 1.8 % of GDP in 2016.

declining to 1.8 % in 2018 and 1.0 % in 2019. The primary surplus is set to rise to 1.8 % of GDP by 2019. This is a markedly less ambitious fiscal plan than in the previous ERP, which targeted an overall fiscal deficit of 0.5 % of GDP and a primary surplus of 2.4 % in 2018. Essentially, the current programme foresees the budget stabilising in 2017 and 2018, with the deficit set to fall only in 2019. For 2017, the rising deficit has to be seen against the background of under-execution of expenditure in 2016. Following last year's drop, the ratio of expenditure to GDP is projected to rise by 0.6 pp. to 29.3 % in 2017. This would still be a 0.3 pp. decline compared to the original target for 2016. Over the following two years, the expenditure ratio is projected to fall by a combined 1.1 pps. to 28.2 %. The ratio of total revenue to GDP is projected to rise by 0.3 pp. in 2017 and to remain at this level in the following two years. This means that the projected narrowing of the fiscal deficit is expected to be largely achieved through a cutback in expenditure relative to GDP. This cutback is, however, more modest than in last year's ERP, which projected an expenditure-to-GDP ratio of 27.8 % as early as 2018. The projected paths for the fiscal deficit and for nominal GDP growth (around 7 %) would allow the debt-to-GDP ratio (including state guarantees) to decline gradually by 8 pps. to 63 % over the three years to the end of 2019. Overall, the government's planned fiscal stance is sufficiently strict to reduce the debt ratio further.

Table 3:
Composition of the budgetary adjustment (% of GDP)

	2015	2016	2017	2018	2019	Change: 2016-19
Revenue	26.4	27.0	27.3	27.3	27.3	0.3
- Taxes and social security contributions	21.0	21.5	21.7	21.7	21.7	0.2
- Other (residual)	5.4	5.5	5.6	5.6	5.6	0.1
Expenditure	30.5	28.7	29.3	29.1	28.2	-0.5
- Primary expenditure*	27.8	26.3	26.7	26.3	25.5	-0.8
of which:						
Gross fixed capital formation	5.3	6.2	6.0	5.9	5.6	-0.6
Consumption	9.4	8.7	8.9	8.7	8.4	-0.3
Transfers & subsidies	11.4	11.8	11.7	11.5	11.2	-0.6
Other (residual)	1.7	-0.4	0.1	0.2	0.3	0.7
- Interest payments	2.7	2.4	2.6	2.8	2.7	0.3
Budget balance	-4.1	-1.7	-2.0	-1.8	-0.9	0.8
- Cyclically adjusted	-3.9	-1.6	-1.9	-1.8	-1.0	0.6
Primary balance*	-1.4	0.7	0.6	1.0	1.8	1.1
Gross debt level	72.7	71.0	68.9	66.3	62.8	-8.2

**: Excluding arrears clearance*
Sources: Economic Reform Programme (ERP) 2017, ECFIN calculations

The 2017 budget seeks to lock in the gains from fiscal consolidation achieved in the previous three years during the IMF's economic programme for Albania[5]. Parliament adopted the 2017 budget law on 15 December 2016. Compared to the budget outcome for 2016, it projects total revenue to rise by 7.7 %. Oil-related revenues are projected to strengthen significantly, on the assumption of a 21 %-rise in the annual average price for oil. Tax revenues are also expected to benefit from the 10 % wage hike in large parts of the public sector, which was implemented in March following a three-year wage freeze. Revenue-generating measures include broadening the base of a tax on luxury cars and improvements in revenue administration. Total expenditure is projected to increase by 8.4 % year-on-year, which allows

[5] The IMF's three-year economic programme for Albania (an Extended Fund Facility equivalent to about EUR 377.3 million) was completed in February 2017.

scope for increases in public wages and pensions while containing the wage bill at the 2016 level as a percentage of GDP. Budget expenditure also covers the cost of structural reforms, such as strengthening the water utilities sector and implementing judicial reform. It provides for property restitution claims related to the communist era and additional resources for decentralisation. Following the surge in 2016, public investment spending is projected to increase at the relatively modest rate of 2.9 %, which reduces its share of GDP to 6.0 %. Fiscal plans assume that nominal GDP will grow by 6.3 % in 2017, which is one percentage point more than projected in the Commission's winter forecast. The budget deficit of 2.0 % of GDP is lower than the original and revised budget deficit targets for 2016 (2.2 % and 2.4 %, respectively), but higher than the realised deficit of 1.7 %. It is also higher than the 1.4 % deficit projected for 2017 in last year's ERP. In this perspective, a budget deficit of 2 % of GDP suggests that there is less ambition for fiscal consolidation, which might also be explained by the election cycle.

Beyond 2017, plans for fiscal consolidation rely on spending restraint, but the underlying measures are unclear. The ERP does not provide information about fiscal measures or analytical support for the budget projections, which are presented as tables. Total expenditure relative to GDP is projected to decline by 1.1 pps. between 2017 and 2019, with all the major spending categories increasing clearly at rates below the projected growth for nominal GDP. Interest expenditure, however, is projected to rise, reflecting an expectation of increasing interest rates in domestic and foreign markets. Social insurance outlays, the biggest expenditure item, are now linked to the annual rate of inflation, and social transfers' share of GDP is expected to decline by half a percentage point to 11.1 % in 2019. Improving the efficiency of public administration and better targeting social assistance schemes may create savings, but the ERP has no details. Total public investment is projected to continue to fall as a share of GDP, to 5.6 % in 2019. In the light of Albania's successful fiscal adjustment under the IMF programme in 2014-2016, the major downside risk regarding the ERP's expenditure targets seems to be the loss of the disciplinary anchor provided by the IMF programme. Another risk is posed by the outcome of the parliamentary elections in June 2017, which might lead to changes in political priorities. On the revenue side, risks stem mainly from the possibility that nominal GDP growth will fall short of the projection. In addition, without further revenue measures, meeting the target of keeping the revenue-to-GDP ratio stable will require sustained efforts to improve revenue collection, for which there is ample scope given the large informal economy.

The ERP's medium-term budgetary projections entail a number of additional risks which have not been fully evaluated in the programme. Apart from risks inherent in the implementation of fiscal discipline under conditions of uncertainty, Albania's budget position may be affected by financial obligations for which the government can ultimately be held responsible. Public guarantees represent one such source of risk, even if they are fully accounted for in the public debt and were reported to amount to 3.6 % of GDP at the end of 2016. There are also continuing fiscal risks associated with the electricity sector, which is expected to start repaying subsidies received in previous years. A further long-standing risk to the budget outlook is posed by the obligation, confirmed by international court rulings, to provide compensation to former owners of property expropriated in the communist era. The budget line dedicated to such compensation payments may be insufficient to cover the totality of eventual claims. There are plans to increase the use of public-private partnerships and concession contracts, which might entail fiscal risks in the form of contingent liabilities for the state budget. However, the ongoing tightening of the government's control of these arrangements, if implemented properly, might mitigate such risks. Finally, there are continuing risks entailed in financial management by local governments; their expenditure represents 3.2 % of GDP in 2017. However, in this area too the central government is in the process of improving public finance management, partly by drafting a new law on local finance.

Box: Debt dynamics

The debt ratio started to fall in 2016 as the primary balance moved into surplus. The ERP projects that the debt ratio will continue to fall on the back of a sustained primary surplus, rising inflation and a pick-up in real GDP growth. The implicit interest rate is expected to rise only moderately. The low level of stock-flow adjustments indicates that the government does not expect significant net flows of guarantees or exchange rate movements. The expected debt trajectory appears to be based on somewhat optimistic forecasts of the main macroeconomic and fiscal variables.

Table 4:
Composition of changes in the debt ratio (% of GDP)

	2015	2016	2017	2018	2019
Gross debt ratio [1]	**72.7**	**71.0**	**68.9**	**66.3**	**62.8**
Change in the ratio	2.9	-1.7	-2.0	-2.6	-3.5
Contributions [2]:					
1. Primary balance	**1.4**	**-0.7**	**-0.7**	**-1.0**	**-1.8**
2. "Snowball" effect	**0.7**	**-0.8**	**-1.5**	**-1.6**	**-1.7**
Of which:					
Interest expenditure	2.7	2.4	2.6	2.8	2.7
Growth effect	-1.7	-2.4	-2.5	-2.6	-2.6
Inflation effect	-0.2	-0.9	-1.6	-1.7	-1.9
3. Stock-flow	**0.8**	**-0.2**	**0.2**	**0.0**	**0.0**

Notes:
[1] End of period.
[2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and
Source: Economic Reform Programme (ERP) 2017, ECFIN calculations

The public debt ratio has started to decline from a high level, but public debt continues to entail risks. At the end of 2016, Albania's public debt (including public guarantees) stood at 71.0 % of GDP.[6] This was 1.5 pps. below the long-term peak at the end of 2015 and was the first decline in the debt ratio in seven years. Almost all of the public debt is owed by central government**.** In a benign interest rate environment, the debt generated interest payments worth 2.4 % of GDP, down from 2.7 % in 2015. Efforts to lengthen the maturity profile of the debt produced some results, but domestic refinancing needs still amount to about 21 % of GDP annually. With a narrow investor base consisting mainly of domestic banks, Albania is vulnerable to changes in market sentiment or host country regulatory requirements that could influence debt holders' willingness to hold Albanian securities. Foreign debt increased slightly to 47.3 % of total public debt in the course of 2016, which represents 33.6 % of GDP. Two thirds of the foreign debt is denominated in euros and most of the remainder in US dollars. The foreign currency debt exposes the government to exchange rate risk, especially to a potential depreciation of the lek against the euro. The envisaged fiscal consolidation is therefore essential to mitigate debt-related vulnerabilities and rebuild room for policy manoeuvre.

The reintroduction of a fiscal rule may support the achievement of debt sustainability over the medium term. Parliament amended the Organic Budget Law in June 2016, reintroducing a fiscal rule which mandates a long-term debt ceiling of 45 % of GDP and annual budget balances that ensure a falling debt ratio until the target is reached. However, the rule does not set a deadline for the target to be reached or require an independent body to monitor compliance. Whether the rule is sufficiently strict to ensure budgetary discipline and medium-term debt sustainability has to be proved in the programme period and beyond. In principle, the rule is likely to be helpful. Among other amendments to improve debt sustainability was the introduction of an annual budgetary reserve of 0.7 % of total expenditure to cover risks to public debt from adverse exchange rates and interest rate fluctuations.

[6] On the basis of GDP data released on 3 April 2017, the debt-to-GDP ratio stood at 72.0 % of GDP at the end of 2016.

1.4. STRUCTURAL REFORMS

The improvement in the quality of the structural reform part of the ERP compared to last year's programme is limited. The key obstacles to growth and competitiveness are properly identified. The ERP outlines a number of relevant measures to address these obstacles. Most of the proposed measures have been carried over from the previous ERP. In most areas, reform measures have been prioritised in line with the diagnostic section of the ERP and the expected impact on competitiveness is relevant. The Commission's assessment of last year's ERP has been partially taken into account. In many cases the evaluation of the measures' expected outcomes is not realistic enough or is not clearly analysed.

The proposed reform measures cover nine different areas reflecting the overall challenges to the competitiveness of the Albanian economy. The focus is mainly on the area of energy, transport and telecommunications markets with five measures included, while the other sectors are more evenly covered. This is broadly justified by the severity of the problems and/or the sector's potential. There is a good mix of legislative, administrative and infrastructure reforms without overemphasising infrastructure, but rather looking at genuine structural reforms. Contributions from the national budget are planned in most of the measures, showing a strong commitment of the government to the content of the reforms. However, the cost estimates, the respective budget impact and links between sectors and measures given are not comprehensive which makes this element more difficult to assess. Also, the infrastructure-related measures depend on co-financing by international financial institutions or donors, which raises questions about whether they will prove sustainable when maintenance funding is needed.

Further efforts in the implementation of comprehensive structural reforms in key areas such as transport, energy, telecommunications, business environment and education are needed to ensure sustainable economic growth. The business environment remains hampered by regulatory issues, weak contract enforcement and the lack of clarity of land ownership. The quality of education needs to be raised at all levels to better equip people with skills in line with the labour market needs. Last year's policy guidance covered these three areas specifically, but has unfortunately only been implemented partially. Implementation of judicial reform is beyond the scope of the ERP; nevertheless it is a key cross-cutting item needed for significant and sustained improvement of the business environment.

Public finance management

The ambitious public finance management (PFM) reform which the government is implementing could have a positive impact on competitiveness. However, the ERP fails to analyse this impact. The ERP only very briefly points out the constraints to competitiveness in the PFM field. In the ERP, it would be appropriate to select a few measures which could have a positive impact on competitiveness, for example public procurement reform or other measures increasing the efficiency of public spending, such as reform of local finances. The budgetary impact of the PFM reform strategy remains unexplored.

Transport, energy and telecommunications markets

Main obstacles to competitiveness in the transport, energy and telecommunications markets include the lack of efficient rail transport and the inefficient or inadequate capacity and operational structure of maritime infrastructure. The ERP diagnostic recognises this. While the low quality of transport infrastructure can be an impediment to integration in regional and global supply chains, the ERP should focus more on proper structural reform of network markets, i.e. the connectivity reform measures of the connectivity agenda (some of which are ongoing in Albania) in order to contribute most efficiently to improving competitiveness.

Four out of the five measures included in this area are rolled over from the previous ERP and are therefore well covered by the analysis (although less so on diversification/gasification). The two measures in the energy sector are highly relevant, but cover mainly the supply side, while the demand side is discussed less. Energy demand management, including measures to stimulate investment in energy efficiency, can also contribute positively to the competitiveness of the economy and to energy security.

The measure to further liberalise the energy market is needed and is in line with the obligations under the Third Energy Package and Albania's own strategies. However, the assessment of the specific contribution of this measure to competitiveness is weak. The measure is not imbedded in the overall framework of accompanying actions, like strengthening of the regulatory body, demand management, energy efficiency, or the need for price reforms. The price and tariff reform will require further efforts, while bill collection rates have improved significantly.

The measure connecting the country to the international gas network to create conditions for gasification in line with the development of the TAP project will promote energy diversification. The analysis of the state of play and of the challenges to competitiveness in this field is weak. If efficiently implemented, the measure is expected to have a positive impact on competitiveness, but risks should be considered. The measure has not been taken further since last year's ERP and only includes activities in 2017-2018, although the gasification project will go on into 2019 and beyond. The costs of implementing the measures have not been properly accounted for and the list of activities for 2017 seems unrealistic; more information on further plans should be provided.

With regard to transport, the two foreseen measures are in line with the TEN-T core network extension priorities, but do not address regulatory and structural needs related to the connectivity agenda, the so-called connectivity reform measures, which would have a more direct impact on competitiveness. In view of the shortcoming of infrastructure in Albania, the feasibility study for the extension of the Adriatic-Ionian corridor appears appropriate, but the project is at a very preliminary stage and can hardly be considered a structural reform even if it does address a structural need. The expected impact on competitiveness is presented in broad terms without figures for the expected passenger or freight traffic increase. Related issues, like the maintenance budget, have not been discussed.

The measure aiming at rehabilitating and extending the Durres-Airport-Tirana railway will allow the development of intermodal transport, but its estimated competitiveness impact appears over-optimistic. Some of the main risks are outlined, but no mitigating measures are proposed. The adoption of the Railway Law at the beginning of 2017, aiming to align the legislation with the requirements of the EU *acquis*, is an important step encouraging the development of the railway sector as a whole. There was progress in implementing the activities planned for 2016 under the previous ERP, especially the reconstruction of the port of Durres, but delays were reported for many of them.

The telecommunications measure to adopt the legal and regulatory framework for the construction of broadband infrastructure sets out the approach to ensuring broadband development in Albania well. A clear action for the coming two years is presented, without adding activities for 2019. The analysis of its impact on competitiveness goes far beyond the scope of the measure itself, as it can only be considered a very first step towards enabling synergy effects during the construction and roll-out of the physical infrastructure. In 2016, a law on the development of a high-speed electronic communications network was adopted, but the work on the development of spectrum policy continues. The measure is not expected to have any additional budgetary impact, apart from the administrative cost of the public staff involved (covered by the state budget), which is probably true for the legislation part. However, rolling out broadband requires broadband infrastructure investment, maybe even incentives, and this is not taken into account.

Sector development

Agricultural sector development

The small average size of agricultural holdings, low levels of co-operation between farmers, the absence of a comprehensive land register and low levels of investment in the sector are serious obstacles to the development of the sector. The diagnostic section correctly points to these challenges, but fails to flag up other problematic areas such as for instance phytosanitary issues and veterinary capacity. In view of agriculture's significant economic contribution to both GDP and employment in Albania, the consolidation and defragmentation of agricultural holdings remains a major priority, which should allow the development of a more efficient agriculture sector.

The rolled-over measure on consolidation and defragmentation of agricultural land focuses mostly on capacity development and public awareness-raising, without taking into consideration the creation of the technical conditions for the land consolidation process. Progress in its implementation in 2016 was limited to the adoption of the strategy on land consolidation. At the same time, efforts should be made to clarify property rights and develop a comprehensive land cadastre. Adopting a land consolidation strategy is an important step, but could be more ambitious and linked to cadastre development in general. Some risks are described, but others, such as delays due to property rights disputes, should also be considered.

Industry sector development

In general, the industrial sector is weak and exports are concentrated in a few product groups of low sophistication and level of processing. The 2017-2019 ERP is the first programme to examine the development potential of the industrial sector. However, the analysis focuses only on processing of different raw materials available in the country**.**

The measure introducing a strategy for the development of non-food industry outlines some preparatory actions towards a more strategic policy approach, in particular in the processing industry. The measure consists only of a number of feasibility studies, without a clear objective or impact on competitiveness, which calls its effectiveness into question. The considerable risks and uncertainties on the results of the studies are also not assessed.

Services sector development

The services sector contributes 70% of the gross value added and has an important export potential. The tourism sector in particular has significant development potential, but is impeded by a number of challenges linked to the lack of skills of tourism professionals, low accessibility of tourism services, the absence of a sustainable natural and cultural offer, etc. The ERP diagnostic of the services sector is not sector-wide; however, in terms of tourism development the main challenges are highlighted.

The measure to standardise the tourism sector, if implemented successfully, could be a driving factor for competitiveness. However, it should be implemented in the broader context of other challenges to the sector, like the lack of qualified staff, poor accessibility and unclear land ownership, etc., which may inhibit the development of the sector, in spite of the efforts outlined. More ambitious measures should be considered to keep pace with the steadily increasing popularity of Albania as a tourist destination. Information on the implementation of the measure in 2016 is not presented in Table 12 of the Annex to the ERP. The risks are well described and some mitigating measures, like awareness-raising, financial incentives and capacity-building, are considered.

Business environment and reduction of the informal economy

Insufficient clarity of land ownership, weak contract enforcement, poor access to finance and a large informal economy are the key weaknesses of the business environment. The diagnostic section of the ERP recognises all of these key challenges; in addition, it focuses on the need to further support female entrepreneurs. This gender-sensitive perspective is welcome. More could have been said about the need for significant streamlining of business regulations, including better impact assessments of legislative proposals and better stakeholders' consultations. There is no clear reporting on implementation of the policy guidance from last year on the development of an e-cadastre. Actions to reduce the informal economy are not specified as a measure, but they are described in the programme and should contribute to improving the business environment.

The measure to reduce the regulatory burden on businesses by expanding and improving the activity of the National Business Centre could have a major impact on the business environment and thus on the competitiveness of the economy, but it needs to be implemented in the broader context of tackling the other challenges identified in the sector. The same is true of the measure on improving access to finance by tackling the high number of non-performing loans. Implementation of the relevant reform measures in 2016 went well, in particular with the introduction of the system for e-construction permits, and the adoption of the new bankruptcy law.

Research and innovation

Research and innovation capacities in Albania are very low with no positive effects on the competitiveness of the economy. A policy and specifically an implementation framework for research and innovation is still lacking and is not provided by the ERP. The state of play and the challenges to competitiveness in the Research Development and Innovation (RDI) sector are also not comprehensively examined. The strategic documents quoted are outdated, and it is not clear if they are still relevant. Engaging the Albanian diaspora, increasing funding and a more focused RDI strategy in a number of specific sectors (e.g. in energy, the agri-food sector and sustainable tourism) could improve overall research and innovation capacity. Improving the governance of the R&I policy making process and reforming the public science base to increase quality and impact would also make a big difference.

The implementation of the measure aiming to support the development of innovation policies has been hampered by delays in approving the action plan based on the triple helix model. The plans for the creation of the innovation hub and the incubator for the ICT start-ups are welcome. The capacity development strategy for agencies providing innovation support services should be drafted earlier than in 2019 so that the agencies can start delivering in their policy fields. The cost per activity is stated, but the source of funding is not.

The measure on setting up basic structures for R&I governance addresses an essential weakness, but the activities lack ambition. The proposed budget is limited and the actions remain modest, focusing on developing institutional capacity, rather than implementing specific measures in the field. This means the expected impact on competitiveness is more long-term, which is not sufficient in view of the current challenges. Some risks are identified and devising a strategic framework for the sector is considered as a mitigating measure. The absence of indicators, baselines and statistics makes it very difficult to assess the potential impact of the two measures in this area.

External trade and investment facilitation

Trade remains constrained by non-tariff barriers and complex and unsynchronised border procedures. At the same time, the investment regulatory regime needs to be harmonised and enhanced. To increase productivity and economic competitiveness, conditions should be improved to foster much-needed investment. The ERP takes stock of the actions needed in this respect, such as improving the qualification of the workforce, fighting the informal economy, and protecting intellectual property rights effectively.

The trade facilitation measure is highly relevant and in line with national priorities and regional initiatives, such as the connectivity agenda agreed in the Berlin Process and the Central European Free Trade Agreement (CEFTA) Trade Facilitation protocol. It includes references to exchange of information with neighbours through the EU-financed system for the electronic exchange of data (SEED) maintenance project and to the efforts to establish an authorised economic operator (AEO) programme in Albania that is aligned with the EU's *acquis* in this area and that will facilitate trade for Albanian AEO's within the CEFTA region. To have a bigger impact on competitiveness, this measure needs to be combined with efforts to expand the country's industrial base (these are still underdeveloped in ERP) in order to diversify tradable goods.

Setting up a transparent legal framework for investment will be an important step in Albania's effort to attract foreign direct investment. While the measure may contribute to improving investor confidence, the expected impact on increasing investment appears optimistic.

Education and skills

The skills mismatch and a lack of vocational and entrepreneurship skills inhibit competitiveness and social cohesion in Albania. This is recognised by the ERP diagnostic and a number of broadly relevant measures are proposed. The ranking in PISA is low compared to other European countries and the World Bank reports a functional illiteracy rate above 50%. Teacher training is a major issue, partly because most teachers have only secondary education themselves. Furthermore, the lack of cooperation between education institutions and the business sector and employers affects school-to-work transition and timely and accurate adaptation to the labour market needs.

Vocational education and training (VET) is prioritised compared to other components of education, from preschool to higher education. Yet, progress in the field of VET is hindered by the delay in the adoption of the VET Law. Support for basic education is the essential starting point for meaningful reform and a foundation for further education, social and employment prospects. A number of measures implemented under the National Strategy for Employment and Skills can have a positive impact on the quality of VET and increase labour market participation, but the implementation remains weak.

Albania plans to continue with the two measures foreseen already in the 2016 ERP - drafting new competence-based curricula and modernising its VET system. New curricula based on the European Qualifications Framework and teacher training are being implemented for the pre-university education. The measures can help address some of the challenges related to the reform of curricula and a stronger VET system. Sustained, in-depth reforms and investments would be necessary to bring public VET provision in Albania up to the standards. The ERP gives little information on the content of the changes, which prevents the assessment of the relevance of the measure in terms of social and economic outcomes, and none of the measures include monitoring or evaluation mechanisms. The relevance of linkages with the private sector is recognised, but there is no indication of any concrete activities.

Employment and labour markets

High structural unemployment and inactivity remain major labour market challenges in Albania. Progress in linking education with the labour market is slow and the support through active labour market policies (ALMPs) and employment services is insufficient. Half of the registered unemployed only have basic education and their prospects to find regular jobs are minimal. The coverage rate of jobseekers with ALMPs has been very low until now (4.35% in 2016) and training measures are short, which is why - at current funding levels - no sizeable impact on reducing unemployment can be expected.

Low labour market participation particularly affects young people, women and the low-skilled and is linked with widespread informal work. Women have poorer education, employment and social prospects and are over-represented in the agricultural sector and in unpaid family work. The lack of targeted employment measures and weak preschool education further impede their position. Youth unemployment has only started to fall slightly in 2016, but remains at a high 30%, which is significant given the high proportion of youth in the population. Informality remains widespread, particularly in construction and agriculture, the latter being the main employer in the economy. The ERP recognises the challenges, but the design of the proposed measure is weak.

Funding for employment programmes continues to increase, but their outreach remains low. In line with the ERP, some employment programmes have targeted socially vulnerable groups, but the Employment Promotion Law, which should improve the situation, is still awaiting adoption. Similarly, the Law on Crafts was adopted, but the apprenticeship scheme has not been implemented yet.

The implementation of ALMPs and training of employment service staff continue slowly, but the ERP measure covering these activities is weak. Efforts to clear unemployment registers and to modernise employment offices and services are welcome. However, the budgets and the availability of services are limited. For example, there are no services outside urban centres, which is why a major impact on reducing unemployment cannot be expected. In particular older and the long-term unemployed persons stand little chance of benefiting from any new jobs created due to their low skills. In addition, the vague design of the measures will make them quite difficult to monitor.

Social inclusion, poverty reduction and equal opportunities

Poverty gaps in Albania are influenced by the education structure, geographic location and ethnicity. Labour market vulnerability contributes to aggravating poverty patterns. Unemployed people and workers with low wages are at greater risk of social exclusion. To advance the national agenda on social inclusion and fight against marginalisation and poverty, there is a need for strong commitment to tackle multidimensional aspects of social exclusion and poverty in the country. The diagnostic section of the ERP focuses on the recent efforts of the government rather than identifying the key challenges in the field.

Albania is working to improve outreach and coverage of social protection and has included a measure with this aim in the ERP. The Ministry of Social Welfare and Youth has developed a National Strategy on Social Protection (2015-2020), which aims at providing a holistic approach to social exclusion through establishing a social care system and puts greater emphasis on pinpointing beneficiaries' needs. Yet, its implementation so far has been limited. There is a National Electronic Register for Management of Economic Aid. By 2017, the numerical system is expected to have been introduced in all Albanian municipalities. Successful implementation should increase the efficiency and targeting of cash transfers to beneficiaries, but Albania has not made significant progress so far, as the relevant law was just recently adopted.

Strengthening social protection and social inclusion is better prioritised, but the design of the measure remains weak. Albania lists actions to improve financial assistance schemes, ensuring the sustainability of pensions and extending the national electronic registry to all municipalities by the end of 2017. A stronger design of the measure in terms of prioritising, setting specific targets and action points could contribute to a more comprehensive follow-up on the implementation. The interplay between social assistance and activation needs to be strengthened by extending ALMPs to include social scheme beneficiaries. The measure is relevant and can have a positive social impact if it is properly implemented, which is not guaranteed. The limited capacity of local governments poses a risk to implementation.

1.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2016

2016 policy guidance	Summary assessment
PG 1: Pursue fiscal adjustment by ensuring that revenue and expenditure targets and, by extension, the deficit target, are met. Evaluate and quantify fiscal risks stemming from all active PPP and concession contracts and from local government arrears.	Albania has **partially implemented** PG 1: • The budget deficit was below target in 2016 as a result of a broad-based under-execution of expenditure, while revenue also fell short of the target but to a lesser extent. • In January 2017, a public register of all active PPP projects was launched. It is envisaged to publish summaries of all PPP contracts as well as the contracts themselves. • Amendments passed in June 2016 to the Organic Budget Law (OBL) set a cap on annual budget support for PPPs, integrated PPPs into the budgetary process, and strengthened the MoF's role in their oversight. • MoF estimates local government arrears at 0.7 percent of GDP. The new local government units have developed action plans to gradually clear the arrears. The 2017 budget provides more resources to local governments to support fiscal decentralisation. Outright transfers from the budget will be conditioned on the successful clearance of arrears. A draft law on local finances has been prepared that will improve transparency, monitoring, and accountability when adopted. • A new fiscal risk unit at the MoF became fully operational in October 2016. It will periodically monitor and report on fiscal risks related to macroeconomic forecasting; central and local government debt and arrears; central government PPPs; state-owned enterprises and public investments; central government revenue collection; the financial sector; and central government restitution.
PG 2: Underpin fiscal consolidation by improving the fiscal framework; in particular, (i) strengthen medium-term budget plans by empowering the Parliament to approve binding three-year ceilings at programme level and by clearly showing in the MTBP which funds are effectively committed and which are new expenditure under the ceiling; (ii) move decisively towards adopting a fiscal rule which ensures debt sustainability, counter-cyclicality and transparency.	Albania has **substantially implemented** PG 2: • The OBL amendments from June 2016 fully empowered the Parliament to adopt binding medium-term expenditure ceilings at programme level. • Work has started to develop tools and methods for distinguishing existing policies from new policy initiatives in the MTBP. MoF and some line ministries will benefit from technical assistance by SIGMA during the preparation of the MTBP for 2018-2020 in order to better differentiate ongoing and new policy expenditure. The exercise will be extended to

	comprise all line ministries in the MTBP for 2019-2021. • The OBL amendments re-introduced a fiscal rule which mandates a long-term debt ceiling of 45 % of GDP and annual budget balances that ensure a falling debt ratio until the target is reached. However, the rule does not stipulate a deadline for the target to be reached or an independent body to monitor compliance.
PG 3: Continue to address risks to financial stability and the real economy by following-up on the NPL action plan which has been adopted and developing a medium-term strategy to promote the use of the local currency in the financial system, including all relevant stakeholders. Throughout this process, the central bank's monetary policy stance may remain accommodative insofar as the path of fiscal consolidation remains favourable, but risks related to further policy easing should be carefully assessed.	Albania has **partially implemented** PG 3: • The Parliament has adopted a new Bankruptcy Law as well as amendments to the Law on the Registration of Immovable Properties, the Law on Securing Charges, and the Private Bailiffs Law. These laws aim to strengthen the protection of creditors' rights and collateral enforcement. The adoption of several related bylaws is still outstanding. Measures have been adopted to accelerate NPL resolution through the use of out-of-court debt restructuring. • The Bank of Albania has revised its regulatory framework to facilitate the sale of NPLs to specialised non-bank financial vehicles and improve the management of repossessed collateral. The credit registry has been strengthened to contain information on court procedures, loan restructurings and sold loans. • Work has started on the de-euroisation strategy with discussions in the Financial Stability Advisory Group and the preparation of a draft MoU. The MoU identifies the areas where each of the participating institutions should focus its efforts and also contains indicators to facilitate regular monitoring and reporting. In its area of competence, the BoA has identified possible measures to deal with euroisation in the banking sector. The identified measures, affecting both sides of banks' balance sheet, are expected to be implemented gradually.
PG 4: Fully implement the obligations under the Energy Community Treaty including, in particular, the full unbundling of transmission and distribution activities in the electricity and gas sectors in order to improve energy security and allow market entry of independent operators.	Albania has **partially implemented** PG 4: • Legal framework is adopted but not the secondary legislation and the unbundling has not been finalised. • Market entry of independent operators is allowed by law, however, the conditions for supplier switching have yet to be implemented in practice. The applied distribution network tariffs are not fully cost-reflective relative to voltage level. ERE adopted switching rules as a first step in building the switching platform.
PG 5: Strengthen administrative capacities to ensure smooth legal land registration, the full functioning of the cadastre in general and	Albania has **partially implemented** PG 5: • There was limited progress regarding the

especially the e-cadastre until 2019. Implement the e-procedure for building permits in order to cut red tape and encourage investments.	functioning of the cadastre through the continued process of property registration; no details have been provided in the ERP; • E-procedure for building permits is in place.
PG 6: Increase the coverage of active labour market policies and improve the activation of unemployed and inactive persons, especially youth, women and long-term unemployed. Step up current efforts to achieve a comprehensive approach to reducing undeclared work.	There has been **limited implementation** of PG 6: • ALMPs are supported through sector budget support under the Instrument for Pre-Accession Assistance. Albania has been increasing budgetary allocation for ALMPs, but coverage remains very low (4% of all registered unemployed). • There have been some employment programmes implemented targeting socially vulnerable groups but groups vulnerable on the labour market should be prioritised as well. Employment Promotion Law is still pending adoption. The Law on Crafts has been adopted, but the apprenticeship scheme has not been applied yet. Measures to link ALMPs with social protection support are planned, but have not begun to be implemented yet. • No progress has been made in setting up a strategic/comprehensive approach to reducing undeclared work.

1.6. THE 2017 POLICY GUIDANCE

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

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

Brussels, 23 May 2017

[…]

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

1. Continue pursuing fiscal adjustment with a view to meeting the indicated medium-term targets for reducing public debt as a share of GDP. Introduce further fiscal consolidation measures if debt reduction is at risk of falling short of target.

2. Persist with recent revenue mobilisation efforts, in particular by (i) strengthening tax administration further; (ii) broadening the tax base based on a review of tax expenditures; and (iii) introducing a valuation-based property tax.

3. Implement the remaining measures of the NPL resolution strategy. Implement the measures foreseen in the Memorandum of Cooperation to increase the use of the national currency effectively, including differentiated reserve requirements for lek and foreign exchange deposits. Strengthen the supervision of the non-bank financial sector by increasing the capacity of the financial supervisory authority. Return to a normalisation of monetary policy if inflation rates converge to the target in a sustained way.

4. Ensure the full unbundling of transmission and distribution activities in the electricity and gas sectors, and establish a power exchange. Adopt the legal provisions necessary to promote and monitor energy efficiency improvement measures in compliance with the Energy Community Treaty.

5. Continue the processes of clarifying the ownership of agricultural land and registering property, and put in place a functioning comprehensive cadastre and an e-cadastre by 2019.

6. Enhance the capacities of employment services and their provision of active labour market measures to the unemployed and inactive. By end 2017, outline concrete plans to address undeclared work. Intensify teacher training to improve quality of teaching and support curricular reform.

ANNEX: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The economic reform programme 2017-2019 was adopted by the government on 25 January 2017 and submitted to the Commission on 31 January, as required. No components of the ERP are missing and its structure largely follows the guidance note provided by the Commission. However, Annex II on external stakeholders´ contributions contains only a summary instead of written contributions.

Interministerial coordination

The programme was jointly coordinated by the Ministry of Economic Development, Trade, Tourism and Entrepreneurship and the Ministry of Finance. All relevant line ministries were involved and contributed to the drafting exercise. However, the programme suffered from changes in staffing and organisation regarding ERP coordination between the two lead institutions. The ERP was adopted by Council of Ministers Decision No 49 of 25 January 2017 *On the adoption of the economic reform programme (ERP) 2017-2019*.

Stakeholder consultation

A public consultation was held at a suboptimal stage of the adoption process, including a meeting on 28 December with a deadline for written contributions of 7 January. Because of the holiday season, stakeholders could not properly influence priority-setting or the content of reforms. Annex 6 gives an overview of the opinions received from a number of stakeholders, but no original written comments are annexed. Parliamentary committees received the ERP for their consideration.

Macroeconomic framework

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

Fiscal framework

The fiscal framework is detailed and well integrated with the policy objectives. It is also consistent with the macroeconomic framework. Data on the implementation of the 2016 budget cover the first 11 months of the year — an improvement from the previous ERP, which covered only the first 9 months. The factors behind projected revenues are presented clearly, including the expected fiscal impact of economic growth, discretionary measures and better tax administration. However, there is scope for a better description of the planned expenditure measures and their anticipated budgetary impact. Forward-looking plans for debt management are less detailed than in 2016. Fiscal data do not meet ESA2010 requirements as regards the delimitation of general government, the distinction between financial and non-financial transactions, or the recording of accruals. Since November 2014, Albania has submitted regular excessive deficit procedure notifications to Eurostat on a best-effort basis and is expected to gradually align its fiscal statistics with EU requirements.

Structural reforms

The structural reforms sections (4, 5 and 6) broadly follow the guidance note. Section 4 and Table 12 in the Annex give an adequate but not complete overview of the implementation of the structural reform measures from the ERP 2016-2018. The total number of reform measures is limited to 19 and the page limit (40 pages) for section 4 has been met. The overall structure of the reform measures is in line with the guidance note; however, some measures would have benefited from a more comprehensive diagnostic, a more targeted and ambitious approach or a more forward-looking timeline. The description of the impact on competitiveness is not always based on rigorous analysis and baselines and indicators are missing. The quality of estimates of costs and budgetary impact varies greatly across different measures and in general leaves a lot of room for improvement. The identification of risks and mitigating measures is generally underdeveloped. The tables on budgetary impact and on implementation of ERP 2016-2018 measures have only partially been completed.

2. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

2.1. EXECUTIVE SUMMARY

Continued economic expansion depends on resolving the political crisis and restoring investor confidence. The economy expanded at an accelerated pace each year between 2013-2015**,** supported by accommodative fiscal and monetary policy, and fuelled by public investment and exports. Growth slowed down in 2016, as a protracted political crisis dented gross capital formation. The financial sector remained well-capitalised and highly liquid. The ratio of non-performing loans dropped significantly as a result of write-offs required by the central bank. The Economic Reform Programme (ERP) projects that growth will pick up again in 2017-2019, to 3.5% annually on average, on the back of a revival in investment, strong exports and further increasing private consumption. The external sector is not expected to contribute to growth as imports, driven by rising domestic demand, are projected to outweigh expected export gains. There are downside risks on this economic outlook, especially if the political crisis is not resolved and continues to weigh on investor and consumer confidence.

Containing fiscal risks, increasing employment, and developing the domestic private sector remain key challenges for the economy. Public debt has more than doubled since 2008, mainly as a result of sustained primary deficits. Structural problems in the labour market, such as low participation rates, and mismatches between skills supply and demand, restrict growth potential, while the development of the domestic private sector is hindered by a lack of legal certainty for companies. Sustained efforts are needed to address these issues.

- **Budget execution remains weak and fiscal consolidation plans are not underpinned by concrete measures.** For the medium term, the ERP adheres to previous deficit reduction targets. However, in the absence of concrete revenue or expenditure measures, the fiscal consolidation plans seem to rely on improving growth prospects and thus face downside risks. Fiscal transparency can be improved, including detailed multi-annual information on government spending.

- **Growing fiscal risks and a further increase in public debt are jeopardising growth-enhancing infrastructure spending.** The ERP projects a further increase in public debt until 2019 as a result of additional guarantee-backed borrowing by state-owned enterprises carrying out public investment. A potential failure to meet deficit targets would cause debt to rise at an even faster pace. Additional significant fiscal risks stem from the lack of a strong medium-term budgeting framework and a rising pension fund deficit. Capital spending suffers from repeated mid-year budget revisions slashing the investment budget as well as shortcomings in the planning and execution of capital projects.

- **Inadequate public finance management (PFM) still constitutes a main constraint for effective, efficient, transparent and accountable economic governance and has negative effects on structural reform implementation**. Gaps include an insufficiently transparent and efficient public procurement system and insufficient monitoring of public procurement implementation. The ERP acknowledges the importance of PFM and the urgent need to adopt the 2017-2020 PFM reform programme after several years of delays.

- **The business environment remains somewhat unpredictable with frequent legal changes and many para-fiscal charges at different administrative levels. The** main weaknesses include a frequently changing regulatory framework along with insufficient consultation of stakeholders, a large informal sector and problematic access to finance for SMEs. The ERP does discuss some of these obstacles, but fails to address others. Overall, it does not focus sufficiently on structural reforms for private sector development that will have a more fundamental effect on competitiveness.

- **Low employment levels among women, youth and the low-skilled remain impediments to more inclusive economic growth in the country.** Key obstacles in education include low levels of preschool education, insufficient numbers of teachers, unattractiveness of the vocational education and training (VET) system and insufficient links to labour market needs. There is only limited cooperation across policy sectors to improve planning, outreach, delivery and monitoring of active labour market policies so as to tackle the lengthy school-to-work transitions faced by young people. The coverage of active labour market measures for low- skilled and low educated unemployed in particular needs to be stepped up, since at present most active labour market measures target unemployed with at least secondary education. High rates of poverty and material deprivation remain persistent social challenges and worsen inequality.

Implementation of the policy guidance jointly adopted in the Economic and Financial Dialogue of 25 May 2016 has been limited. The government did not identify concrete measures it could implement to underpin fiscal consolidation, and a medium-term budget framework is still missing. The information contained in the fiscal documents was not improved. No concrete steps have been taken towards adopting a credible PFM reform programme. The use of the urgency procedure to pass legislation has not diminished and there is no systematic stakeholder consultation. Activation measures for the unemployed have been strengthened, but measures targeting low-skilled or long-term unemployed are still scarce.

The macroeconomic projections in the ERP are plausible, but fiscal targets are too optimistic. Risks related to a continuation of the political crisis are clearly acknowledged in the growth projections, which have been revised downwards compared to the previous year's programme. The expectations for general government revenues and expenditure appear less realistic against this background, and fiscal deficit targets remain ambitious. The fiscal framework's spending priorities are broadly in line with the structural reform measures outlined in the ERP. Structural obstacles to competitiveness and reform measures presented in the ERP largely match bottlenecks and reform needs identified by the Commission. However, the planned measures sometimes do not cover market functioning or regulatory reform.. There is a mismatch between the diagnostics and the programme's focus on transport and other infrastructure investments. There are either no or just a few measures in other important areas such as services, industrial development, corruption, the informal economy, education and skills, employment and social inclusion. For the vast majority of measures, reforms are mostly reliant on donor support, which raises concerns regarding government commitment to and sustainability of the reforms.

2.2. ECONOMIC OUTLOOK AND RISKS

In 2016, the economy proved resilient amidst a protracted political crisis and sluggish investment. Following annual GDP growth of 3.8 % in 2015, the pace of expansion slowed down in 2016 to an estimated 2.4 %. Economic activity was driven by a surge in private consumption and exports, fuelled by enhanced production capacities of foreign companies established in the country. However, negative confidence effects from the enduring political crisis restrained private investment. The government also again reigned in capital expenditure, due to constraints arising from the political crisis, and to mid-year budget rebalancing. Consumer prices dropped for the third consecutive year, propelled by lower food, energy, transport and housing and utilities costs. The core inflation rate remained positive.

The ERP projects an acceleration of economic growth in 2017-2019 to 3.5% on average, based on strengthening investment and exports. Gross investments are projected to increase on average by 5.8 % annually, as a return to political stability will improve private investors' sentiment. Public investment spending, estimated at some 25 % of the economy's total investment spending since 2009, is expected to remain an important growth driver, also in view of ongoing and new public infrastructure projects. Further increase in households' disposable income and projected 2 % annual average employment gains are expected to propel private consumption to grow by 2.5 % on average between 2017 and 2019. The external balance is likely to detract from growth in each of these years,as rising domestic demand and foreign companies' production would push import growth to an annual average of 5.5 %, overcompensating for export gains.

The risks from a further protraction of the political crisis to growth performance are clearly acknowledged in the programme. The government presents two alternative macroeconomic scenarios for 2017-2019 based on what it views as the main risks to growth. As in previous programmes, the first scenario presumes lower-than-baseline growth in the main trade partner economies and weaker external demand, leading to a lower increase in both domestic demand and, in particular, in exports. Output growth is projected to be lower by 0.8pp on average in each of the 3 years of the period covered in the forecast. In addition, the 2017 ERP contains a second alternative scenario assuming a protraction of the domestic political crisis into 2017 which results in lower output growth in 2017 by 0.8 pp. The ERP clearly points out that investors and consumers are likely to show increasing restraint in spending should the crisis persist. It also underscores that achieving its baseline macro scenario depends on implementing the fiscal consolidation strategy.

The ERP's growth projections and identified risks are broadly plausible. Overly optimistic growth and public revenue assumptions for 2016-2018 in last year's ERP made a downward growth revision necessary mid-year as the slowdown in economic activity became evident. As a consequence, the GDP growth projections for 2017 and 2018 are lower by 1.2pps, on average for each of these years compared to the previous ERP. Private consumption growth in particular has been revised and is now projected to be lower by 1.1 pps on average each year. Yet, household spending may surprise positively assuming that the political situation improves, as the fundamentals remain solid. Disposable incomes are likely to benefit from robust though lower increases in real net wages, compensating for the decline in private transfers from abroad, and, based on the ERP's assumptions, by further increases in government transfers, including pensions in a low-tax environment. Further improvement in the labour market and a benign price environment are also beneficial to household spending.

The external sector is expected to detract from growth throughout the programme's horizon. This comes as a result of buoyant import demand related to the expected rise in domestic investment and to the production of foreign companies, which is intensive in imported raw materials and equipment goods. The ERP's assumptions about trade performance in 2017-2019 might be too pessimistic given the programme's baseline assumptions on external demand developments. Previous years' programmes consistently overestimated the trade deficit, likely underestimating the contribution of export-oriented production by foreign companies. The increasing share of higher-value added exports is also contributing to an improvement in export performance. The government markedly lowered its expectations for both export and import growth in 2017 and 2018 compared to the previous ERP, but does not explain further.

Inflation projections have been revised downwards compared to the 2016 ERP. In 2016, consumer prices dropped for the third consecutive year, declining by 0.2 % y-o-y. The largest contributions to this drop came from lower food, energy, transport and housing and utilities costs. The core inflation rate remained positive. Based on firming foreign inflation and global prices of primary commodities, the ERP realistically expects consumer prices to rise moderately between 2017 and 2019. For 2017 the government has significantly revised its expectations compared to the 2016 ERP as a result of a lower than expected increase in energy prices in 2016.

Challenges from the external sector remain contained. The current account deficit widened in 2016 more sharply than expected by the previous ERP, to 3.2 %, compared to 2.1 % in 2015. It was more than covered by foreign direct investment inflows, which amounted to 3.7 % of GDP. The shortfall in the primary balance became more acute and private transfer inflows slowed down, although they still covered the much improved merchandise trade deficit. The government expects the current account deficit to narrow in 2017-2019 to 2.5 % on average. Primary and secondary income from abroad are, however, expected to decline further, while both the merchandise and the services trade balance are foreseen to improve.

While foreign companies are becoming important growth drivers, spillovers to the domestic economy remain modest. Foreign companies established in the country accounted for over 45 % of total exports in 2016, up from 16 % in 2011. They are the main drivers of export diversification and thus contribute to raising the economy’s resilience to external shocks. Since 2012, the share of higher-value added products in the country's export structure has increased gradually as foreign direct investment started to intensify in the sectors chemicals and machinery and transport equipment; these accounted for some 50 % of all exports in 2016 or almost double their share of 2011. The share of traditional export sectors, iron and steel and clothing, declined accordingly. However, export activity remains heavily concentrated with the top 20 exporters, about three quarters of them foreign-owned, accounting for some 56 % of the total. In spite of recent government programmes supporting the building of backward linkages between local firms and foreign companies, these relationships are mainly restricted to low-skilled service supply, rather than to technical cooperation. Therefore the economy is not fully realising the opportunity these companies offer for productivity-raising upgrading of domestic industrial production, which is required to help the economy achieve a self-sustaining structural change towards higher-value added production.

Table 1:
Macroeconomic developments and forecasts

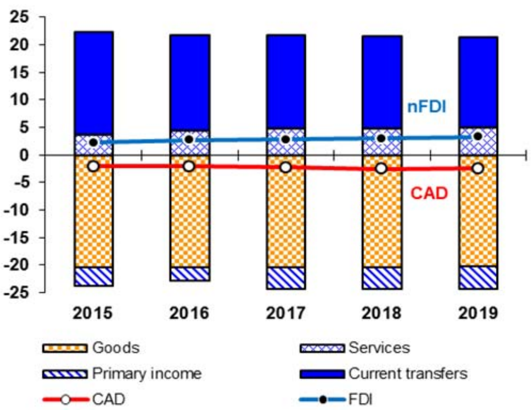
	2015		2016		2017		2018		2019	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	3,8	**3,8**	2,1	**2,3**	3,2	**3,0**	3,6	**3,5**	na	**4,0**
Contributions:										
- Final domestic demand	3,8	**4,0**	2,6	**3,7**	3,2	**4,5**	3,4	**5,1**	na	**5,2**
- Change in inventories	0,2	**na**	-0,6	**na**	0,0	**na**	0,0	**na**	na	**na**
- External balance of goods and services	-0,4	**-0,2**	0,1	**-0,2**	0,0	**-0,5**	0,2	**-0,8**	na	**-0,7**
Employment (% change)	2,3	**2,3**	1,8	**2,3**	1,6	**1,8**	1,6	**2,1**	na	**2,4**
Unemployment rate (%)	26,1	**26,1**	24,4	**23,9**	23,2	**23,0**	22,0	**22,1**	na	**21,1**
GDP deflator (% change)	1,9	**1,9**	1,0	**1,5**	1,7	**2,2**	1,9	**2,2**	na	**2,4**
CPI inflation (%)	-0,3	**-0,3**	-0,2	**0,0**	0,7	**1,3**	1,5	**2,0**	na	**2,0**
Current account balance (% of GDP)	-2,1	**-2,1**	-2,5	**-2,1**	-1,7	**-2,3**	-1,6	**-2,6**	na	**-2,5**
General government balance (% of GDP)	-3,4	**-3,4**	-3,6	**-4,0**	-3,2	**-3,0**	-3,1	**-2,6**	na	**-2,2**
Government gross debt (% of GDP)	38,0	**38,2**	40,2	**41,3**	41,7	**42,7**	42,7	**43,0**	na	**43,9**

Sources: Economic Reform Programme (ERP) 2017, Commission 2017 Winter Forecast (COM)

External debt is increasing as the public sector borrows heavily abroad. Gross external debt increased further in 2016, mainly on account of foreign borrowing by the government and by public sector companies. It amounted to 74.4 % of GDP at the end of the third quarter 2016, which is an increase of 5pps compared to end-2015. Despite this high level, the structure of external debt has improved recently. Three quarters of external debt is long-term, providing a stable maturity structure and mitigating refinancing risks, and some 80 % is denominated in euros. Debt indicators point to low indebtedness. The ERP contains a sustainability analysis of external debt as an annex, which is more elaborate than in past programmes and projects only a slight decline in the ratio until 2019. This would come as a result of lower private-sector borrowing, and in spite of increased borrowing by public enterprises. The share of more flexible kinds of debt (trade credits and intercompany loans) is projected to rise to some 40 % of total debt over the programme horizon, making external debt less vulnerable to shocks to the primary current account and to GDP growth.

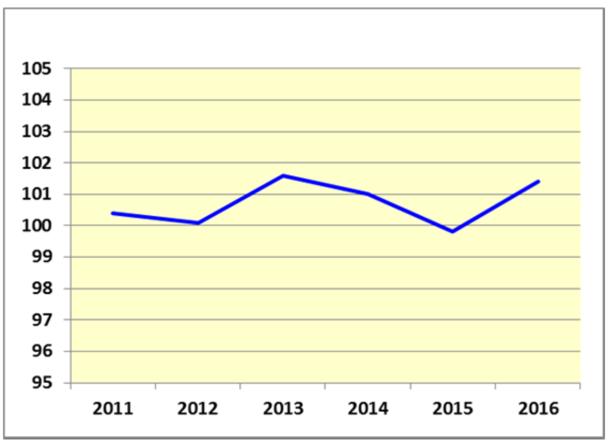
Graph 1: **External competitiveness and the current account**

Changes in the current account balance
(% of GDP)



Sources: ERP 2017, Commission calculations

Real effective exchange rate
(CPI based, total economy, 2005=100)



The banking sector shows resilience amidst a slowdown in loan and deposit growth. The sector's solvency, liquidity and profitability indicators remained robust throughout 2016. There was a marked slowdown in private sector credit growth in 2016, due in large part to the December 2015 central bank decision obliging banks to write-off by June 2016 fully-provisioned loans that had been on their books for more than 2 years. The bank also raised capital requirements for long-term consumer loans. Excluding the impact of write-offs, annual growth in credit to households and private companies amounted to 7.9 % on average in 2016, which is 1.2 pps lower than the previous year. The non-performing loan ratio dropped significantly in the second half of the year to 6.6 % of total loans by end-2016 as a result of the write-offs. Without the write-offs it remained at some 11%, as in 2015. There was a marked withdrawal of household deposits in April and May as a result of politically-induced speculation. The decline was more than recovered in the second half of the year, and overall deposit growth amounted to 5.7 % y-o-y in 2016.

Monetary policy is appropriate in the light of the challenges faced. In response to the massive outflow of deposits in the spring, the central bank raised the key interest rate by 75 basis points to 4 %. This was the first raise since 2013. However, transmission to commercial interest rates was sluggish. The central bank also took several macro-prudential measures, e.g. higher reserve requirements on deposits with foreign exchange element, and intervened in foreign exchange markets. As the situation in foreign exchange markets stabilised, the bank has lowered the key lending rate again in three successive moves of 25 basis points each since December.

Table 2:
Financial sector indicators*

	2011	2012	2013	2014	2015	2016
Total assets of the banking system, mEUR	5,385	5,738	6,008	6,509	6,889	7,230
Credit growth to private sector, annual change in %	8.1	7.3	4.3	8.4	9.0	6,5**
Deposit growth, annual change in %	4.6	7.2	6.1	10.4	6.5	5.7
Loan-to-deposit ratio	86.4	88.1	88.8	88.1	90.6	87.0
Financial soundness indicators						
- non-performing loans (in % of total loans to the non-financial sector)	9.6	10.4	11.9	10.8	11.3	6,6***
- regulatory capital to risk weighted assets	16.7	17.3	17.2	16.4	16.0	15.2
- liquid to total assets	32.0	32.9	32.8	33.2	31.4	30.9
- return on equity	3.4	3.8	5.7	7.4	10.4	13.6
- foreign-currency denominated loans (in % of total loans)	59.2	55.4	52.7	49.4	46.5	44.9

Sources: National Central Bank, DataInsight
**at end-year*
***excluding the impact of write-offs*
****including the impact of write-offs*

2.3. PUBLIC FINANCE

Budget execution was again weak in 2016. The government continued providing a fiscal stimulus to the economy throughout 2016. Pensions were, again, raised *ad hoc* beyond indexation. The government resorted to two supplementary budgets over the summer, necessitated by a downward revision of GDP growth and by compensation for flood victim respectively. These raised the general government deficit target to 4 %, from 3.2 % and increased budgeted current spending by 0.7 % of GDP, while lowering revenue projections and capital expenditure. As in previous years, revenue performance was again below even the revised budget projection due to lower Value-Added Tax (VAT) revenue. As a share of GDP and compared to 2015, revenues decreased by 3.1 pps. to 27.9 %. The 2016 general government fiscal deficit remained below the revised target, at 2.6 % of GDP, compared to 3.4 % in 2015. This came however on the back of a marked under-execution of capital expenditure (75 % of the revised budget, or 2.8% of projected 2016 GDP), which was downsized again as a result of both budget rebalancing and legal constraints imposed by the political situation.

The 2017 revenue and expenditure targets seem over-ambitious in the light of the 2016 outcome. On 17 October, the Macedonian Parliament adopted the 2017 budget. The budget provides for a general government deficit of 3% of projected GDP and is based on assumptions of 3 % real GDP growth and 1% annual inflation. The ERP projects the revenue share in GDP to increase by 0.6 pps. compared to the 2016 projection, to 32.7 % in 2017. However, this target appears hard to achieve in the light of the actual 2016 revenue outcome (27.9 %) and given existing shortcomings in revenue collection and compliance. In nominal terms the target would amount to an 18 % increase over the 2016 outturn, mainly as a result of higher collection of income and production taxes. The expenditure ratio would amount to 35.7 %, somewhat lower than the government's expectation for 2016 at the time of drafting, yet higher by 5.2 pps. than the 2016 outcome (30.5 %). Based on the 2017 budget, the ERP foresees a nominal increase in capital expenditure of almost 60 % compared to the 2016 outcome. This appears unrealistic in view of the persistent under-execution of capital expenditure, the continuation of political constraints hindering the commencement of new projects and the risk of renewed budget rebalancing mid-year. The fiscal stance is expected to be more restrictive, with the cyclically-adjusted primary deficit calculated by the government narrowing markedly and gradually to 0.7 % of GDP by 2019. Compared to the 2016 ERP, 2017 revenue projections have been revised upwards, albeit based on a lower growth projection. The general government deficit was revised upwards, but only marginally. The ERP would have benefited from an explanation how the government intends to meet these targets in the light of significantly revised growth assumptions.

Mid-term consolidation is envisaged, but specific measures to achieve this remain unclear. The government projects total revenues to rise by 28 % between 2016 (actual outcome) and 2019, and total expenditure to increase by 25 % in nominal terms. In line with the 2016 fiscal strategy, the programme envisages a reduction of the general government deficit to 2.6 % of GDP in 2018, unchanged from previous year's ERP and fiscal strategy, and then to 2.2 % in 2019. In the absence of concrete revenue or expenditure measures, these plans seem to rely on strong growth and optimistic revenue assumptions. Given that the government reached the target set for 2018 already in 2016, it could set itself more ambitious targets. This would have to be underpinned by clear and costed consolidation measures for 2017-2018, but without jeopardising growth-enhancing capital spending. This would also be a positive step towards stabilising general government debt ratios.

The government's plans to raise the efficiency of revenue collection and of spending seem to progress only slowly. Given an inflexible expenditure structure and low tax rates, the government has declared its intention, in the 2017 ERP (as in previous' years programmes), to underpin its fiscal consolidation plans by measures increasing the efficiency of social and capital spending and by improving tax collection and administration. Social assistance programmes remain fragmented and the measures announced by the government to streamline these payments have not visibly been implemented. General government capital expenditure amounted to only 4 % of GDP on average between 2011 and 2016, a relatively modest amount among peer countries. Moreover, there seems to have been a decline in the quality of public investment in recent years with a move towards projects with lower growth-enhancing potential and towards lower-value added sectors. To raise its efficiency, public capital spending needs better prioritatisation from the outset, based on multi-year projections of all involved costs, including the maintenance needs of transport infrastructure projects, as well as ongoing monitoring and performance evaluation.

Budget transparency concerns remain. Although the government’s budget documentation has become more comprehensive in recent years, important information is missing from the annual budget law and the medium-term fiscal framework. This relates mainly to (i) composition of deficit financing; (ii) financial assets; (iii) budgetary arrears; (iv) costing of major policy changes; (v) contingent liabilities. The ongoing project to set up a medium-term expenditure framework to improve budget planning capacities and increase transparency is progressing at technical level. Swift implementation of its results is essential.

Table 3:

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

	2015	2016	2017	2018	2019	Change: 2016-19
Revenues	31,0	32,1	32,7	32,4	31,6	-0,5
- Taxes and social security contributions	27,5	27,1	27,6	27,3	27,9	0,8
- Other (residual)	3,5	5,0	5,1	5,1	3,7	-1,3
Expenditure	34,4	36,1	35,7	35,1	33,8	-2,3
- Primary expenditure	33,2	34,9	34,3	33,6	32,2	-2,7
of which:						
Gross fixed capital formation	4,2	4,8	5,4	5,5	5,4	0,6
Consumption	11,6	12,0	11,2	10,7	10,1	-1,9
Transfers & subsidies	14,9	15,4	15,2	15,0	14,5	-0,9
Other (residual)	2,5	2,7	2,5	2,4	2,2	-0,5
- Interest payments	1,2	1,2	1,4	1,5	1,6	0,4
Budget balance	-3,4	-4,0	-3,0	-2,6	-2,2	1,8
- Cyclically adjusted	-3,4	-3,8	-3,1	-3,1	-3,3	0,5
Primary balance	-2,3	-2,8	-1,7	-1,2	-0,7	2,1
Gross debt level	38,1	41,3	42,7	43,0	43,9	2,6

Source: ERP 2017. Figures for 2016 are based on the Finance Ministry's projections from mid-2016.

Public infrastructure investment is vital, but driving up debt levels. While growth-enhancing public investments in the country's transport and energy infrastructure are vital to increase the economy’s productivity and competitiveness, the ERP acknowledges the risks these investments pose to public debt developments. Sustained primary deficits, and the borrowing of state-owned enterprises tasked with carrying out investments, have driven up public debt levels by 25 pps. since their low in 2008, to some 48 % of GDP by the end of 2016. The government projects a further rise to 56 % of GDP by end-2019 due to a further increase in borrowing by public sector companies. With general government debt projected to rise to 44 % of GDP by 2019, this implies an increase in public guarantees to 12 %, compared to 9.2 % of GDP at end-2016. The Public Enterprise for State Roads is the country's largest borrower, with guarantees amounting to some 4% of GDP. At the same time, borrowing costs are on the rise, in response to the protracted political crisis and a recent downgrading of the govenrment's long-term debt by Fitch.

Sizeable refinancing needs ahead. The government expects the level of public guarantees to decline after 2019 as the bulk of public construction projects would have been implemented by then. Repayments of sizeable external commercial loans are due to commence in 2019, followed by Eurobonds maturing in 2021 and 2023, respectively. These will require substantial refinancing, notwithstanding the government's abundant deposits at the central bank. Annual gross financing needs are estimated at about 14% of GDP on average between 2017 and 2020, rising to about 17 % in 2021 as the third Eurobond (500 million) matures. Over one fifth of the total is accounted for by external debt repayments. The government plans to finance the budget deficit and maturing debt repayments by a combination of external sources (international financial institutions, commercial banks, Eurobonds) and domestic sources. The proceeds of the July 2016 Eurobond (450 million) cover the 2016 budget deficit (some EUR 260 million) and finance parts of foreign debt repayments in 2016 and 2017.

The structure of government debt has improved. To reduce risks inherent in debt build-up, the government has improved the debt structure in recent years by lengthening maturities in the domestic bond portfolio and increasing the share of fixed interest rate debt, which accounts for about three quarters of total government debt. Borrowers do not hedge against foreign currency risks, mainly due to a lack of suitable instruments in the domestic financial markets. The government successfully lengthened the maturity structure of its domestic debt portfolio by issuing longer-term bonds. In the past year, there was a shift in the structure of bondholders away from commercial banks towards institutional investors, in particular pension funds and life insurance companies, reflecting the increasing weight of the mandatory second pension pillar, as well as towards foreign investors.

The adoption of envisaged fiscal rules has been stalled by the political crisis. To boost transparency and fiscal discipline the government had planned to introduce fiscal rules as an amendment to the Constitution, before the political crisis had set in. These rules would limit the general government fiscal deficit to 3% and the public debt level to 60% of GDP. However, these plans were put on hold as the political situation deteriorated and the two thirds parliamentary majority required for amending the Constitution could not be achieved.

Box: Debt dynamics

General government debt is expected to increase by 2.6 pps. between 2016 and 2019. The debt-increasing impact of the primary deficit would diminish gradually, as a result of fiscal consolidation, while the contribution of interest payments would increase. Real growth and inflation would, to an increasing extent, moderate the rise in debt. For 2019, the government projects a substantial debt-raising stock-flow effect which it fails to explain further.

Table 4:

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

	2015	2016	2017	2018	2019
Gross debt ratio [1]	**38,1**	**41,3**	**42,7**	**43,0**	**43,9**
Change in the ratio	0,1	3,2	1,3	0,3	0,9
Contributions [2]:					
1. Primary balance	**2,3**	**2,8**	**1,7**	**1,2**	**0,7**
2. "Snow-ball" effect	**-0,2**	**-0,6**	**-0,7**	**-0,7**	**-0,8**
Of which:					
Interest expenditure	1,2	1,2	1,4	1,5	1,6
Growth effect	-0,6	-1,3	-1,5	-1,6	-1,7
Inflation effect	-0,8	-0,6	-0,6	-0,6	-0,7
3. Stock-flow	**1,3**	**1,0**	**0,3**	**-0,2**	**1,0**

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual data.

Source: ERP 2017, Commission calculations

This year's ERP no longer mentions these projects. It would nevertheless be sensible to pursue the introduction of fiscal rules, but in a simple law rather than in the Constitution. This would make it easier to implement the rules and allow for subsequent adaptations using a less cumbersome procedure than that required for constitutional changes.

The ERP contains a **sensitivity analysis of the budget deficit** based on lower growth, lower revenue and higher expenditure than assumed in the baseline scenario. If GDP growth averages only 2.7 % over 2017-2019 (baseline scenario: 3.5 %) the deficit would be higher by 0.3 pps. in 2017, 0.5 pps. in 2018, and 0.7 pps. in 2019. If a domestic demand shock lowered 2017 growth to 2.2 %, the 2017 budget deficit would be 0.5 pps higher than in the baseline scenario. Lower revenue growth of 20 %, during 2017-2019 would result in a higher deficit by 0.7 pp. on average. A third scenario assumes higher expenditures (+25 %) in 2017 and 2018, resulting in higher budget deficits (+0.4 pp. in 2017, +0.7pp. in 2018).

A **sensitivity analysis of public debt developments** in response to interest rates and exchange rates shows that due to the high share of external government debt at variable interest rates, and denomination in euros, debt servicing costs would not increase significantly as a result of a 1 pp. increase in interest rates in 2017-2019 and a 10 % appreciation of other currencies in the debt portfolio in relation to the euro. The impact would be more significant if interest rates were to raise by 2 pps. in this period (which would lead to a 10-11 % annual increase in debt-servicing costs).

2.4. STRUCTURAL REFORMS

While the overall presentation of structural reform measures in the ERP has improved, their prioritisation remains problematic. The ERP contains clearer and more concise language and layout than in previous years. In addition, the overall diagnostic identifying key constraints on growth and competitiveness is relevant, as are some of the area diagnostics, although these vary in quality. At times, the area diagnostics are incomplete, especially on regulatory reform and market functioning. Additionally, there has been no visible improvement on prioritising reform measures, despite criticism already expressed in the 2016 Commission assessment. There is still a heavy emphasis on building transport infrastructure, both in terms of the number of actions planned and allocated budgets. The diagnostic does not justify this emphasis by demonstrating that transport is a more significant obstacle than, for example, skills or entrepreneurship. In general though, the estimation of the measures' impact on competitiveness has improved in response to the Commission's 2016 ERP assessment.

The proposed measures are spread over eight of the nine reform areas, leaving out the area of social inclusion, poverty reduction and equal opportunities. There is, however, still a particular focus on energy, transport and telecom markets (five measures) with emphasis on building transport infrastructure capacity. Also, the measure included under trade facilitation is an infrastructure measure rather than a policy reform. There is a justifiably strong emphasis on the agricultural sector. The emphasis on these two areas/sectors is especially clear when looking at the programme's budget allocations. There is less focus on improving the business environment and no measure tackling the informal economy, even though several key obstacles to competitiveness have been identified. Similarly, the two areas of education and skills and labour market and employment only include two measures despite the existence of key bottlenecks to the overall competitiveness of the economy in these areas.

The measures primarily entail investing in public infrastructure projects, although some also include more administrative and legislative reforms. Moreover, financing is mainly secured through external donor sources. Here, the relatively small contribution of the national budget to these projects raises concerns about government commitment to the reform process and measure sustainability when follow-up government engagement and expenditure for continuation or maintenance will need to be secured.

Main structural bottlenecks to competitiveness and growth include an unpredictable business environment with a frequently changing regulatory framework, little stakeholder consultation and no systematic law enforcement, a large informal sector, and problematic access to finance for SMEs. Private sector investment is persistently low, especially in research and innovation, while entrepreneurial skills remain underdeveloped. Public financial management remains inadequate, which also constitutes a considerable constraint on effective, efficient, and transparent economic policy and hence on economic development. Active labour market policies still need to improve their outreach and coverage to have a significant impact on the labour market. The policy guidance jointly adopted in the Economic and Financial Dialogue of 25 May 2016 covered these three areas but were only partially addressed.

Public finance management

The country's public finance management (PFM) system is weak when it comes to medium-term budget planning; public investment management; fiscal transparency; and assessing the budget impact of policy proposals. The transparency and efficiency of public procurement systems remain low, including the monitoring of public procurement implementation. The ERP diagnostic identifies some of these shortcomings, but not all.

The intention to adopt a comprehensive PFM reform programme in 2017, included as a measure in the ERP, is welcome. After adoption this needs to be followed up by concrete actions and clear timelines. The ERP provides some indications on the expected positive impact on competitiveness, but little discussion of risks and no further information on budgetary impact or social outcomes.

The measure on providing an IT platform for co-ordinating, monitoring and evaluating funds on a regional and local level is rolled over from the 2016-2018 ERP and is relevant as it would address the recommendation to improve fiscal transparency and budget planning capacity. It is well-designed and includes detailed, tangible and feasible activities. Nonetheless, the measure is not necessarily a systemic reform to improve fiscal transparency and budget planning capacity. It is arguably more of a public administration reform, which falls outside of the scope of the ERP.

Transport, energy and telecommunications markets

The economy is still characterised by a high energy intensity and inefficiency in energy production and limited integration into the regional power market. The ERP underlines that energy sector performance will be a key condition for sustained economic development and improved competitiveness and highlights the ageing energy system and convincingly argues for the need to revitalise the network and system management. However, the diagnostic does not include important issues such as liberalisation of utilities markets to increase competition. Despite recognising that electricity market liberalisation has been delayed and is now expected by 2020, the ERP does not discuss further specific measures to improve market functioning. The diagnostic on the transport market concentrates on road and rail networks but fails to assess the relative importance of this constraint. The country's transport networks are in adequate condition by regional standards and not necessarily a key constraint to growth and competitiveness. The telecommunications sector is relatively well developed and the diagnostic does not identify any obstacles to competitiveness.

None of the measures related to transport aim to reform the transport market through regulatory reform but focus exclusively on infrastructure investment. The measure to construct a joint railway border station with Serbia is new but it is not clear to what extent this responds to a key constraint to competitiveness. The measure does not indicate a budget for maintenance investment, and little or no discussion of risks and mitigating actions. The two measures on upgrading and rehabilitating corridors X and VIII include sub-measures on both rail and road transport. The 2016 Commission ERP Guidance note states that such infrastructure measures should be put in the wider context of reforming each specific transport market. The ERP did not follow this request, contributing to the programme's imbalance toward infrastructure investment at the expense of structural reforms with a potentially larger impact on competitiveness. The actions for construction measures planned in the 2016 ERP were all partially implemented.

The ERP does not foresee further regulatory measures targeting these markets. There is no discussion of measures to remove regulatory and administrative obstacles to opening transport markets, creating a transparent regulatory environment, and fixing fees that send proper price signals to users and allow for infrastructure repayment and maintenance. Not addressing such structural regulatory constraints significantly hinders any opening up of the economy. The Commission encouraged the government in its 2016 assessment and in discussions to refocus the ERP on structural reforms rather than infrastructure projects. In addition, as referred to in the 2016 Commission's ERP assessment, large infrastructure projects carry a higher risk of corruption and increase the need for a PFM reform programme with rigorous expenditure monitoring. Furthermore, reliance on external resources for new projects raises a concern over securing adequate follow-up resources for subsequent maintenance of the infrastructure system.

The two measures on energy aim to deal more comprehensively with energy needs but do not tackle regulatory reform. The measures focus on the supply side to increase production and transmission capacity to increase efficiency and strengthen regional connectivity and network reliability and security. The measures are rolled over from 2016, with the actions only partially implemented. There are still open issues on how to manage the country's ageing power generation plants, tackle dependency on imported gas and address the high energy inefficiency of the economy. The latter would require additional demand-side measures, including price and tariff reforms to send proper costing signals and align with the EU Energy Union goals. Also, the measures do not address the overarching need for market liberalisation and reform priorities related to the country's Energy Community obligations, particularly those on opening the electricity market, participating in the regional electricity Coordinated Auction Office and preparing and adopting the national energy efficiency and renewable energy action plans.

Sector development

Agricultural sector development

The agricultural sector suffers from poor irrigation as well as a large share of state-owned and fragmented land. The ERP rightly emphasises the problematic fragmentation of agricultural land. Private farms are too small to take advantage of economies of scale or to invest in new technologies. In addition, the share of irrigated land is significantly lower than in neighbouring countries. Forms of economic cooperation between farmers are at an embryonic stage of development. Moreover, migration from rural areas continues and a significant part of the land is abandoned.

The measures are well-conceived and attempt to tackle the primary structural constraints facing the sector; including land fragmentation, outdated equipment and technology, and increasing irrigation water shortages. All three measures are complementary to each other, meaning that coordinated implementation would strengthen their effectiveness. Two of the three measures are rolled over from the previous ERP where they had also been assessed as highly relevant, and the planned 2016 actions for both were fully or mostly implemented. The measure to improve irrigation systems is based on a clear diagnostic and assesses future requirements, including those arising from climate change and the growing need for additional irrigation, water management and flood protection structures. The ERP sets out timelines and includes considerable budgets. Given the size of construction work and the potential multi-dimensional impacts, a description of direct stakeholder involvement would be helpful.

The measure on the consolidation and defragmentation of agricultural land is a necessary and complex reform with potentially a significant positive impact. At the same time, the specific means to achieve the reform is not well detailed and possible risks have not been considered. There is no discussion of developing proper legislation on abandoned land, efficient monitoring of the use of state-owned land or of amending the law on land consolidation to incorporate state-owned land into the process. The new measure to establish agricultural cooperatives provides a detailed description and feasible timeframe and could further promote rural development and investment, and facilitate competitiveness and employment in the agri-food processing industry. There is, however, no discussion of risks and mitigating actions.

Industry sector development

There is a need to diversify industrial exports in terms of sectors and trading partners, as traditional products such as iron and steel, and textiles, still make up an important share of exports**.** Other key obstacles include the dependence on imported raw materials, underdeveloped enterprise clusters, limited access to finance, and insufficient management and marketing skills. The links between domestic industry and international production chains, including in the Technological Industrial Development Zones (TIDZ), are weak. The analysis in the ERP plausibly highlights these main bottlenecks to competitiveness of industry, but could in addition have mentioned the problematic access to energy, the significant skills gaps and insufficient levels of technological capabilities in domestic companies. No measures are planned as regards industry sector development.

Services sector development

The services sector employed almost 52% of the workforce in 2015 and provided over 60% of GDP. The ERP identifies three services sectors the government considers as having high growth potential (electronic commerce, tourism and creative industries). The brief diagnostics for each lists some of the main structural sectoral obstacles, and include regulatory impediments, including on consumer data, online security and lack of consumer awareness. The analysis also recognises the lack of a long-term strategy for developing tourism. It is, however, not clear on what criteria the sector selection is based as there is no diagnostic of the services sector as a whole. What the ERP refers to as "Creative Industries" is rather the information and communication technologies (ICT) sector.

The measures to increase the competitiveness of the tourism, hospitality and creative industries lack detail and are not embedded in a strategic approach. Two of the sectors (tourism and creative industries) also had measures in the previous ERP. The reporting of measure implementation lacks information on some activities. The measure on increasing competitiveness in the tourism and hospitality sector is relevant but is not part of the existing strategic national policy for tourism development. Similarly, the measure on increasing competitiveness in the ICT sector could have positive effects on higher valued-added production and employment for SMEs, but does not seem to be part of a strategic or comprehensive approach. The annual activity description is not very specific and could be further detailed, and there is no discussion of risks or mitigating actions. The measures are funded by an external donor, which raises concern over government commitment and sustained financial continuity or possible follow-up action.

Business environment and reduction of the informal economy

Private sector development is hampered by the large informal sector, a weak access to finance and political instability. The ERP diagnostic recognises some of these. It describes the country's relatively favourable position in the region but also depicts the deterioration in several areas in recent years, including on enforcing contracts, corruption, the informal economy (accounting for an estimated 20% of total employment), access to finance and fragmented government e-services. Other important challenges facing business, such as the unpredictable legal environment, including an uneven application of regulations and frequent changes to the legal framework receive inadequate attention in the programme.

Recurrent legislative changes without adequate stakeholder consultation make the business environment less predictable and reduce ownership. There is a need for more stakeholder involvement, in line with the 2016 policy guidance. However, this is prevented by continued use of the urgency procedure for legislation, and the lack of systematic use of the National Electronic Register of Regulations (ENER). The share of the informal economy in the economy remains large, distorting private sector competition and depriving the government of revenues; it would have warranted a reform measure. The weak links between FDI and local businesses could have been further elaborated.

The measures aimed at development of a national portal for e-services and the adoption of a national strategy for SMEs address some constraints, but to a limited extent. Given the many obstacles to competitiveness, this area could have contained more measures. The measure to develop a national portal for e-services can contribute to increased ease of doing business and strengthened transparency. It is likely to assist SMEs through decreased administrative burdens, especially in conjunction with measures to simplify requirements for licences and remove unnecessary regulations. The measure is related to one included in the previous ERP but there was no progress or implementation of it in 2016.

The new measure to adopt a national strategy for SMEs with an action plan represents a useful first step to provide a much-needed update of the national strategy. The numerous implicit actions included in the strategy and action plan need to be more clearly explained and prioritised. Similarly, the impact assessment requires a more precise discussion of specific activities. There is no discussion of risks or mitigating actions for adoption of the strategy and action plan.

Research and innovation

Limited access to finance, lack of innovation infrastructure and weak cooperation between academia and the private sector are key obstacles to growth in the RDI area. The ERP diagnostic notes that relative RDI performance has steadily improved over the past years, albeit from a very low base. However, it also recognises that as a share of total GDP, total R&D expenditure remains low (0.52% of GDP in 2014) and essentially consists of public expenditure, with negligible private sector contributions (0.02% of GDP in 2010). The diagnostic shows an awareness of the strong correlation between investment in R&D and competitiveness and economic growth. It rightly acknowledges the low RDI absorption capacity of SMEs as a problem. However, it does not analyse the reasons for the weak cooperation between universities and private sector.

The measure on improved infrastructure and access to funding for research plans to provide funding instruments for several stages of the innovation cycle. The measure is rolled over from the previous ERP, albeit under a different name. The activities planned in 2016 were not implemented. The measure is targeted at SMEs and should help increase innovation and competitiveness; this will depend on SME absorption capacity, which has been low. There is a concern that no actions are planned to improve such absorption capacity, limiting the potential impact of this measure.

The measure on creation of a 'Triple Helix Partnership' between academia, private sector and government fosters an inclusive approach to structural reform in this area. It is rolled over from the ERP 2016-18 and concentrates on three sectors, based on potential growth and country strategies: agriculture, ICT and renewable energy. The focus is not exclusive and several other industrial and service areas are included as well. In 2016 the planned establishment of the National Technology Transfer Office (NTTO) was delayed due to regulatory compliance issues. NTTO establishment is now foreseen for 2017. Again there is no discussion of mitigating actions for the risks related to measure implementation. If this measure can be sufficiently developed it could lead to the creation of several innovation hubs and have an appreciably positive impact on the economy.

External trade and investment facilitation

Obstacles in this area relate to SMEs' difficulties in entering export markets due to relatively high logistical and customs costs and to a lack of managerial, financial and technical capacities. The ERP highlights these constraints, together with the limited linkages between FDI and domestic companies.

The measure upgrading customs clearance facilities at road border crossings considered bottlenecks to cross-border trade, is likely to support trade. The measure focuses on improving the physical structures and does not include associated plans to increase IT capabilities, such as the project to develop a new customs IT system (Customs Declaration and Excise Documents Processing System) whose completion is long overdue. Such an integrated approach is required if the volume of traffic crossing at these points is to increase in line with projections. Another important customs administration project already implemented (the New Computerised Transit System NCTS) is also not mentioned as a supporting element.

Education and skills

Key challenges in education and skills area include the low attendance in preschool education, insufficient number of teachers, the unattractiveness of the VET system and insufficient links to labour market needs, as well as low participation in lifelong learning, and a low level of transversal/soft skills. The main challenges for higher education are quality, accreditation and evaluation, relevance of study programmes, skills mismatch and lack of cooperation with the labour market. The vocational education and training system is characterised by weak capacity of the VET Centre and VET providers and lack of effective cooperation with the business sector The ERP diagnostic recognises most of these challenges.

However, the ERP fails to mention the low quality of primary and secondary education. Relevant indicators, such as the 2015 PISA results, where the country is at the bottom of the ranking table - over 100 points below the OECD average in each of the three domains, point to persistent challenges of the country's education system, revealing, i.a. that two-thirds of 15-year-olds are functionally illiterate in each tested subject area. The country's largely segregated education system brings additional challenges, in particular the fact that students from the different communities are taught separately, making it harder to ensure a uniform level of quality and investment in education across all schools.

The measure on the further development of the qualification system focuses primarily on occupational standards. Apart from them, an effective qualification system needs other elements and the steps for their implementation require a strong institutional framework not yet expressed clearly enough in the ERP. The occupational standards (e.g. 60 new occupational standards) will not suffice to achieve the impact on competitiveness it is claimed it will have, if the links between the labour market needs, curricula, learner assessment and certification are not incorporated into a systematic approach. Other important aspects include increasing the quality of work-based learning, updating teacher skills, developing post-secondary education. The activities under the measure should be more specific in terms of: selection of the two priority sectors for development of new qualifications; data collection approaches; the role of Skills Observatory; and, quality assurance of qualifications. The budgetary impact is rather general and tends to show a listing of donor supported initiatives rather than a government-led holistic and strategic approach.

Employment and labour markets

Low employment levels among women, young people and Roma remain impediments to more inclusive economic growth in the country. Despite continued marginal improvement, the female employment rate (20-64 years) remains quite low at 42.1 % (2015). At the same time, the rate of young people not in employment, education or training is persistently high at 33.9 % (2015). The ERP diagnostic reflects the key challenges. However, there is only limited cooperation across policy sectors to improve planning, outreach, delivery and monitoring of active labour market policies to tackle the lengthy school-to-work transitions. In addition, regulatory and procedural barriers impede access to internships and work-based learning.

The provision of activation measures for vulnerable young people, women and long-term unemployed has only been partially strengthened. Most activation measures for young unemployed people target people with at least secondary education who are active job seekers. At the same time, the administrative division between active registered unemployed people and others looking for work (i.e. passive unemployed people) creates an artificial and administrative barrier to the take-up of active employment measures. Investment in activation measures targeting people with low levels of education is insufficient. The current operational plans provide scarce options for activating passive registered unemployed people, the long-term unemployed and unemployed people with only primary education. Such people should be provided with literacy courses and similar offers profiled for their educational/gender/ethnicity background. While the Employment Service Agency's capacity to carry out profiling and personalised counselling of job seekers has been strengthened (to a large extent by EU-funded activities), the continuity and sustainability of reform efforts still need to be secured.

The measure for profiling of the unemployed and designing individual employment plans continues a previous commitment to build up the capacity of the Employment Service Agency. The instruments planned are welcome steps towards a more effective delivery of services and a sustainable fight against unemployment. However, the coverage of low-skilled unemployed people needs to be gradually increased, since most active labour market measures target unemployed people with at least secondary education. Only 7500 unemployed people per year will receive support through individual employment plans. This figure is low given the number of people who face difficulties gaining employment. The high adviser–client ratio and limited resources are impeding factors that may put at risk full accomplishment. In addition, the number of unemployed people to be covered will remain the same for all 3 years, which might not necessarily reflect reality. To have a reasonable impact on the labour market the measure has to be more ambitious in terms of coverage and funding.

Social inclusion, poverty reduction and equal opportunities

The high rates of poverty - 21.5 % (2015) - and material deprivation - 51.4 % (2015) - remain persistent obstacles to social inclusion and are worsening inequality. The unemployed and households of two adults with three or more dependent children face the highest poverty rates – 39.7 % and 52.2 % respectively. While the ERP recognises the key challenges, the current policy does not provide appropriate and accessible social protection for all in the context of high unemployment rates, irregular wages and high demand for social welfare. The social assistance scheme may have generated disincentives for potential low-wage and part-time earners to shift from inactivity or from the informal sector to formal jobs. In addition, child protection is essentially targeted at working parents (i.e. through child benefit, use of public kindergartens, etc.) and there is very little or no support for the unemployed and low-income households with children.

No reform measure is proposed under this heading even though data point to multiple barriers for vulnerable groups, gender gaps and a high incidence of poverty. However, to advance the national agenda on social inclusion and fight marginalisation and poverty, what are needed are updated insights on the incidence of vulnerability and a clearly expressed commitment to tackle multidimensional aspects of social exclusion and poverty in the country, through measures in such areas as education, employment and regional development. This implies a need for a more fundamental reform so that the country has a social welfare assistance system that is better run, better targeted at those who need it and which engages in inter-institutional coordination.

2.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2016

2016 policy guidance	Summary assessment
PG 1: Underpin fiscal consolidation by identifying concrete revenue and expenditure measures; move towards a better targeting of transfer spending and improve the growth-friendliness of public finance, in particular by fully executing planned priority public investment spending. Protect against fiscal risks by using any excess revenue to create fiscal buffers.	PG 1 has **not been implemented**: • The government has not defined measures underpinning fiscal consolidation plans. • Revenue projections were adjusted downward twice mid-year. • Capital expenditure spending reached only 75% of revised budget, mainly as a result of two budget rebalancings cutting capital spending. • Pensions were again increased ad hoc by 5% on average above indexation in 2016.
PG 2: Improve fiscal transparency and budget planning capacity by the swift introduction of a medium-term expenditure framework; by providing multi-annual projections of detailed revenue and expenditure components in the medium-term strategy as well as by comprehensive reporting of extra-budgetary expenditure in the consolidated fiscal reports. Inform systematically about payments arrears.	PG 2 has **not been implemented**: • There was no enhancement of information contained in the fiscal documentation. Gaps remain, for example, regarding the budget impact of policy changes; multiannual costing of investment projects; information on payment arrears. • The medium-term fiscal strategy for 2017-2019 does not contain details of annual revenue or expenditure categories, nor does it contain a numerical composition of external and domestic sources of deficit financing. • The project for implementation of a medium-term expenditure framework started in December 2015 and is still ongoing.
PG 3: Develop comprehensive strategies involving all relevant stakeholders in order to both further foster the resolution of non-performing loans by banks and further promote the use of the local currency with a view to reducing risks to financial stability and the real economy. There would be a case for a gradual removal of the central bank's accommodative monetary policy stance to the extent that authorities' sanguine macroeconomic scenario is realised (including through its impact on inflation expectations and on the output gap).	There has been **limited implementation** of PG 3: • There was no comprehensive strategy developed to deal with the resolution of non-performing loans. The central bank required commercial banks to write off all non-performing loans that had been fully provisioned for more than 2 years, by June 2016. This implied a move of a part of NPLs from on-balance sheet item to off-balance sheet item, with banks keeping the opportunity to collect the claims, and debtors still having the NPL on their balance sheet.
PG 4: Adopt a credible public finance management reform programme. Prioritise public investments against clear policy objectives and identify the needs to which they respond. Increase the transparency on the selection criteria for the investments and on their impact on economic growth and on the fiscal path.	There has been **limited implementation** of PG 4**:** • The National Investment Committee responsbale for preparating and implementing infrastructure investments was created in June 2015 and has become more operational. It has introduced tools incl. cost-benefit analysis, and single pipeline approach and met several time,

	most recently in December 2016 to present investments to be submitted to the WBIF. • There is as yet no PFM reform programme finalised and adopted yet with a concrete action plan for its implementation. Due to the political crisis this process might be substantially delayed. A PFM policy dialogue is planned to be carried out and the PFM reform programme is expected to be approved once the new government is established and functional.
PG 5: Ensure a reliable and predictable regulatory environment for businesses by reducing the use of the urgency procedure for legislation, ensuring proper consultation of the stakeholders and reinforcing the independence of commercial courts.	PG 5 has **not been implemented**: • Although the country improved its ranking in the World Bank Doing Business Report 2017, it dropped in other ranking reports. The practice of using urgent procedures for adoption of business related legal acts continued. There is no systematic consultation with interested parties to ensure transparency and ownership. Consultation relies solely on the National Electronic Registry of Regulations (ENER) and the work of the National Competitiveness Council (which was closed recently). However, these do not secure proper consultation with the business sector.
PG 6: Strengthen the provision of activation measures especially for vulnerable youth, women and long-term unemployed and further improve the capacity of the Employment Service Agency for profiling and personalised counselling of job seekers.	PG 6 has been **partially implemented**: • The provision of activation measures especially for vulnerable young people, women and the long-term unemployed has been partially strengthened. Most activation measures for young unemployed people address people with at least secondary education who are active job seekers. However, the current operational plans provide few options for the activation of passive registered unemployed people, the long-term unemployed and unemployed people with only primary education. • The capacity of the Employment Service Agency for profiling and personalised counselling of job seekers has been strengthened, to a large extent thanks to EU-funded activities. The continuity/sustainability of activities like staff training and IT upgrading still needs to be secured.

2.6. THE 2017 POLICY GUIDANCE

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

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

Brussels, 23 May 2017

[…]

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

1. Develop a proper fiscal consolidation strategy by defining and costing concrete revenue and expenditure measures on a multi-annual basis, whilst protecting growth-enhancing spending. Improve the efficiency and effectiveness of public spending by streamlining and better targeting transfer payments.

2. Improve budget planning capacity, in particular through the introduction of a medium-term expenditure framework. Enhance fiscal transparency by including information in the budget documentation on the composition of deficit financing; the budgetary impact of new policy initiatives; payment arrears; and spending and borrowing by state-owned enterprises. Adopt fiscal rules, as an ordinary budget law if their constitutional embedding proves difficult.

3. Continue efforts to further strengthen the use of the local currency and to further foster NPL resolution by developing a comprehensive strategy to these ends, with the participation of all relevant stakeholders. The monetary policy stance should remain consistent with the exchange rate peg, using available scope within this framework in line with safeguarding price stability.

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

5. Reduce the use of the urgency procedure for legislation and make full use of the National Electronic Registry of Regulations (ENER) to ensure proper and systematic consultation of the stakeholders, and reinforce the independence and the capacities of commercial courts.

6. Strengthen the outreach and coverage of active labour market policies towards the long-term unemployed, youth, and the low-skilled. Improve the qualifications of teachers and increase enrolment in pre-school education. Stimulate work-based learning in both initial and continuous vocational education and training.

ANNEX: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Economic Reform Programme (ERP) 2017-2019 was submitted by the government on 31 January 2017. It is broadly in line with the medium-term fiscal strategy and the 2017 Budget Law. The programme includes sections assessing the sustainability of the external position and the main structural obstacles to growth. This responds to the requirements for candidate countries and potential candidates to progressively adapt their economic and fiscal surveillance to bring it into line with the new EU approach to economic governance. No components of the ERP are missing.

Inter-ministerial coordination

The preparation of the ERP was centrally coordinated by the Ministry of Finance. The programme was formally endorsed by the government. An inter-ministerial ERP working group involving seven ministries, several agencies and other offices worked on its preparation.

Stakeholder consultation

The draft ERP 2017 was put on the website of the Ministry of Finance for the period 26 December 2016 to 10 January 2017, when it was open to comments/recommendations by external stakeholders, including social partners. The government also invited interested stakeholders to contribute directly at a public ERP consultation which was held in Skopje on 4 January 2017 at the Ministry of Finance, but only five participants attended. The contributions are included as an annex to the ERP.

Macroeconomic framework

The macroeconomic projections are more realistic than in previous years. They take account of the government's downward revision of growth projections in the summer. The programme presents two alternative scenarios compared to the baseline, assuming lower growth in trade partner countries, and lower domestic demand in 2017 as a result of a further protraction of the political crisis, respectively. An analysis of external debt sustainability is provided as an annex.

Fiscal framework

For 2016, the programme is based on the most recent budget projections following the second budget revision, and on fiscal data available at the end of the third quarter. In spite of the revised economic growth assumptions, the programme adheres to the fiscal targets of previous years, but it does not present concrete measures underpinning the planned consolidation. Compared to the 2016 fiscal outcome, the revenue projections, and the envisaged increase in capital expenditure for 2017-2019 seem unrealistic. There is no detailed numerical breakdown of deficit financing sources, and of domestic and external debt repayments falling due. The programme would have benefitted from information on the expected budget impact of policy changes, as well as explanation of the differences in projections compared to last year's ERP. The programme includes an analysis of the budget deficit's sensitivity to lower GDP, lower revenue, and higher expenditure growth, and of the sensitivity of public debt to changes in interest rates and exchange rates.

Structural reforms

In contrast to ERPs submitted in 2015 and 2016, the structure of the 2017 ERP follows much more closely the guidance note and provides both an overarching analytical assessment and a focused diagnostics per sector area. The measures now have clear headings with measure description, timelines per year, budget estimations, competitiveness impact assessments, and social outcome estimations (except measures 1, 17). Some measures include -or at least very briefly mention- implementation risks, but risks are missing from measures 9, 11, 12, 13, 17 and 19. Even if risks are briefly mentioned, none of the measures include a discussion of planned mitigating actions. In some cases the proposed measures are described or named in terms of desired outcomes or objectives.

The ERP only refers briefly to two of the three structural reform measures from the 2016 policy guidance with little further reporting on their implementation. The reporting on the structural reform measures of the 2016-2018 ERP is, however, generally clear as it is helpfully described in Table 12.

The ERP describes in total 19 measures, thereby respecting the set maximum of 20 measures. The page limit of 40 pages was only slightly exceeded at 44 pages.

Some of the measures across the nine diagnostic areas lack precise focus and are rather diffuse and/or lack detail on precise annual activities, such as in the area of Business environment (e.g. the adoption of an SME strategy incorporating a broad range of measures and actions) or the measures in the services sector where annual activities also are rather general. Further, some of these measures amount more to objectives/desired outcomes rather than a precise targeted and focused activity.

The Annex tables 9-12 were all completed although table 10 (Matrix of policy commitments) was only filled in partially as many cells were left empty or given a '0' –value. While there might be valid reasons for this as measures do not necessarily always have direct budgetary impacts, it more often seems to indicate a lack of precision or insufficient analytical capacity to further detail the budgetary expenditure and revenue impacts of the measures. Reflecting the main text, and similarly to the previous ERP, Table 11 (Summary of structural reform measures) could have contained more specific details. The summaries in Table 12 (Reporting on the implementation of the structural reform measures of the ERP 2016-2018) were clear and helpful.

3. MONTENEGRO

3.1. EXECUTIVE SUMMARY

Montenegro experiences a gradual economic upturn driven by large investment projects in the energy and tourism sectors and debt-financed public infrastructure works. GDP growth is projected to average 3.4 % in the period 2017-2019, largely driven by the strong investment cycle. However, the need for fiscal consolidation is set to restrain public and private consumption. The narrow production base and the high import content of investments result in large external imbalances.

Public debt is on a steep upward trajectory and fiscal sustainability is a serious concern, set to further weaken given Montenegro's high and increasing refinancing needs as of 2019. Despite substantial underspending in the capital budget, the fiscal position weakened in 2016 as a result of strong expenditure pressure in the pre-election period. Montenegro's economic reform programme (ERP) introduces a set of corrective measures for the 2017 budget, but a full-fledged medium-term fiscal policy strategy still needs to be developed.

Tackling macroeconomic imbalances and rebuilding fiscal policy buffers would make the country more resilient to adverse external shocks and return the public finances to a sustainable path. At the same time, implementing structural reforms is key to achieving high rates of sustained economic growth beyond the current cycle expansion. The main challenges in these respects include the following:

- **Debt-related vulnerabilities are rising and there is little room for manoeuvre of fiscal policy.** Montenegro's public debt remains high and is set to become more exposed to rollover and exchange-rate risks. The country's fiscal adjustment plans are incomplete, with most of the budgetary measures concentrated in the short term and several tax exemptions still in place. Implementing a sound medium-term fiscal consolidation strategy would support fiscal credibility and underpin investors' confidence.

- **Although slowly declining, non-performing loans burden banks' balance sheets and impede the functioning of the bank lending channel.** Overall, banks present robust capital buffers and liquidity ratios. However, there are still weaknesses with collateral execution and provisioning of non-performing loans (NPLs).

- **Enhancing the growth potential is crucial to reducing external imbalances**. Strong investment activity will help in this regard when new facilities and infrastructure are completed; however, at this juncture the key challenge Montenegro is facing is to find new ways to increase productivity and become more competitive in foreign markets. This would enable the country to boost exports and become less reliant on imports.

- **Network infrastructure investments need to be complemented by regulatory reforms.** Good progress has been made in opening the energy market, but continued efforts are needed to ensure rail market opening through strengthening the capacity and independence of the rail regulatory and safety authorities. Measures that facilitate the digitisation of the economy, including better broadband access, would support growth and innovation. Effective investment in broadband infrastructure will result in quality broadband connections in all the regions and boost the economy' digitisation.

- **Small and Medium Sized Enterprises' (SME) access to finance and a low level of internationalisation remain key barriers to increasing competitiveness**. The continued development of high quality public and private SME support services and the creation of a more level-playing field through strict implementation of EU competition rules are key. The latter requires ensuring the operational independence of the state aid authority as a first step. Continued efforts are needed to strengthen the rule of law, reduce the informal sector, and tackle corruption. This will ensure that regulatory improvements translate into an improved investment climate.

- **Main labour market imbalances stem from low labour market flexibility, the skills mismatch and ineffective employment support to the unemployed and inactive.** Employment opportunities of young people are limited due to oversupply of obsolete professions and insufficient practical learning. The ongoing modernisation of school programmes does not sufficiently address the root causes of the skills mismatch. High levels of inactivity point to the weak employment support and widespread undeclared work. Poorly targeted social assistance creates disincentives to work, which has recently resulted in negative labour market impacts for women. Labour law reform should bring about better functioning of the labour market; yet a comprehensive solution should encompass stronger employment support policies and linkages between employment and social protection.

The policy guidance jointly adopted at the Economic and Financial Dialogue of 25 May 2016 has been partially implemented. Some measures have been taken to restrain current spending, including the public sector wage bill, and to improve revenue collection. However, the plan for the correction of the deficit and public debt and a full-fledged fiscal strategy still need to be completed. Good progress was made in opening the energy market, but more needs to be done to ensure that the rail regulatory authorities have the capacity and independence to achieve this. Some initial efforts have been made to improve the financial and non-financial support for businesses and further steps are planned in the programme. The modernisation of school programmes is ongoing, but further efforts are needed. After a stall in discussions, the preparation of the new labour law has resumed. Active labour market policies were not strengthened, and they continue with low financing, coverage and targeting. Relevant actions have been initiated to establish cooperation between employment offices and social work centres and enhance the social protection information system. Overall, the structural reform measures planned in last year's ERP were only partially implemented.

The articulation between the ERP's macroeconomic and fiscal framework is broadly coherent to provide a basis for policy discussions. However, the macroeconomic assumptions could be better balanced between the negative spill-overs from fiscal tightening on consumption (larger than foreseen in consensus forecasts) and the rather optimistic underestimation of imports required for developing ongoing investments. Moreover, the fiscal consolidation measures appear barely sufficient to address the short-term policy objectives and challenges. The structural reform section of the ERP retains a strong focus on investments in transport and energy in terms of budgetary impact. Education reforms could yield more sustainable returns in the medium to long term if they addressed root causes of the inefficiencies, such as school-to-work transitions and creation of professions for which there is no longer demand. The envisaged labour market reform could help better translate economic growth into job creation. However, it needs to be accompanied by effective active labour market policies and well-targeted social assistance to reduce disincentives for work, including for women. More needs to be done to ensure that the reform measures are well-planned and implemented in a timely manner, given that several of the 2016 measures were delayed.

3.2. ECONOMIC OUTLOOK AND RISKS

The economic reform programme (ERP) projects accelerating growth in 2017-2018 and a slowdown in 2019. Albeit decelerating, investment is expected to remain the main growth driver until 2018 and to stagnate –in real terms– in 2019. This should cause a slowdown of GDP growth in the same year. The programme does not expect domestic consumption to support economic activity. In fact, the need for fiscal restraint translates into consecutive real decreases in public consumption. Furthermore, fiscal consolidation is also seen to limit the growth of disposable household incomes. As a result, private consumption is expected to contract in 2017, before picking up mildly. The ERP expects both exports and imports to decelerate substantially following strong growth in 2016, with imports contracting slightly in 2018-19. On the production side, the ERP projects all branches of the economy to contribute positively to growth, especially construction and tourism-driven services. The planned completion of new power plants should lead to the energy sector contributing more to growth. Agriculture and manufacturing would also grow, but only modestly contribute to overall GDP growth.

The GDP growth scenario is broadly plausible, but the projected sources of growth raise some questions. The overall growth path and the expected strong investment activity in 2017 and 2018 remains consistent with planned large-scale public and private capital projects and with consensus and Commission forecasts. However, the programme presents a rather weak correlation between some of the macroeconomic variables. For instance, the link between gross fixed capital formation (largely driven by private[1] investment) on the one hand, and foreign direct investment (FDI) and construction activity on the other hand seems underestimated. Also, the strong deceleration of imports forecasted for 2017 does not appear fully consistent with investment dynamics. Ongoing investments may indeed be less dependent on imports than in 2016, when the construction of a windmill farm and the start of the highway[2] works required more substantial (one-off) imports of construction machinery and equipment. However, this does not fully explain the imports profile considering the still ongoing robust activity in other major import-dependent projects. The projected decline of household consumption in 2017 also seems at odds with underlying macroeconomic assumptions, in particular accelerating employment and robust wage growth. Historical data suggest that drops in private consumption usually appear in recession years. Similarly, the expected contraction of government consumption seems rather ambitious and does not appear to be fully explained by the corresponding fiscal programme.

The programme presents an alternative low-growth scenario, focused on the event of an 8 % year-on-year reduction in the level of gross fixed capital formation in 2017 compared to the baseline, followed by further marginal deceleration in the following two years. However, in this alternative scenario, private consumption growth is higher than in the baseline, despite the predictable negative impact from the slowdown on employment, credit availability and rising unemployment. The main risks to the programme's macroeconomic projections are, apart from delayed implementation of investments and geopolitical risks, a deterioration of investors' confidence (resulting in more expensive external financing) and unfavourable weather conditions hampering agriculture (which could affect tourism and electricity output).

1 In the period 2017-2019, the total value of planned investments is EUR 3.14 billion, including 34.4 % in tourism, 21.5 % in energy, 15.3 % in a highway, 6 % other transport, and 2.7 % in agriculture.

2 Unless otherwise indicated, the highway mentioned in this assessment refers to the priority section (Smokovac-Mateševo) of the Bar-Boljare highway which will connect the port of Bar with the Serbian border. The estimated cost of the 40 km of this priority section is EUR 810 million or 20 % of GDP in 2014. Due to exchange rate movements, the cost raised to EUR 1.01 billion in March 2017.

Table 1:
Comparison of macroeconomic developments and forecasts

	2015		2016		2017		2018		2019	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	3.4	**3.4**	2.6	**2.4**	3.7	**3.2**	3.1	**4.4**	n.a.	**2.6**
Contributions:										
- Final domestic demand	4.4	**4.4**	8.4	**9.2**	6.5	**3.6**	3.8	**3.3**	n.a.	**1.0**
- Change in inventories	-0.7	**-0.7**	1.5	**0.3**	0.0	**0.0**	1.0	**0.0**	n.a.	**0.0**
- External balance of goods and services	-0.3	**-0.4**	-7.3	**-6.8**	-2.7	**-0.3**	-1.7	**1.1**	n.a.	**1.6**
Employment (% change)	2.4	**2.5**	1.6	**1.0**	2.9	**2.0**	2.9	**1.0**	n.a.	**0.5**
Unemployment rate (%)	17.5	**17.5**	17.9	**19.4**	17.4	**17.8**	17.1	**17.0**	n.a.	**16.6**
GDP deflator (% change)	1.4	**1.5**	0.7	**0.4**	1.3	**2.0**	2.3	**1.9**	n.a.	**1.6**
CPI inflation (%)	1.4	**1.4**	0.1	**0.4**	1.4	**2.2**	2.1	**2.0**	n.a.	**1.7**
Current account balance (% of GDP)	-13.3	**-13.3**	-19.5	**-21.0**	-22.7	**-20.8**	-23.4	**-18.8**	n.a.	**-16.9**
General government balance (% of GDP)	-8.4	**-8.4**	-3.8	**-3.8**	-6.6	**-6.1**	-6.0	**-5.5**	n.a.	**-3.8**
Government gross debt (% of GDP)	61.2	**62.8**	65.5	**66.6**	70.3	**71.6**	73.3	**74.9**	n.a.	**77.5**

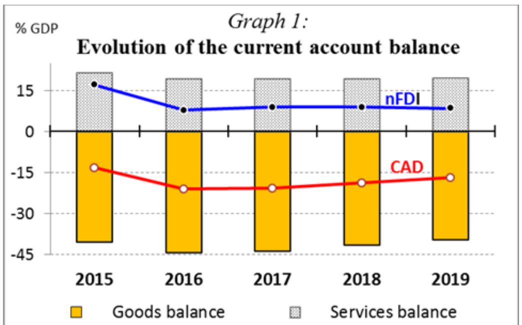
Sources: Economic Reform Programme (ERP) 2017, Commission Winter 2017 forecast (COM)

Labour force supply remains a structural factor constraining growth. Despite high unemployment rates, there is a scarcity of workers in key sectors of the economy (i.e. construction and tourism). This is due to skills mismatches, poor mobility and low labour participation (caused by early retirement and an ageing population). The ERP's analysis shows some deterioration in price competitiveness as unit labour costs (ULC) increased marginally in 2016 because of the 3.5 % overall increase y-o-y of Montenegrin salaries (which are relatively high by regional standards). Introducing life-time social benefits for mothers of three or more children also negatively affected labour market activity in 2016. There is evidence that many women opted out of the workforce to become eligible for the generous[3] benefits. Others – previously inactive– registered as unemployed. All of this resulted in further deterioration of labour statistics.

Inflationary pressures are led by imported prices. Overall, inflation trends are being led by the rebound of global oil and food prices through imports. After a mild increase in the final months of 2016, inflation is set to grow moderately, reaching an annual average of some 2 % in the period 2017-2019. This forecast also assumes weak inflationary pressures from private consumption as a result of high unemployment rates and modest wage growth. Moreover, the impact of unemployment and wages on overall price dynamics remains substantially lower than import prices. However, higher prices in restaurants and hotels (rising since June 2015) could nonetheless dampen the competitiveness of the Montenegrin tourism industry.

The current account deficit is expected to narrow as a result of slowing growth in import-intensive investments. A substantial trade deficit, caused by a narrow production and export base, is the main factor driving Montenegro's historically large current account gap. In 2016, the current account deficit broadened markedly to 19 % of GDP (from 13 % recorded a year earlier), reflecting last year's substantial surge in investment. Looking forward, the ERP expects imports to decline as a result of lower investment, weak private consumption, and a modest but sustained growth in

Graph 1:
Evolution of the current account balance



Source: Economic Reform Programme (ERP) 2017

[3] The law on Social and Children's care providing for this benefit was amended in December, reducing the level of benefits provided by around 25 % as of 2017. While the pension legislation foresees 40 years of work to acquire full pension rights (average EUR 284/month), the benefit for mothers registered 25 years in the employment office is EUR 264 (down from EUR 336 before the reform).

exports, especially tourism-related services. The income balances surpluses are expected to remain stable but small. Overall, although investments are set to remain robust, the current account deficit would gradually narrow down to 17 % of GDP in 2019 according to the projected slowdown of investment in real terms in the baseline scenario.

The large external imbalances reflect the weak competitiveness of the Montenegrin economy mainly due to non-cost factors, and the country's large investment needs. Completion of the various types of infrastructure, tourism and energy facilities is expected to boost productivity and contribute to lowering external imbalances in the long run. However, structural reforms are necessary to sustain productivity gains and bring about substantial improvements in the business environment. FDI is expected to remain stable and cover half of the current account gap, while the financing of public works will mostly rely on long-term government borrowing. Downside risks to this outlook stem from political or financial stability risks which could hinder the access to, or increase the cost of, finance. For the first time, the ERP also provides an estimate of total external debt, including private sector, but with data coverage only until 2015. The external debt remained high but relatively stable at around 145 % of GDP during the period 2013-2015.

The stability of the banking system is improving but lending growth remains weak. Credit risk remains concentrated in a few domestic banks. Overall, banks present robust capital buffers, with regulatory capital to risk-weighted assets ratio at 16 % in 2016, well above the regulatory minimum of 10 %. Liquidity is increasing, with banks' funding shifting from external sources to more stable domestic deposits. However, there are still weaknesses present in collateral execution and the provisioning of non-performing loans (NPLs). To address the problem of impaired loans, the Central Bank of Montenegro is asking banks to prepare three-year strategies to deal with NPLs, and is extending the scope for banks to restructure loans under what is referred to as the Podgorica approach, which –so far– failed to yield results. Meanwhile, credit risk results in tight credit conditions and weak lending growth, in particular to domestic companies. In order to increase banks' liquidity and stimulate lending, the Council of the Central Bank of Montenegro cut in March 2017 the mandatory reserve requirement ratios by 2 pps (from 9.5 % to 7.5 % and from 8.5 % to 6.5 % for deposits with maturity up to or more than one year, respectively). Several banks used part of this additional liquidity to extent loans to the government.

Table 2:

Financial sector indicators

	2012	2013*	2014	2015	2016
Total assets of the banking system, mEUR	2,808	2,959	3,136	3,472	3,791
Foreign ownership of banking system	81.9	83.5	82.7	80.4	79.4
Credit growth	-0.7	3.1	-1.9	0.8	1.3
Bank loans to the private sector %	93.3	91.4	93.2	93.8	93.6
Deposit growth	9.0	5.9	10.0	13.7	9.4
Loan to deposit ratio	1.2	1.2	1.0	0.9	0.8
Financial soundness indicators					
- non-performing loans	17.6	18.4	16.8	13.4	10.3
- net capital to risk weighted assets	14.7	14.4	16.2	15.5	16.1
- liquid to total assets	24.0	20.0	22.0	24.8	24.5
- return on equity	-18.3	0.5	5.4	-0.7	1.5
- forex loans to total loans %	1.9	3.9	3.9	8.2	6.4

Sources: National Central Bank, DataInsight
** International Accounting Standards were introduced in 2013.*

3.3. PUBLIC FINANCE

A loosening of fiscal discipline prior to the elections and underspending on capital projects marked budget developments in 2016. Substantial increases in wages and social benefits forced the government to ask the Parliament to revise the central government budget after the October 2016 elections. Current expenditure reached a record high of 46 % of GDP due to higher than planned increases in social benefits, public sector salaries and the need to pay the health fund debt. The budget revision reduced capital spending by 65 % compared to the plan because of delays in the implementation of the highway. As a result, the central government deficit in 2016 amounted to 3.5 % of GDP, compared to the original plan of 7.1 %, and the previous year's deficit of 8.4 %. Budget revenue increased by 12 % y-o-y thanks to the good performance of value added tax (VAT), personal income tax and concession fees boosted by the one-off auction of radio-frequencies.

Fiscal imbalances are set to increase compared to 2016, despite some corrective measures in the 2017 budget. The 2017 budget foresees a 4.4 % y-o-y increase in revenue, an overall freeze in current expenditure and a strong (113 %) surge in capital spending. On this basis, the budget deficit is expected to increase to 6 % of GDP. This deficit target incorporates the effect of a fiscal consolidation plan[4] that specifies measures to contain the increase of the fiscal deficit and is expected to yield budget savings equivalent to some 3.2 % of GDP (see box below). If the announced measures are not fully implemented, further consolidation may be necessary before the end of the year to cope with the high financing needs of the budget. The nature and impact of the 2017 budget measures are quite diverse, and to a large extent they do not qualify as durable consolidation measures. They partially reverse earlier increases in wages and social benefits, are of a one-off nature (e.g. restructuring of tax arrears), are not yet fully specified or rely to a large extent on broadening the tax base by reducing informality. When designing the 2017 budget, authorities sought a compromise between maintaining a competitive low-tax environment while investing in large infrastructure projects and preserving to a large extent disposable household income. A few tax measures may have a longer lasting effect on public finances beyond 2017. But the estimated overall fiscal impact appears optimistic, and a more complete medium-term plan is missing. As a result, there is a risk that the consolidation plan will yield less than 3 % of GDP.

Box: The budget for year 2017

* The budget was endorsed by the government on 18 December and adopted by the parliament on 29 December 2016.
* The general government deficit target is 6 % of GDP, basically because of the commitment of 5 % of GDP to build a highway (out of a total 8 % of GDP planned for overall capital spending).
* The macroeconomic scenario supporting this budget was slightly revised downwards, forecasting GDP growth of 3.2 % (compared to 4 % growth in earlier estimates) and an inflation rate of 2.2 %.
* The budget was accompanied by a recovery plan with measures totalling 3.2 % of GDP:

Table: Main measures in the budget for year 2017

Revenue measures*	Expenditure measures**
• Amendments to the Law on excise tax ‡ Increase of excise on mineral oil (9 cts/lt) (0.8 % of GDP) • Collection of tax arrears (Law on rescheduling of tax claims) ‡	• Amendments to the Law on Wages of Public Sector employees ‡ a) Reduction of public sector wages (by 8 %) (0.1 % of GDP (+ additional 0.03 % in gov. savings on taxes and contributions))

[4] This 'Plan for the correction of the budget deficit and public debt' was a legal requirement stemming from the fiscal rules enshrined in the law on budget and fiscal responsibility. However, despite being a five-year plan, the current version mostly presents consolidation measures for 2017.

(0.3 % of GDP)

- Increase of VAT rate (from 7 % to 19 %) on computer equipment ‡
(0.04 % of GDP)
- Introduction of the electronic VAT system‡
(0.28 % of GDP)
- Maintaining the higher personal income tax rate (PIT) of 11 % (until end of 2019) ‡
(neutral impact)
- Increasing fiscal discipline (legalisation of employment and regular payment of liabilities)
(0.4 % of GDP)
- Legalisation of informally built structures
(fiscal impact not available)

b) Two-year suspension of years of experience bonus[5] in public sector salaries ‡
(0.07 % of GDP)

- Amendments to the Law on Social and Children's care ‡ :
a) reduction of the benefit for mothers of 3 or more children
(0.4 % of GDP)
b) postponing 6 months (to 1st July 2017) benefits for children with unemployed parents
(0.02 % of GDP)
- Reduction of the budget for financing political parties ‡
(0.04 % of GDP)
- Reduction of the capital budget
(0.25 % of GDP) ‡
- Other discretionary measures
(0.94 % of GDP)
- Optimisation of the number of public sector workers
(fiscal impact not available)

Total from revenue measures: 1.5 % of GDP **Total from expenditure measures: 1.7 % of GDP**

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.
‡ Legislative measure or amendments adopted in December 2016.
Source: Economic Reform Programme (ERP) 2017, Ministry of Finance

The ERP lacks a complete medium-term fiscal strategy and does not sufficiently address fiscal sustainability concerns. The set of fiscal measures presented in the ERP is expected to be complemented in the second quarter of 2017 by a medium-term fiscal strategy. The measures presented in the programme remain focused on intensifying investment in infrastructure and optimising current expenditure, with the aim of consolidating public finances and reducing the budget deficit and public debt (net of capital investment) during the programme period. Public investment, and in particular the highway works, will remain the main driver of public debt and deficit until 2019, when the work on the main section is expected to be completed. The next stages of the highway –later on– should not be considered unless considering a different financing scheme (for instance, including highly concessional or grant financing), to avoid hampering public finances.

Key elements of a fully-fledged fiscal strategy are expected to be adopted in the second quarter of 2017. Some preliminary ideas announced by the government are: First, a more though-through reform of the law on social protection (better targeted and means-tested) would significantly reduce the excessive cost of the current scheme. Second, the centralisation of fiscal cash registers (i.e. electronic fiscal invoices) is expected to come into effect in 2018, with an estimate impact of some EUR 10 million (or 0.25 % of GDP) in extra revenue. Third, a comprehensive reform of public administration could address low efficiency while contributing to the sustainability of public finances. Fourth, the legalisation of illegally built structures would improve the public finances of municipalities. Importantly, a sound fiscal strategy would require that legislative measures are not adopted without ensuring that adequate financial resources are available.

[5] On 3 March 2017, the Ministry of Finance and public sector trade unions agreed to replace this measure by a 1 % decrease in the base salary (until end-2018) for wages with a coefficient above 4.10. The impact of this measure should be equivalent to the suspension of the years-of-experience bonus.

Table 3:
Composition of the budgetary adjustment (% of GDP)

	2015	2016	2017	2018	2019	Change: 2016-19
Revenues	42.1	45.1	44.8	43.9	42.9	-2.2
- Taxes and social security contributions	35.3	37.0	37.5	36.7	36.0	-1.0
- Other (residual)	6.8	8.1	7.3	7.2	6.9	-1.2
Expenditure	50.4	49.0	50.8	49.4	46.7	-2.3
- Primary expenditure	48.0	46.8	48.2	47.1	44.3	-2.5
of which:						
Gross fixed capital formation	8.2	5.0	9.0	10.0	8.4	3.4
Consumption	14.7	16.3	15.6	14.7	14.3	-2.0
Transfers & subsidies	14.1	16.2	15.3	14.5	14.2	-2.0
Other (residual)	11.0	9.3	8.3	7.9	7.4	-1.9
- Interest payments	2.4	2.2	2.6	2.3	2.4	0.2
Budget balance	-8.3	-3.9	-6.1	-5.5	-3.8	0.1
- Cyclically adjusted	:	5.7	-3.0	0.9	3.4	-2.3
Primary balance	-5.9	-1.7	-3.5	-3.2	-1.4	0.3
Gross debt level	65.7	66.6	71.6	74.9	77.5	10.9

Sources: Economic Reform Programme (ERP) 2017

Several risks could derail the fiscal projections. The programme presents a detailed and realistic list of the risks in a SWOT[6] analysis matrix, and their impact is considered in an alternative scenario (see box on sensitivity analysis). These risks include: further delay or cost overruns in public investment, external shocks hindering public debt financing, political instability in the region, or simply a failure to achieve fiscal consolidation goals. On the latter, the ERP highlights adverse spillovers from recent social benefit increases into the labour market and into public finances. It also considers the risk of a formal deterioration of fiscal parameters as a result of the implementation of the European system of accounts (ESA 2010) in government finance statistics. There are also some upside risks, like higher investments following the expected accession to NATO or higher budget revenue from implementation of the reforms agenda.

Overall, improving the fiscal framework is key to supporting budget consolidation. The cash-based budget fails to reflect all budget commitments on time, and therefore remains subject to revision. Authorities are implementing an action plan to introduce accrual accounting in government financing statistics (compliant with ESA 2010). The restructuring of accumulated local-government arrears was accompanied by measures to prevent their re-emergence. These measures included improving checks on multi-year commitments and introducing more binding medium-term budgetary ceilings. In general, the medium-term budgeting process still needs improvement, not least because unrealistic expenditure allocations have undermined its credibility. To reinforce debt sustainability, a fiscal strategy needs to be adopted and the five-year plan for correcting the budget deficit and public debt completed with measures beyond 2017. In addition, implementing concrete policies to strengthen public finances and reinforce the fiscal rules would also help anchor expectations of budget discipline.

6 Strengths-weaknesses, opportunities-threats analysis.

Box: Debt dynamics

The ERP expects the debt ratio to further increase and come close to 80 % of GDP by the end of 2019 driven by high primary deficits fed by further withdrawals from the highway loan. The overall implicit interest rate is expected to remain broadly stable at around 3.7 %. The level of stock-flow adjustments will increase markedly in 2019, (although details are not explained in the programme). However, the expected debt trajectory appears rather conservative, and further slippages are not to be discarded. Moreover, the already high financing needs will surge in 2019 as, in addition to the highway loan and budget deficit financing, the government will also need to refinance maturing Eurobonds worth some 6.4 % of GDP.

Table 4:
Composition of changes in the debt ratio (% of GDP)

	2016	2017	2018	2019
Gross debt ratio [1]	**66.6**	**71.6**	**74.9**	**77.5**
Change in the ratio	3.8	5.0	3.3	2.6
Contributions [2]:				
1. Primary balance	**1.0**	**4.0**	**3.7**	**0.5**
2. "Snow-ball" effect	**0.5**	**-0.7**	**-1.9**	**-0.6**
Of which:				
Interest expenditure	2.2	2.6	2.3	2.4
Growth effect	-1.5	-2.0	-3.0	-1.9
Inflation effect	-0.2	-1.3	-1.3	-1.1
3. Stock-flow adjustment	**2.3**	**1.7**	**1.5**	**2.7**
Memorandum item				
Gross financing needs	15.7	12.5	10.8	17.2
Highway loan [3]	**0.3**	**5.0**	**5.5**	**4.1**

Notes:
[1] End of period.
[2] The snow-ball effect captures the impact of interest expenditure on
[3] Includes loan and government own contribution.
Source: Economic Reform Programme (ERP) 2017, ECFIN calculations

Fast growing public debt, coupled with considerable gross financing needs, remains a cause for concern. A considerable stock of Eurobonds maturing in 2019 and 2020 will boost debt refinancing needs up by an additional 6.4 % and 12 % of GDP, respectively. Montenegro's public debt, including guarantees, already exceeds 70 % of GDP. The share of external debt is predominant, accounting for 89 % of the total. Around half of it corresponds to Eurobonds, 29 % to international financial institutions and bilateral loans, 15.4 % to the highway loan, and 1.4 % (the most expensive and shorter maturity) to commercial banks. Montenegro is vulnerable to changes in market sentiment and to host country regulatory requirements that could influence debt holders' willingness to hold Montenegrin securities, as occurred with the emission of domestic bonds in November 2016. The exchange-rate risk is largely concentrated on the Chinese loan to finance the highway, issued in US Dollars at fixed exchange rates of 2014. A sound fiscal strategy is therefore essential to mitigate debt-related vulnerabilities and rebuild room for policy manoeuvre.

Box: Sensitivity analysis and comparison with previous ERP

Based on the macroeconomic low-growth scenario's lower level of investment, the fiscal position would weaken as a result of lower economic activity and budget revenue would contract by some 2 % annually. In this alternative scenario, the level of expenditure would (optimistically) remain at the same level as in the baseline, due to the high level of non-discretionary spending of the budget. This would result in a higher deficit, in particular in 2018 and 2019. This higher deficit would also feed into the public debt stock, to reach 84 % of GDP in 2019, up from 77.5 % in the baseline.

Compared with previous ERPs, revenue projections were conservative, but actual revenue was systematically higher than planned. However, for expenditure, the opposite was also observed. In 2016, there were systematic overruns of expenditure over the plan, except for capital spending.

3.4. STRUCTURAL REFORMS

The ERP identifies key obstacles to growth and competitiveness, and outlines a number of relevant measures to address them. The 2017-2019 programme is clearer than the 2016 ERP. The Commission's assessment last year was for the most part taken into account; however, the link between the diagnostics and the identified obstacles with the reform measures could be strengthened.

The reform measures are appropriate to foster growth and competitiveness. The majority of these measures represent a continuation or further development of the previous ERP. Where a measure from last year is not anymore presented as reform priority, the programme provides an explanation. However, several reform measures identified in the 2016-2018 ERP were delayed, underlining the need for realistic planning and close monitoring of the implementation of the structural reform agenda. Given the challenging fiscal situation and a rapidly growing public debt, fiscal consolidation and less costly regulatory reforms should be prioritised. Instead, the ERP retains a strong budgetary focus on investments in transport and energy. The business environment measures are relevant, but implementation has recently slowed down. Compared with other sectors, the budgetary allocation for industrial and SME support is comparatively low and depends on external funding sources. The envisaged restructuring of business zones should be pursued cautiously to ensure a positive return on related public investments and given incentives in the medium term. The envisaged labour market reform could help better translate economic growth into job creation; it needs to be accompanied by well-targeted social assistance to reduce disincentives for work. Implementing education, public administration and public finance reform could yield higher and more sustainable returns in the medium to long term.

Structural reform needs remain essentially concentrated on the improvement of the labour market, and human and physical capital. The labour market is characterised by high youth unemployment, low participation of women and high long-term unemployment. Labour market performance is poor and active labour market policies are ineffective. More progress is needed to align education and skills with the labour market needs. There are significant transport bottlenecks, but they need to be addressed in a fiscally sustainable and transparent manner, with due attention given to network maintenance and regulatory reform. Expensive and low availability of high-speed broadband access is not supportive of economic growth and innovation. Local companies are insufficiently integrated in regional and international production processes. Ensuring the operational independence of the State aid authority, as required by the Stabilisation and Association Agreement, would guarantee a more level playing field and bring benefits to consumers and businesses. Despite ongoing work, challenges remain in the area of rule of law. Corruption continues to be a serious problem and the informal sector is large, creating unfair market conditions. The policy guidance of the Economic and Financial Dialogue with the EU in May 2016 on structural reforms was only partially implemented.

Public finance management

Weaknesses in public finance management (PFM) continue to undermine Montenegro's fiscal position. The diagnostic in this area is limited to public procurement and public internal financial control**.** A stronger reference to implementation of the PFM reform programme adopted in December 2015 would have been appropriate. In addition, the existing fiscal responsibility framework is weak, and the deficit and debt thresholds established by the fiscal rules are not met. Fiscal reporting also remains weak with successive fiscal data revisions, especially on the spending side. There is scope for improving reporting on municipal arrears. Other areas for reform concern medium-term financial planning and the management of public funds. A public investment management system which uses sound cost-benefit analyses to inform budgetary priorities would improve fiscal control and increase transparency.

The measure to introduce e-procurement could have a positive impact on the level of competition on public tenders and transparency in the use of public funds, but implementation initially planned in 2016 has been delayed. The ERP also recognises the need to regulate concessions and public-private partnerships in line with the EU *acquis*. This will help ensure a level-playing field, while stimulating further economic development. A law on concessions and public-private partnerships has been in preparation for several years and a further delay in aligning this with the *acquis* could hinder private investments.

The measure strengthening managerial responsibility in the public sector is an important public internal financial control reform, but it is unlikely to become a key driver for economic development. Economic benefits will be long-term and are difficult to quantify. Moreover, the measure needs to be further developed, notably by defining what managerial accountability means in line with Commission and OECD recommendations and by including detailed information on how managerial accountability will be implemented. A timeline is lacking, and there are no details on the extent of the training needs.

Transport, energy and telecommunications markets

High regional connectivity and infrastructure costs hinder economic growth. Infrastructure development is constrained by the country's difficult topography, which results in high investment needs and maintenance costs. Despite the formal opening of the energy market, the entry of new firms is yet to materialise. The diagnostic section does not recognise the potential for improving energy efficiency and reducing the economy's energy intensity. In line with the 2016 policy guidance, Montenegro advanced its regulatory alignment with the EU energy policy framework, albeit implementing legislation is still pending. Montenegro also completed the legal unbundling of electricity distribution from energy generation. As for rail transportation, safety and interoperability remain to be improved through the strengthening of the capacity and independence of the rail regulatory body and rail safety authority.

The importance of further facilitating the rollout of broadband for innovation and economic growth, including to rural areas, is not considered in the programme. Less than 4 % of Montenegrins (1 % in rural areas) have access to broadband connections with a data speed of 10 to 30 Mbps, far below the EU average. Low investment in fixed-line broadband infrastructure results in the slowest broadband connections in the region, with connection costs above the UN International Telecommunication Union's affordability threshold of 5 % of disposable income.

The measure to build a robust power interconnection with Serbia complements other efforts to strengthen regional interconnection, including the ongoing construction of an undersea electricity cable to Italy. The undersea cable to Italy is foreseen to be completed by the end of 2018, and work to improve the interconnection with Serbia is expected to last until 2019. All of this will support network stability and complement ongoing efforts to develop a regional energy market.

The measure aimed at the construction of Block 2 of the thermal power plant in Pljevlja is part of Montenegro's energy strategy to complement its hydro-power potential with coal. It seeks to increase domestic energy generation, ensure network stability by balancing the less predictable renewables, increase employment in Pljevlja, and provide thermal district heating. The use of the existing coal power plant would be phased out after a few years of parallel operation. The public debate in Montenegro nevertheless points to some questions on the relevance as well as economic and social viability of this undertaking. Montenegro already ranks first in the Energy Community when comparing the estimated external costs of SO2, NO2 and dust emissions. While the new block should comply with EU environmental standards by using the best available technology, there may be a negative impact on Montenegro's ability to meet its long-term climate change commitments. Using coal may also expose the sector to the volatility of allowance prices under the EU's Emissions Trading System, and financing conditions, yet to be finalised, need to comply with the applicable EU state aid rules.

Scaling up the sustainable energy-efficiency programme could result in significant budget savings and reduce future energy consumption needs. This would complement the installation of 23 wind turbines in Krnovo, which was completed in 2016 and accounts for approximately 8 % of national electricity output. There is also scope to further reduce the high energy intensity of the Montenegrin economy, which is due to outdated metal production technology and inefficient energy consumption in households and public buildings.

The two measures on transport, both rolled over from the previous ERP, faced some delays in 2016, resulting in substantial underspending of the capital budget. As for the measure to build a priority section of the Bar-Boljare highway, excavation works and bridge construction are ongoing on the most challenging sections, engaging approximately 1350 workers, out of which 30 % are of Montenegrin origin. The full benefits of the Bar-Boljare motorway and of the Bar-Belgrade rail network will materialise only when the entire corridor is upgraded, linking the port of Bar to Belgrade, via Podgorica. Due to the significant resources invested in one section of the motorway construction, other important transport bottlenecks and high maintenance needs may not be properly addressed. Montenegro also needs to revise its transport development strategy to ensure alignment with the regional agenda on connectivity.

The large public investments in roads, railway and power interconnectors are in line with the priorities agreed under the connectivity agenda but weigh heavily on public finances. Investment planning needs to take into account the fiscal constraints, EU rules on public procurement, state aid, and environmental impact assessments and should be accompanied by sound cost-benefit analyses.

Sector development

Agricultural sector development

Agricultural development continues to be constrained by a number of challenges. These include the fragmented and small parcels with high production costs, limited export opportunities, weak sector organisation, limited access to credits and a lack of qualified labour and adequate technology and infrastructure. The ERP diagnostic recognises most of these challenges.

The measure to invest in the food production sector to help companies achieve EU standards is welcome. The level of public support provided is steadily increasing, but measures on access to credit for farmers should also accompany the support scheme to ensure its effective implementation. To export more, Montenegro is also encouraged to make faster progress in obtaining EU export accreditation for exports of animals, products of animal origin or food products.

Industry sector development

Low product diversification, low labour productivity and underinvestment in modernisation, as well as weak linkages between private companies and science and research are key bottlenecks for further development of the industry sector. To support an increased diversification and industrial modernisation, Montenegro has adopted a comprehensive industrial policy. Nevertheless, the production of competitive higher value-added products remains limited and the local industry is characterised by marginal participation in global supply chains, as well as a low level of digitisation, including in the manufacturing and construction sectors. Given the current steel and aluminium production overcapacity on world markets, the objective as regards base metals should be to strengthen the manufacturing industry with a view to shifting towards higher quality and material efficiency, including metal recycling. Moreover, non-energy resource efficiency and circular economy policy aspects should be considered as part of Montenegro's efforts to support industrial modernisation.

The measures to boost investment in processing industries and industrial modernisation foresee an expansion of the available support instruments. This is achieved through new credit lines and a new pilot programme launched in mid-2016 to support industrial modernisation. The scheme for supporting processing industries delivered its first results, creating 253 jobs at a total cost of €1.48 million in subsidies. By contrast, the pilot scheme on industrial modernisation has so far not seen any significant uptake.

Services sector development

Insufficient tourism infrastructure and accommodation structures, limited accessibility of destinations, high seasonality and the regional disparities are key bottlenecks to Montenegro's effort to become a high-end tourism destination. The ERP does not contain an analysis of the services sector as a whole but only identifies obstacles in the tourism sector. Other services such as information and communication technologies (ICT), retail and wholesale trade and non-financial professional services are not mentioned.

The measure that seeks to address seasonality by improving skiing facilities in the North of Montenegro relies on publicly financed construction activities. It represents a continuation from last year. However, so far private investors seem to lack interest. Previous plans to develop public-private partnerships for this have not advanced.

Business environment and reduction of the informal economy

There is room to further improve the business environment. The ERP diagnostic is narrowly focussed on areas with lower grading in the World Bank's Doing Business report, including company registration, the work of cadastral services, the issuing of construction permits and contract enforcement, as well as limited access to credit as regards SME development. It fails to mention other areas frequently identified by businesses as presenting weaknesses, such as access to electricity, cumbersome tax administration procedures, and a high level of informality. Another important reform in this area, albeit not mentioned in the ERP, is to make the state aid authority operationally independent and to ensure that it has the necessary powers and resources, which, however, has been delayed. There is a lack of transparency and conflicts of interest among the authority's staff, and it lacks enough qualified staff to cope with an increased workload to establish a good enforcement record.

While Montenegro has been successful in attracting a steady high flow of foreign direct investments, further efforts are needed to strengthen the rule of law, to reduce the informal sector, and to tackle corruption. Recent progress on further improving the business environment has been more incremental as shown by different rankings, including due to delays in implementing planned reforms. Businesses also continue to complain that the outcome of judicial proceedings is at times difficult to predict due to inconsistent case law, lengthy enforcement proceedings and the possible non-enforcement of court orders. However, the duration of enforcement proceedings has improved, following the introduction of a public bailiffs system. Efforts are also ongoing to strengthen SME non-financial and financial support in line with 2016 policy guidance. However, SMEs' limited access to finance and low level of internationalisation remain key barriers to increasing competitiveness. Being frequently family-run, SMEs often face weak internal capacities, poor investment readiness and financial literacy, as well as a lack of professional management expertise.

The measure that introduces e-services to the land registration system seeks to accelerate the issuance of cadastre documents. However, while the ERP also identifies the parallel use of land-based and inventory-based registries as a related obstacle, the reform does not include plans to improve the data quality and coverage.

The measure that introduces e-fiscal invoices was rolled over from the previous ERP, as the coverage of the mobile phone networks needed to be tested first. The measure remains relevant for reducing the informal economy and has the potential to create a better level playing field for registered businesses and improve revenue collection. Montenegro expects a revenue increase of some €10 million in 2018.

The two SME measures represent ongoing efforts to further expand the available financial and non-financial support. While SME financial support has increased in recent years, only limited budgetary resources are dedicated to non-financial support. On the latter, the ERP envisages mentoring services, targeted training courses and conferences for stakeholders including on financial literacy, as well as the development of a database on private consultancy services among others. With regard to financial support, the Investment and Development Fund's (IDF) activities continue to largely depend on external funding from international financial institutions. It is recommended that the performance and effectiveness of the IDF's activities are externally reviewed.

Research and innovation

The ERP recognises the importance of research and innovation as a driver for competitiveness and the diagnostic highlights key bottlenecks. These include insufficient integration of private sector support through cooperative projects between the public research sector and industry, and a fragmented research landscape. There is also a low level of cross-border synergies. The number of domestic innovative and internationally competitive enterprises is low. Montenegro is in the process of upgrading its statistical capacities for this sector. This could also allow for eventually providing greater incentives for private spending on R&D. In this context, the foreseen development of a Smart Specialisation Strategy could help identify key measures to support competitiveness and growth.

The measure to establish a Science and Technology Park (STP) at the University of Montenegro in Podgorica is a further step in the right direction to enabling technology development and innovation. A first Innovative Entrepreneurship Centre "Tehnopolis" was opened in Nikšić in 2016 to help boost technology transfer and innovation, as foreseen in last year's programme. While operations have commenced, the laboratories remain to be equipped. The current measure presents a balanced approach to developing incubators and start-ups in different geographical areas and establishing connections between local and regional business centres. However, construction alone is not enough, as investment in technology and skills development is needed. The programme does not provide a clear timeline and lacks relevant statistics and indicators. Negotiations on securing funding are still ongoing. Montenegro should consider ways to mobilise private investment to ensure sustainability of the STPs. Private sector companies could be involved to give non-financial support to aid start-up capacity building, in return - for example - for shares, benefits, or intellectual property rights.

External trade and investment facilitation

The export sector is hampered by a narrow export base, a low level of export diversification and a predominance of low added-value products with only a few companies that trade internationally. The diagnostic section further recognises the interlinkages between trade facilitation and the ability to attract investment, as well as the need to address weaknesses in the general business environment. Further regional economic integration was achieved under Montenegrin chairmanship of the Central European Free Trade Agreement, when negotiations on a Trade Facilitation Protocol were completed in 2016. Swift implementation could significantly reduce related transaction costs. Montenegro could also promote a more service-oriented organisation culture in its customs service through, for example, ensuring that its authorised economic operators programme is more widely used and simplifying customs procedures to increase the efficiency of the clearance process.

The measure to restructure existing business zones aims at attracting direct investments and technology transfer. While such zones may help attract investments, experience in other countries suggests that they have to be carefully designed to be financially and economically effective and to ensure strong linkages with domestic suppliers. In addition to the cost for the zones' establishment and infrastructure, there is the potential loss of income depending on the incentives provided.

Education and skills

Poor educational outcomes represent structural bottlenecks on the labour market. Insufficient coverage of preschool education negatively affects labour market participation of women. Low preschool enrolment rate and low quality of the basic education system result in a high share of low achieving students, which affects performance at higher levels. Enrolment in vocational education and training (VET) is high, but so is the transition to higher education, creating an oversupply of higher education graduates which the labour market cannot absorb. Practical learning and future skills anticipation need to be ensured as an essential part of the reform measures. The ERP diagnostic includes some of these aspects, but not all.

The two measures covering development of new occupational standards for VET and aligning higher education with the labour market needs are ongoing and appropriate. The implementation of the revised curricula and a new higher level studies model are foreseen in the 2017-2018 school year. A working group has been tasked to assess and improve the professional training programme for university graduates. However, no activity is mentioned on monitoring and evaluation mechanisms to assess quality and impacts which would provide a sound basis for future policy planning and skills forecasting.

The root causes of the skills mismatch should be better targeted. Reinforcing basic and transversal skills, introducing work-based learning and stronger career guidance are essential to improve the transition from school to work. Addressing high enrolment in programmes not relevant to the labour market and rationalising entry from VET to higher education need further attention. A rapid and responsive institutional mechanism to adapt qualifications and curricula is a pre-condition to ensure the reform's success. Continuous teacher training is fundamental and tracing students after they complete education should remain an accompanying measure.

Employment and labour markets

Labour market imbalances stem from high inactivity, low labour market flexibility, a skills mismatch and ineffective employment programmes. High unemployment and low employment concern particularly youth, women and the long-term unemployed. Undeclared work, a lack of job opportunities and inefficient linkages with the social protection system further contribute to high inactivity. Active labour market policies (ALMPs) are weak and lack monitoring and evaluation. Employment offices manage passive programmes and do not provide adequate services to meet the needs of job seekers. Serious concerns remain about the social benefit for mothers with three or more children. This social benefit has had a negative impact on labour market participation of women and on social spending. Social protection and activation measures should be better balanced. The ERP diagnostic in this area includes main employment indicators.

There is a need to incentivise work and offer strong employment support measures, while targeting social assistance at those in need. There have been efforts to improve activation by establishing a system of cooperation between employment services and social work centres. This is a relevant step in bringing more people to the labour market, while better ensuring social protection for those who need it most. Actions to improve the social protection information system could include further linkages with benefits at the local level.

The ERP measure aims to improve labour market participation and employability through new legislation. While the planned activities are relevant, priority should be given to timely and effective implementation. The preparation of the labour law reform has just begun after a long pause in discussions and given that this represents a major labour market reform, it is essential to reach a comprehensive solution and undergo consultations with all relevant stakeholders. While labour market flexibility is important in raising employment levels, the solutions should be evidence-based and avoid the risk of labour market segmentation.

The activities to strengthen the linkages between the labour market and the social protection system are well designed but have not yet produced significant results. Plans to improve labour market participation include giving employment offices a stronger intermediary role, better designing ALMPs and redefining provisions on unemployment benefits. It is essential to provide sufficient support and come up with a comprehensive solution that meets the needs of job seekers and helps them integrate into the labour market. On the other hand, it is essential to ensure sufficient financial support for those who need it. The activities should result in a better functioning labour market and more efficient employment services and programmes.

Social inclusion, poverty reduction and equal opportunities

Poor labour market performance is coupled with a social protection system that does not fully respond to the needs of the population. The ERP diagnostic in this area focuses on the recent introduction of the life-long benefit for mothers of three or more children, which has negative impacts on labour market participation of women and the sustainability of the social protection system. There is a need for a wider approach to address poverty and social exclusion. More has to be done to improve social integration and fight regional differences.

The social protection system provides little access to its services, particularly for the most vulnerable parts of the population. The strategic framework to bring advancements in livelihoods of the population is in place, but there have been little concrete outcomes. The social protection system needs to support activation, while providing help to those most in need. Monitoring implementation of the reforms is a challenge. The planned analysis of the social situation and the ongoing project to establish an integrated social welfare information system should help to identify relevant measures to pursue. Priority should be given to improving the quality of services provided by social welfare centres to activate those able to work.

The measure to reduce the social benefits for mothers with three or more children does not provide a comprehensive solution to the negative impacts of this scheme. The benefit was introduced without an impact assessment and it continues to be dealt with in the same way. It has led to significant fiscal, labour market and legal problems. The effect of reducing the benefit seems inconclusive and will not address the current challenges. More should be done to tackle labour market participation of women through additional support measures, such as childcare services and preschool education, and ALMPs targeted specifically at women who left the labour market to benefit from this law. On the other hand, it is essential to identify socially vulnerable segments among the beneficiaries to ensure they receive adequate support. There is a need for a more strategic reflection on prolonging working lives, through retirement provisions and a long-term care system. While the need for a reflection on pension reform is mentioned, there are no concrete plans yet.

3.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2016

2016 policy guidance	Summary assessment
PG 1: Stabilise the debt-to-GDP ratio net of debt related to capital investments already underway in 2016, and then reduce it over the remainder of the programme period.	Montenegro has **partially implemented** PG 1: • The ERP measures comply (at lease formally for the year 2017) with last year's policy guidance. According to the ERP2017, projections on the debt-to-GDP ratio (net of debt related to capital investments already underway in 2016), would decline over the programme period. However, the effectiveness of the fiscal performance still needs to be assessed in practice, and the Plan for the correction of the deficit, and public debt needs to be completed with measures until 2021.
PG 2: Take immediate measures to restrain current spending, including on pensions and the public sector wage bill. To generate budgetary savings and improve revenue collection, conduct a comprehensive review of tax expenditure as well as exemptions, and implement tax increase in a growth-friendly manner.	There has been **limited implementation** of PG 2: • Measures were taken to restrain current spending, including on the public sector wage bill, and to improve revenue collection. However, measures are mostly corrective of the expansionary fiscal policy pursued in 2016, and with a short-term focus. • The comprehensive review of tax expenditure and tax exemptions remains pending, as does the new government's fiscal strategy. • The implementation of a tax increase in a growth-friendly manner appears insufficient.
PG 3: Develop a comprehensive strategy to further foster the disposal of non-performing loans by banks, including participation by all relevant stakeholders, while establishing a bank lending survey to better gauge underlying credit dynamics.	There has been **limited implementation of** PG 3: • The Central Bank of Montenegro drafted amendments to the Law on voluntary financial restructuring of debts to financial institutions to extend the scope for loans restructuring. The CBM tightened supervision on commercial banks' own strategies to deal with NPLs; however, a comprehensive strategy has not yet been developed.
PG 4: Ensure effective, efficient and independent regulatory and safety authorities to implement the full opening of rail and energy markets.	Montenegro has **partially implemented** PG 4: • The Law on Cross-Border Exchange of Electricity and Natural Gas was adopted in June 2016 to further align with the EU's third Energy Package; adoption of implementing regulations is ongoing. • The power distribution activities of the Montenegrin Electric Power Company were legally separated from the supply function in June 2016. The functional unbundling of the distribution system operator and certification of the national electricity transmission system

	operator is ongoing but not yet completed. • The independence of the Energy Regulatory Agency has been strengthened. • On rail transport, no progress was achieved on ensuring effective and independent regulatory and safety authorities; amending the law on rail transport is planned in 2017.
PG 5: Continue to facilitate the provision and range of financial and non-financial support services for SMEs with a view to foster participation in global value chains. Support the development of the private consultancy market.	There has been **limited implementation** of PG 5: • An increased level of financial support for SMEs has been maintained, with an expanded scope of available credit lines and improved repayment conditions. • Financial resources dedicated to non-financial support services remain limited. • Further reform measure on SME support were developed for inclusion in this year's ERP.
PG 6: Prolong working lives and reduce disincentives to work through strengthening the link between activation measures and social assistance, in order to improve the labour market participation of the long-term unemployed, women and youth. Implement strategies to align education and skills policies with labour market needs.	Montenegro has **partially implemented** PG 6: • The benefit for mothers with three or more children was reduced, but needs to be dealt with in a comprehensive manner to ensure that women have an adequate economic position. Plans have been announced to strengthen unemployment benefits and improve the efficiency of employment services. Activities have begun to improve cooperation between employment offices and centres for social work, to improve activation. No actions have been taken for the pension system. • ALMPs continue to be implemented, but with low financing and coverage, weak targeting and no impact assessment. A new law proposes a better basis for improved design. • New qualification standards are being implemented in VET and teachers' trainings are planned. In higher education, a new study and funding model are planned. Weak cooperation with the private sector and career guidance and the oversupply of higher education graduates are not addressed. There have been no real advancements in enrolment policies and work-based learning.

3.6. THE 2017 POLICY GUIDANCE

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

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

Brussels, 23 May 2017

[…]

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

1. Fully implement the 2017 consolidation package, and take additional fiscal measures if necessary to achieve the envisaged budget savings of around 3% of GDP. Adopt a comprehensive medium-term fiscal strategy with concrete revenue and expenditure measures with sustainable effects in order to stabilise public debt and reduce debt-related vulnerabilities. Consider establishing an independent fiscal council.

2. Gradually reduce public spending on wages and pensions as a share of GDP. Ensure the availability of adequate financial resources for the implementation of new legislative measures. Strengthen tax revenues and review tax exemptions with a view to a further reduction of tax exemptions. Adopt measures in order to facilitate debt servicing by tapping the local debt markets, extending maturities, and advancing the privatisation agenda.

3. Continue efforts to foster NPL resolution by developing a comprehensive strategy to that end, including participation by all relevant stakeholders, with the aim of reducing credit risks in the banking sector and removing impediments to credit extension in the economy. Consider to include corporate debt restructuring and tackle other underlying structural obstacles of resolution as part of the strategy. Enhance prudential and banking resolution frameworks to the end of buttressing financial stability.

4. Harmonise national rules with Directive 2014/61 on cost reduction measures for the development of high-speed electronic communication networks. Ensure effective, efficient and independent rail regulatory and safety authorities to implement the full opening of the rail market.

5. Continue to strengthen financial and non-financial support services for SMEs. Adopt legislation to ensure the operational independence of the state aid authority.

6. Reform the law on social protection to ensure cost-effectiveness, better targeting of assistance and the reduction of disincentives for women to work. Carry out a review of active labour market policies with a view to improving their coverage and targeting the long-term unemployed, women and youth. Improve school-to-work transitions through work-based learning and promoting the appeal of vocational professions.

ANNEX: COMPLIANCE WITH PROGRAMME REQUIREMENTS

Montenegro's Economic Reform Programme 2017-2019 was submitted to the European Commission on time on 31 January 2017. No components of the ERP are missing.

Inter-ministerial coordination

The preparation of the ERP was centrally coordinated by the Office of the Prime Minister, the Ministry of Finance, and the Ministry of Economy. An inter-ministerial ERP working group involving line Ministries worked on its preparation.

Stakeholder consultation

The draft ERP was published on the Government's website for public consultation, but only on 13 January 2017, with a roundtable discussion with stakeholders taking place on 20 January 2017, which did not provide enough time to incorporate comments in the final programme. The draft was also presented to the parliament for information and discussion. The government provided a summary of the comments received and if and how they have been taken on board. Several business stakeholders raised concern over the timing of their involvement and asked to be involved at an earlier stage and to be given more time to provide comments.

Macroeconomic framework

The programme presents a clear and concise picture of past economic developments. Given the volume of investments in progress, the baseline macroeconomic scenario supporting economic policy seems plausible However, the cautious estimates for private and government consumption and for the growth of imports could be arguable. Analytical capabilities are gradually improving. This is, particularly the case of the analysis –for the first time– of the total external debt, including the private one. However, it covers only the period until 2015. Data coverage is also improving, although labour market projections remain largely incomplete. The baseline framework appears coherent, consistent and sufficiently comprehensive. The programme also offers an alternative low-growth scenario based on the occurrence of a sharp contraction of FDI. In this scenario, aggregated demand would contract due to the reduction of investment and consumption; moreover, the startling sharp decline of imports (related to construction and investment) would also soften the negative contribution of net exports and rapidly reduce the current account deficit, which seems at odds with data records.

Fiscal framework

The fiscal framework appears barely sufficient to support the policy agenda beyond 2017. The ERP measures comply –at least theoretically– with the fiscal policy guidance of the Ministerial Dialogue of May 2016. However, their impact is basically limited to 2017 and it will need to be assessed in practice. Furthermore, the medium-term fiscal strategy and the fiscal correction plan remain incomplete, and they would need to incorporate additional measures beyond 2017. The measures presented in the programme are broadly balanced, with both revenue and expenditure measures accounting for some 1.6 % of GDP each. While the most important measures were frontloaded already in December 2016, many of them are short-term. On the revenue side, the fiscal impact of measures like the collection of tax arrears or the legalisation of undeclared work is far from certain. Measures on the expenditure side range from an upfront cut on social benefits or public sector salaries, to some milder ones, like the six-month postponement on freezing the years-of-experience bonus in the public sector (replaced in the meantime by an 1 % decrease in the base salaries of salaries with coefficient above 4.10 until end-2018), or the rather narrow increase in computer equipment VAT. The ERP did not cover last year's recommendation to conduct a review of tax expenditure and exemptions. The programme also offers an alternative low-growth fiscal scenario. However, this alternative scenario is much less developed than the macroeconomic one. Work in government finance statistics is ongoing under the action plan for implementation of the ESA2010 methodology. The public finance management reform strategy (adopted in 2015) progress slowly. Overall, a comprehensive medium-term fiscal strategy, including durable fiscal consolidation measures (planned for the second quarter of 2017), still needs to be developed.

Structural reforms

The structural reform sections (4, 5 and 6) mostly follow the guidance note. However, at times, the diagnostics divert from the guidance note by presenting a diagnostic per sub-sector or measure, rather than for each of the nine sectors foreseen in the template. The number of reform measures is limited to 20 and the page limit (40) for section 4 is only overshot by a couple of pages. The reporting of the implementation of the policy guidance can be improved and should provide more precise information about the actions taken and their impact. Similarly, the monitoring and reporting on the implementation of the priority reforms could be further improved, especially as regards the level of information provided in Annex 12. The Commission welcomes in this regard the government's intention to set up a high-level competitiveness council tasked to monitor the ERP implementation.

4. SERBIA

4.1. EXECUTIVE SUMMARY

Economic growth is forecast to firm up slightly. In 2016, the economy expanded by 2.8%, faster than expected, and surpassed its pre-crisis peak as consumption and export beat initial expectations. The programme forecasts a slight acceleration of economic growth, increasingly underpinned by private consumption, while investment and export are projected to remain robust. Inflation is expected to increase moderately but short-term price pressures are contained. The current account deficit is forecast to stabilise at around 4 % of GDP and to be fully covered by net foreign direct investment (FDI). Non-performing loans (NPLs) declined, helped by the implementation of the NPL resolution strategy and reinvigorated lending.

The macroeconomic scenario is plausible but requires strong reform commitment and steadfast implementation. The economy's structure has changed markedly over the last several years away from consumption towards exports. Sustaining this growth model, however, would require continued investments in expanding the tradable sector, improving the business environment, and upgrading infrastructure. The economy is vulnerable to financial and commodity market shocks and is exposed to developments in the EU, which is the main export market and source of most of the foreign investment inflows.

The main challenges in this respect include the following:

- **Avoiding policy complacency and 'reform fatigue' is a key challenge as successful macroeconomic stabilisation has reduced the pressure for reforms.** The legacy of the unreformed public sector has continued to weigh on the budget and the economy. The slow and uneven progress in restructuring state-owned enterprises (SOEs) and delays in the tax administration reform remain a concern. Challenges remain to further improving budgetary planning and execution. Fiscal rules are weak and require substantial revision to make them more binding and relevant for policy making. Progress with addressing the very high level of NPLs was uneven across banks. Further efforts are required to strengthen the financial performance and governance of state-owned financial institutions, and to advance their privatisation.

- **The envisaged medium term consolidation path could be more ambitious without straining economic growth.** Following an impressive reduction of fiscal imbalances in the last 2 years, the pace of consolidation is forecast to slow significantly. The programme targets reaching a budget deficit of 1 % of GDP by 2019 and identifies additional fiscal space in 2018 and 2019 to be used for accommodating new policy initiatives. However, in view of the better than expected performance and outlook, the still very high level of public debt, revenue volatility, and elevated fiscal risks, it would be prudent to use at least part of this space to further reduce budget deficits.

- **The energy sector continues to be a risk for public finances and management of public investment remained weak.** Public utility companies have not been effectively restructured yet, which hampers the functioning of the energy market. The Economic Reform Programme (ERP) remains vague on reorganising the inefficient system for prioritising and managing public capital expenditure. Better use should be made of the single project pipeline to cover all large public investment projects.

- **The business environment has only improved in limited areas; the burden of red tape and the informal economy is very high.** There is no progress with regulation of parafiscal charges and, despite low inflation, many companies, notably small and medium sized enterprises (SMEs), remain without access to affordable finance. The informal economy is large. The ERP recognises this as a problem, but the response is limited to a reform of the tax administration and an e-inspection service.

- **The labour market continues to be characterised by low activity rates, low level of skills and skills mismatch and a framework that discourages part-time work and formal work in the low earning segments.** Structural deficits across the education system cause low levels of basic skills among a considerable proportion of young people. Moreover, the provision of medium- and higher-level qualifications that do not meet labour market needs is hampering the swift transition of young people to the labour market. At the same time, talented young people are leaving the country. Reforms have started in the skills governance system and further reforms are planned that will introduce entrepreneurial education and dual learning in vocational education and training. It would also be helpful to envisage more ambitious labour market reforms and labour force activation measures. These are also key for improving prosperity levels among the population, which is still strongly affected by poverty.

The policy guidance jointly adopted at the Economic and Financial Dialogue of 25 May 2016 has been partially implemented. Progress was strong in reducing fiscal imbalances, and this provided the necessary space for continuing monetary policy accommodation. Important results were also achieved on reducing NPLs. The progress in restructuring state-owned enterprises was uneven and major challenges to finding a sustainable resolution for systemically important companies remain. The public administration reform advanced as well, although it continues to face implementation delays. Revenue collection improved significantly but needs to be sustained by implementing the tax administration transformation programme. The management of public projects has not improved, but the commitment to the gas interconnector with Bulgaria was reinvigorated. Regulatory dialogue with businesses remains sporadic and little has been done to improve the predictability of the business environment for investors concerning parafiscal charges or new regulation. Although the budget allocation remained stable, steps have been taken to increase the coverage of active labour market policies and strengthen the capacities of local employment offices.

The ERP partially matches the reform priorities identified by the Commission. The macroeconomic and fiscal frameworks are sufficiently comprehensive and coherent, providing a good basis for policy discussions. Stepping-up reform implementation remains crucial in order to lock-in recent gains in macroeconomic and fiscal stability, reduce structural rigidities, further improve the economic outlook, and strengthen the financial system. The structural reform part of the ERP remains largely unchanged from last year. This is appropriate from the perspective of challenges to competitiveness which remain broadly the same. There has been progress across reform areas and in many sectors there is a better acknowledgement of what needs to be implemented and how urgent these reforms are. The ERP fails, however, to recognise these developments and to adjust the reform measures accordingly. Overall, there is an imbalance in the ERP toward infrastructure investments. This comes at the expense of proper structural and market reforms with a potentially larger impact on competitiveness. These mainly relate to the informal economy, parafiscal regulation and transparency of state involvement, and to raising employment levels.

4.2. ECONOMIC OUTLOOK AND RISKS

Economic growth is forecast to firm up slightly. In 2016, the economy expanded faster than expected and surpassed its pre-crisis peak as consumption and export beat initial expectations. Increased confidence as a result of implemented reforms, stronger external demand and tail winds from low oil prices supported the nascent recovery. Boosted by rising employment and private sector wages, household consumption recorded a marginal growth for the first time after years of decline. The programme envisages a slight acceleration of economic growth to 3.0% in 2017 and 3.5% for the two last years. Growth is forecast to be increasingly underpinned by private consumption, while investment and export are projected to remain robust. On the supply side, industrial production and services are expected to be the main drivers of economic activity.

The macroeconomic assumptions are plausible but require strong reform commitment and steadfast implementation. The baseline scenario is broadly in line with the latest Commission forecast. It recognises the presence of a new growth momentum, based on sounder fundamentals. The economy's structure has changed markedly over the last several years away from consumption towards exports. Sustaining this growth model, however, would require continued investment in expanding the tradable sector, improving the business environment and upgrading infrastructure. Stepping up reform implementation and creating additional fiscal space for productive capital expenditure, as envisaged by the programme, would therefore support investment and export-led growth in the years to come. Private consumption growth is poised to accelerate, buoyed by further gains in employment and wages and by a less restrictive fiscal stance. Continuing a sustainable rebalancing of the economy would, however, require that private consumption growth does not become excessive.

Table 1:

Macroeconomic developments and forecasts

	2015		2016		2017		2018		2019	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	0.8	**0.8**	2.8	**2.7**	3.0	**3.0**	3.3	**3.5**	n.a.	**3.5**
Contributions:										
- Final domestic demand	1.0	**1.1**	2.4	**2.4**	3.1	**2.5**	3.6	**3.2**	n.a.	**3.5**
- Change in inventories	0.4	**0.5**	-0.4	**-0.4**	0.0	**0.0**	0.0	**0.0**	n.a.	**0.0**
- External balance of goods and services	-0.6	**-0.8**	0.8	**0.6**	0.0	**0.5**	-0.3	**0.3**	n.a.	**0.0**
Employment (% change)	0.6	**1.0**	4.7	**1.1**	1.1	**1.2**	1.5	**1.4**	n.a.	**1.4**
Unemployment rate (%)	17.7	**18.2**	16.1	**17.0**	14.3	**16.0**	12.6	**14.7**	n.a.	**13.2**
GDP deflator (% change)	2.7	**2.7**	1.0	**1.3**	1.7	**1.6**	2.9	**2.8**	n.a.	**3.0**
CPI inflation, annual average (%)	1.4		1.1	**1.1**	2.4	**2.4**	3.3	**3.0**	n.a.	**3.0**
Current account balance (% of GDP)	-4.7	**-4.7**	-4.0	**-4.1**	-4.2	**-4.1**	-4.2	**-3.9**	n.a.	**-3.9**
Budget deficit (% of GDP)	-3.7	**-3.7**	-1.3	**-2.1**	-1.2	**-1.7**	-1.0	**-1.3**	n.a.	**-1.0**
Government debt (% of GDP)	74.6	**76.0**	73.7	**74.6**	72.3	**73.9**	69.8	**70.7**	n.a.	**67.0**

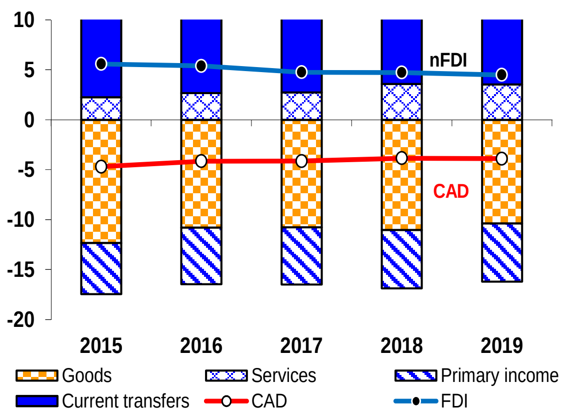
Sources: Economic Reform Programme (ERP) 2017; Commission Winter 2017 Forecast

Risks are not negligible. They are clearly identified in the programme, which also presents an alternative, pessimistic scenario, envisaging lower cumulative growth of just 5.2 % in the period 2017-2019. Due to the recent reduction of domestic and external imbalances, the economy is much better placed to face some of the risks. However, it is exposed to developments in the EU, which is the main export market and source of most of the foreign investment inflows. The economy is also vulnerable to financial and commodity market shocks as it remains highly dependent on foreign capital and energy imports. On the domestic side, avoiding policy complacency and 'reform fatigue' is a key challenge as successful macroeconomic stabilisation has reduced the pressure for reforms.

Inflation is expected to increase moderately but short-term price pressures are contained. Over the last few years, inflation was stable and at historically low levels, undershooting expectations and the central bank target tolerance band. Strong fiscal consolidation and shrinking external imbalances provided room for further monetary policy relaxation and underpinned a relatively stable exchange rate. Low inflation and inflationary expectations allowed the central bank to reduce its inflation target by 1 pp. to 3 % ± 1.5 pps. as of 2017. The lower target still allows for gradual price convergence with advanced economies through the Balassa-Samuelson effect, and is also expected to support confidence in the domestic currency and its use in the economy. Over the short term, the good agricultural season and limited adjustments of administered prices are expected to contain price pressures. However, as the effects of major disinflationary factors, such as low international prices and subdued domestic demand, dissipate or are being reversed, inflation is forecast to rise and approach the new central bank target.

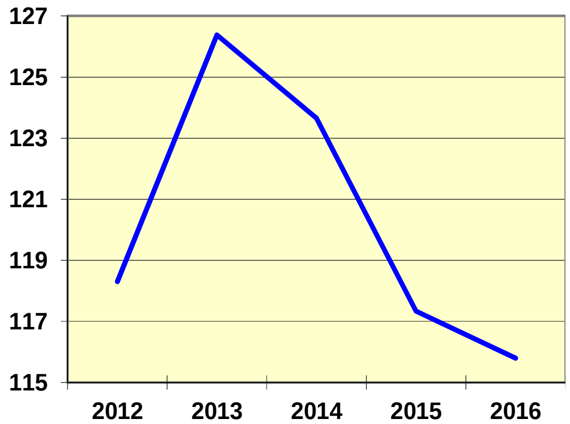
Graph 1: **External competitiveness and the current account**

Changes in the current account balance
(% of GDP)



Source: ERP 2017, Commission calculations

Real effective exchange rate
(CPI based, total economy, 2005=100)



The current account deficit is expected to stabilise at around 4 % of GDP. The deficit fell more strongly than expected in 2016, mostly due to better export performance. Robust inflows of FDI in tradable sectors — particular manufacturing — have boosted export capacity in the last few years. The reduction of the public savings-investment gap contributed decisively to the continuing fall in external imbalances. Thus, with the envisaged slowdown of fiscal adjustment, a major driving force for supressing these imbalances would weaken significantly. As private investment is forecast to move broadly in line with private savings, the programme expects the current account to stabilise at just below 4 % of GDP. There are certain risks to this profile, however. On the downside they come from potentially higher financing costs and negative terms of trade developments. On the upside, the risk is from continued stronger than expected export performance in manufacturing.

Attracting FDI remains crucial for making further gains in competitiveness and underpinning growth. Increases in price competitiveness have been limited recently and are expected to remain so over the medium term. Further improvements in external competitiveness are envisaged to come mainly as a result of productivity-enhancing reforms and investment. Net FDI inflows have been on the rise and fully covered the current account deficit in the last 2 years. They were broad-based and a dominant part of them went into manufacturing and other tradable sectors which helped Serbia expand its global market share. The programme prudently assumes a broadly unchanged nominal level of net FDI inflows, sufficient to cover the current account deficits over 2017-2019. The current account deficit, although reduced, is expected to continue worsening the net international investment position, which is now clearly above 100 % GDP. On the liabilities side, however, the stock of FDI makes up more than half of all obligations, limiting vulnerabilities to a sudden worsening of external financing conditions. In addition, maintaining a comfortable level of foreign reserves and a continued steadfast implementation of the Stand-By Arrangement with the IMF represent important buffers against external risks.

Financial sector resilience improved but still faces major challenges. Macroeconomic stabilisation and acceleration of growth were instrumental in bringing down financing costs and reviving lending activity. Credit to households picked up strongly, while corporate loans, although on the rise as well, lagged behind. The deposit base expanded further, covering almost fully claims on non-government sectors. Despite some inroads in increasing the use of the dinar, the banking system remained heavily 'euroised' on both the assets and liabilities side. Increased reliance on domestic funding allowed banks to reduce their net foreign liabilities. The sector's exposure to the state continued rising and claims on the government reached nearly 18 % of total assets. Commercial banks remained liquid and well-capitalised and their profitability increased, although some still ran losses last year. The implementation of the NPL resolution strategy and reinvigorated lending helped bring down the NPL ratio by 4.5 percentage points to 17%. However, progress was uneven and state-owned banks in particular have not yet satisfactorily addressed the problem. Further efforts are also required to strengthen the financial performance and governance of state-owned financial institutions and to advance their privatisation.

Table 2:
Financial sector indicators

	2012	**2013**	**2014**	**2015**	**2016**
Total assets of the banking system, mEUR	34 980	34 378	34 618	35 655	36 992
Credit growth	9.5	-4.4	3.1	2.9	2.5
Deposit growth	10.4	3.3	7.6	6.5	11.4
Loan to deposit ratio	1.3	1.2	1.1	1.1	1.0
Financial soundness indicators					
— non-performing loans	18.6	21.4	21.5	21.6	17.0
— total provisions to gross NPLs	120.7	113.8	114.5	114.2	118.9
— regulatory capital to risk weighted assets	19.9	20.9	20.0	20.9	21.8
— liquid to total assets	34.5	38.5	35.6	34.3	36.9
— return on equity	2.1	-0.4	0.6	1.6	3.4
— forex loans to total loans*	73.1	70.9	70.0	71.9	69.3

Sources: ERP 2017, National Central Bank, DataInsight
**Includes both denominated and indexed positions.*

4.3. PUBLIC FINANCE

Fiscal consolidation remained very strong. Following a marked reduction in 2015, the budget deficit was cut significantly again to 1.4 % of GDP last year.[1] The outcome far outperformed initial and revised targets and was mainly due to better revenue performance. Favourable macroeconomic developments, improved tax collection and unplanned one-off receipts all contributed to this result. Expenditure, on the other hand, remained largely under control and saw a further fall in current spending. Despite limited indexations in 2016, spending on pensions and wages declined as a percentage of GDP, although they are still above the respective ceilings prescribed by the fiscal rules. Importantly, the lower budget deficit broke the trend of rising interest costs and government debt ratio and both fell for the first time since 2008. The strong budget performance also created space for increasing capital expenditure, in particular on big infrastructure projects, accommodating one-off payments to pensioners and taking over some debt owed by state-owned enterprises.

The legacy of the unreformed public sector continued to weigh on the budget and the economy. The slow and uneven progress in restructuring SOEs and delays in the public administration reform remain key concerns and come at a significant, often unplanned, cost to the budget. They also force the preservation of inefficient and often burdensome and ad hoc solutions, such as the extension of an employment attrition rule for the public sector for another year, to 2017. The level of government spending is high and its structure is still not sufficiently supportive of growth. State aid to public companies is significant and is often granted in a non-transparent manner. Key budget systems, processes and institutions need to be strengthened to improve budget transparency, boost efficiency and support sustainable fiscal consolidation.

Table 3:

Composition of the budgetary adjustment (% of GDP)

	2015	2016	2017	2018	2019	Change: 2016-19
Revenues	41.9	43.3	42.4	41.6	41.1	-2.2
- Taxes and social security contributions	35.9	36.8	36.8	36.3	36.1	-0.8
- Other (residual)	6.0	6.5	5.6	5.3	5.0	-1.4
Expenditure	45.6	45.4	44.1	42.9	42.1	-3.3
- Primary expenditure	42.4	42.1	41.0	40.0	39.5	-2.7
of which:						
Gross fixed capital formation	2.8	3.1	3.3	3.5	3.6	0.5
Consumption	16.7	16.9	16.7	16.2	16.0	-0.9
Transfers & subsidies	20.9	19.9	18.9	18.1	17.6	-2.3
Other (residual)	1.9	2.2	2.1	2.1	2.3	0.1
- Interest payments	3.2	3.3	3.1	3.0	2.7	-0.6
Budget balance	-3.7	-2.1	-1.7	-1.3	-1.0	1.1
- Cyclically adjusted	-3.2	-1.9	-1.6	-1.4	-1.1	0.8
Primary balance	-0.5	1.2	1.4	1.6	1.7	0.5
Gross debt level	76.0	74.6	73.9	70.7	67.0	-7.6

Sources: ERP 2017, Commission calculations.

[1] The text comments on the actual execution data for 2016, which differ from those in the ERP.

The envisaged medium-term consolidation path could be more ambitious without straining economic growth. Following an impressive reduction of fiscal imbalances in the last two years — the structural deficit was cut by more than 4 % of GDP — the pace of consolidation is forecast to slow down significantly. The programme targets reaching a budget deficit of 1 % of GDP by 2019, to be achieved primarily by a further reduction of expenditure. Importantly, and for the first time, the medium-term framework has also identified additional fiscal space of 0.3 % of GDP in 2018 and 0.8 % of GDP in 2019. This gives the authorities leeway for accommodating new policy initiatives. However, in view of the better than expected 2016 outcome, the positive macroeconomic outlook, the still very high level of public debt, revenue volatility, and high fiscal risks, it would be prudent to use at least part of this space to further reduce budget deficits.

The 2017 budget is conservative and builds upon recent successes. It sets a deficit target of 1.7 % of GDP (defined before the favourable deficit outcome for 2016 became known) which includes some reserves and is also subject to upside risks on the revenue side. There are no major changes in tax policy and tax rates in 2017 and over the span of the programme. The revenue ratio is expected to fall by 0.9 % of GDP in 2017, mostly due to a decline in non-tax revenue after a surge in one-offs the previous year. Tax revenue is kept broadly unchanged as a ratio to GDP, reflecting the forecast dynamics of respective tax bases, without taking into account any possible gains due to improved collection and reduction of the informal economy. The positive momentum built up on the revenue side in 2016 has allowed for a targeted increase of salaries by 3-6 % in some segments of the public sector and a 1.5 % indexation of pensions. Nevertheless, the expenditure on wages and pensions, representing nearly half of total spending, is still set to decline further as a percentage of GDP.

The successful implementation of structural reforms would further support a sustainable fiscal consolidation. Major savings are expected in subsidies and payments on activated guarantees, which are dependent on further advancing the restructuring of state-owned enterprises. Continuing the reform of the public administration, although not expected to bring significant direct savings, is also of key importance for improving public sector efficiency and providing better-quality service in important sectors such as health and education. More determined implementation of the tax administration transformation programme is needed to institutionalise recent gains in revenue collection. In addition to their impact on the budget, these major reforms have an important effect in signalling the authorities' commitment to the process of modernising the economy and improving the business environment, thus, affecting the overall country risk premium.

Fiscal risks are clearly outlined in the programme. They are topped by concerns about the impact of public enterprises on government finance. These range from state-guaranteed loans, subsidies and transferring of liabilities to the budget, to foregone tax revenue. In this context, the recent improvement of financial performance of state-owned enterprises is encouraging, although some of them still remain loss making and undercapitalised. On the basis of a pessimistic macroeconomic scenario, the programme presents an alternative fiscal path with a less pronounced reduction of the government debt and deficit. It also flags the importance of strengthening banking system supervision and stability to reduce the budget's exposure to risks from the financial sector. Idiosyncratic risks from court rulings and national disasters are mentioned as well. Possible future restitution-related obligations of up to EUR 2 billion or some 5 % of GDP to be issued in 2018 have not been incorporated into the analysis, however.

Government debt is on a downward path for the first time since 2008. As a result of fiscal consolidation efforts and a sizeable budgetary over-performance, government debt fell in 2016 after years of constant increase. The reversal of debt dynamics came a year earlier than expected thanks to larger-than-forecast primary balance and economic growth, and a drawdown of budget deposits. A marginal increase of primary surpluses and a steady expansion of the economy are forecast to drive a continued reduction of government debt to 67 % of GDP in 2019. Lower debt, for its part, is a main factor in the projected further fall in interest expenditure to below 3 % of GDP already next year.

There are significant downside risks to the debt trajectory which call for judicious use of any over-performance in the budget. Under the baseline, government debt and debt servicing would still remain very high. Refinancing risks are prominent, with gross financing needs averaging above 16 % of GDP over the next 3 years. In view of the high share of foreign currency in its structure, government debt is highly vulnerable to a depreciation of the dinar. Despite recent progress, the poor overall financial situation of some large state-owned enterprises remains a source of sizeable implicit liabilities for the budget. In addition, restitution-related obligations could also pose a challenge to the envisaged reduction of government debt. Finding a sustainable solution to controlling expenditure on wages and pensions is needed as well. Reform 'fatigue' and fiscal slippages are also not excluded, especially after the programme with the IMF expires in early 2018.

Box: Debt dynamics

The increase in the government debt to GDP ratio was reversed in 2016 due to a strong consolidation effort which brought the primary balance into surplus. Debt-reducing effects from real GDP growth and inflation intensified as well, almost fully offsetting the impact of high interest payments. The expected acceleration of economic growth and a moderate increase in inflation are seen as the main factors behind the forecast further decline of government debt, in particular in the last years of the programme. Stock-flow adjustments are expected to remain marginal, although restitution-related debt and potential privatisation (concession) receipts, not included in this scenario, could significantly impact debt dynamics.

Table 4:

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

	2015	2016	2017	2018	2019
Gross debt ratio [1]	**76.0**	**74.6**	**73.9**	**70.7**	**67.0**
Change in the ratio	4.1	-1.4	-0.7	-3.2	-3.7
Contributions [2]:					
1. Primary balance	**0.5**	**-1.2**	**-1.4**	**-1.6**	**-1.7**
2. 'Snow-ball' effect	**0.8**	**0.4**	**-0.1**	**-1.4**	**-1.6**
Of which:					
Interest expenditure	3.2	3.3	3.1	3.0	2.7
Growth effect	-0.5	-2.0	-2.1	-2.4	-2.3
Inflation effect	-1.9	-0.9	-1.1	-1.9	-2.0
3. Stock-flow adjustment	**2.8**	**-0.6**	**0.9**	**-0.2**	**-0.4**

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

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences between cash and accrual data.

Source: ERP 2017, MoF; Commission calculations.

Steps have been taken to improve budgetary processes and institutions but the fiscal framework needs to be strengthened further. Extra-budgetary loans have been integrated into the 2017 budget and work is under way to establish a single pipeline of investment projects. Monitoring of state-owned enterprises has been stepped up. The framework governing public-private partnerships and concessions has been upgraded to include fiscal risk statements and for projects larger than EUR 50 million the consent of the Ministry of Finance is required. Significant challenges remain, however, regarding further improving budgetary planning and execution. This includes improving coverage of the general government sector and integration of all units into the budget execution system. The fiscal responsibility framework — and the fiscal rules in particular — is weak and requires a substantial revision to make it more binding and relevant for policy-making, able to anchor consolidation efforts and control current expenditure. The Fiscal Council remained a prominent institution, supporting debates on fiscal policy. As the mandate of all members of the Council expires this spring, preserving continuity and institutional knowledge will likely be a challenge.

4.4. STRUCTURAL REFORMS

The structural reforms part of the programme is based on a sound analysis but reform prioritisation could be further improved. The ERP contains a realistic analysis of the key obstacles to competitiveness, growth, employment and social development. Many measures proposed are relevant and address the obstacles identified. However, the Commission assessment of the ERP for 2016-2018 has not been sufficiently taken into account in the revision of the measures included this year. In particular, there is an over-emphasis, both in terms of number of measures and the budget, on infrastructure investments at the expense of proper structural reforms with a potentially greater impact on competitiveness.

The measures included in the ERP are spread across nine different areas reflecting the main challenges for Serbia's competitiveness. Many of the measures in the programme deal with improved public support to businesses, such as access to finance, innovation, industrial prioritisation and quality infrastructure. The reforms of inspections and the tax administration are aimed at reducing the informal economy. The section on energy, transport and telecommunication markets, however, does not deal with the much-needed restructuring of the sectors, but rather lists a number of public investment projects. It also fails to include any connectivity reform measures, which would have a large impact on competitiveness at a lower cost. Contributions from the budget are envisaged in all measures, showing a commitment by the government to reform implementation. However, the budgeting of some measures only partially covers foreseeable costs, while many measures are co-financed by donors and international financial institutions (IFIs). The risks to implementation are identified to come mainly from sluggish administrative procedures, lack of cooperation between the institutions responsible, poor planning and budgetary shortcomings. This indicates the importance of efforts to modernise the administration in general. The programme would have benefitted from including information on planned activities to mitigate the identified risks.

The main structural bottlenecks to competitiveness include inefficient energy market in need of restructured and unbundled utilities, a relatively poor business environment and a large informal sector. There are delays in the implementation of some important reforms that have started a few years ago, at the depth of the economic crisis. This is particularly the case for measures which aim to improve the competitiveness of the industrial and agriculture sectors and remove the burden of red tape. There is little reflection in the ERP as to how growth could be sustained in the medium term, how more formal jobs could be created to increase employment, how skilled young people could be kept in the country and more FDI attracted. In view of persistent delays of reform implementation, the end of the stand-by arrangement with the IMF in early 2018 represents a certain risk for the continuation of structural reforms. Last year's policy guidance related to structural reforms has been only partially implemented.

Public finance management

Key weaknesses in public finance management (PFM) affecting the competitiveness of the economy include the preparation and execution of the budget. Management of public funds could be improved to support fiscal consolidation and provide better public services. The ERP's diagnostic recognises these challenges; however, it does not make a link to the PFM reform programme and its action plan which have been prepared under the obligations of Chapter 32 in the accession negotiations. There are important delays in the implementation of the action plan; most notably, the mechanism for policy dialogue on implementation of the reform with relevant stakeholders is still to be operationalised. Public participation in the budget process is weak and budget oversight by the Parliament needs to be improved.

There has been progress in implementing the measure transforming the tax administration. The measure is rolled over from the previous ERP, but further assessment of the strengths and weaknesses of the tax administration was carried out by the IMF in 2016 under its Tax Administration Diagnosis Assessment Tool (TADAT). A modern system of risk analysis directed towards sectors and tax payers with higher probability of tax evasion is in the pipeline and needs to be effectively put in place. Keeping and recruiting qualified staff, particularly in the IT sector, is one of the Tax Administration's main challenges. Training and IT should be upgraded. Services to tax payers, in particular electronic filing, continued to be developed. They should be further improved through the planned establishment of a sector for services within the Tax Administration.

There was a limited progress in implementing the rolled-over measure to improve capital investment management. Capital expenditure execution remains hampered by weaknesses in budgeting, planning and contract oversight. Serbia has not yet put in place a unified and integrated platform for the prioritising, planning and managing of capital projects and investments. Such a structure should be based on the existing platform for capital investment, namely the National Investment Committee and the Single Project Pipeline.

Transport, energy and telecommunications markets

Low levels of investment in physical infrastructure continue to be an obstacle to economic development and regional integration. The comprehensive diagnostic in this area is well elaborated. Underdeveloped transport infrastructure coupled with a non-harmonised regulatory framework result in high transport costs and low levels of trade integration within the Western Balkan countries and with the EU. An underdeveloped electricity and gas transmission network and lack of interconnections make the energy market inefficient and limit its contribution to economic development. Access to broadband is well below the EU average.

The many sub-measures included in transport area focus on infrastructure investment only, neglecting the fact that infrastructure development needs to be combined with structural market reforms. All eight projects in transport, energy and telecommunication markets are rolled over from last year's programme. The importance of modernising and expanding infrastructure is a core component of the EU-led connectivity agenda under the Berlin process. However, parallel progress in sector reforms including restructuring of public utilities and liberalisation is also needed and should be the focus of the ERP. While railway reforms have progressed steadily on the commitments made under the connectivity agenda, other reforms, such as the unbundling of Srbijagas, have yet to be fully tackled. Moreover, after the Paris Agreement on Climate and given the exceptionally high energy intensity in Serbia, higher priority should be given to energy efficiency measures. Price and tariff reforms would send the right signals for power usage and stimulate investment in energy efficiency.

The measure on developing the broadband network is still in its early phase. The adoption of a law on broadband communication infrastructure aligned with Directive 2014/61/EU has been delayed. It would create a regulatory framework facilitating and incentivising the roll-out of broadband networks. The mapping of broadband availability and penetration is still on-going. Private investments of €150 million have been announced, but need to be confirmed. In the coming years, a subsidy for the development of infrastructure in areas of low population density areas needs to be budgeted for. Similarly, although currently not envisaged, the regulation for providing e-government and e-services needs to be further developed.

Sector development

Agricultural sector development

The challenges facing the agriculture sector are land fragmentation, low productivity due to outdated technologies, small economic size and low utilisation of agricultural land per farm compared to the EU average. The diagnostic recognises these challenges but does not analyse the need to address further alignment of phytosanitary regulations with EU standards or border control procedures, which can contribute critically to improving the sector's competitiveness.

The measure to improve the competitiveness of agricultural holdings is seen only through the prism of legal and institutional framework adjustments in order to be able to use EU IPARD funds. However, national subsidies and the Instrument for Pre-Accession Assistance in Rural Development (IPARD), as identified in the measure, are just two of many vehicles to promote investments. Investments should also be encouraged by increasing the attractiveness of the sector. This could be done by creating a predictable legal framework, progressively liberalising the market for agricultural land and developing modern agricultural infrastructure (including irrigation systems, cadastre management, rural planning, access roads, storage facilities, etc.).

Industry sector development

The recent influx of FDI supported a recovery of industrial activity. However, as the programme points out, the sector continues to face difficulties; it is concentrated on raw materials and few manufacturing sub-branches, some companies depend on state aid, the share of high-tech companies is very low and there is a lack of cooperation with public researchers. Sustained investment in industry and manufacturing is needed to safeguard and upgrade the skills, improve productivity and so ensure the integration of a larger number of firms into global value chains.

The measure aimed at strengthening the competitiveness of the processing industry does not go far enough to constitute a substantial reform of the sector. The programme proposes formulating action plans for priority branches of industry. However, this is not enough to achieve a significant impact on competitiveness. The current dialogue with the World Bank and the opening of Chapter 20 under the EU accession negotiations are starting points for a modern and inclusive industrial policy. The new strategy needs to include co-ordination mechanisms with policy areas such as the one for research and innovation and relevant performance benchmarks and provide guidelines to line ministries on how to design better support measures for industry. The Ministry of Economy cannot be the only ministry responsible. New instruments of industrial support need to be introduced to benefit smaller and local investors.

Steps have been taken to achieve better management and prioritisation of investment aid, which is a key part of Serbia’s measure to support industry. The regulation on the terms and conditions of attracting investment precisely lays down the conditions for granting investment aid. Similarly, priority target sectors have been identified, though the selection criteria remain unclear. A track record needs to be established showing that aid is attributed according to a transparent procedure and to the best projects in terms of competitiveness and sustainable development. The conditions for granting aid to the projects of special importance remain opaque. The attribution of aid should be de-politicised and based only on socio-economic criteria.

Services sector development

Further development of the services sector is inhibited by non-transparent administrative requirements for the provision of services, the low share of e-commerce, a lack of skills and knowledge required for complex services and an underutilised tourism potential. A diagnostic of the challenges of the services sector is included in the programme; however, there is no service-focused planned response. As the majority of the economy is in services, most of the horizontal measures of the ERP will have an impact on their improved functioning. In particular, services provided by SMEs would benefit from a better registry and a modern regulation of e-commerce. The tourism strategy is being implemented, but its priority concerning restructuring of public spas has progressed only slowly.

Business environment and reduction of the informal economy

There are still significant barriers to businesses to attract and facilitate private investments. Little progress has been achieved in advancing business-friendly reforms since the simplification of the procedure for issuing construction permits in 2015. The continuing barriers to private investment include a costly, unpredictable and non-transparent system of parafiscal charges, difficult access to capital for smaller firms and red tape. Competition remains distorted by state-owned enterprises and the high share of informal economy. Despite some progress in restructuring state-owned enterprises, 166 remain in the privatisation portfolio. They employ 52,000 workers and include some of the largest strategic companies. Their resolution should be completed within a reasonable period, in particular for those companies that still represent a significant cost or fiscal risk for the State budget. The ERP provides a comprehensive analytical part listing all the relevant shortcomings of the business environment in Serbia.

The rolled over measure on improving access to finance for SMEs remains a priority and needs to be put into place with fewer delays than so far. As part of their macroeconomic stabilisation efforts, the government and the central bank have addressed many issues concerning access to finance for SMEs. The main remaining challenges include strengthening equity finance providers, making EU-based funds easier to access, and putting risk capital in place to support SMEs and start-ups. The measure deals with these challenges and proposes to develop a regulatory framework for microfinance. However, there is no information on how this new microfinance regulation could help the market and whether there is interest among financial institutions to engage in such lending. In addition, the regulatory framework for new financial instruments, such as venture capital funds, crowdfunding, etc., also needs to be upgraded.

The measure reforming public utility companies is of high importance but its implementation continues to be a challenge. The framework for introducing corporate governance is in place and now needs to show concrete results in terms of de-politicisation and merit-based recruitment of top management. Genuine progress has been achieved in restructuring Serbia railways: its workforce is being reduced on a voluntary basis, unprofitable lines are being closed and private operators' access to the rail infrastructure has become effective after the unbundling of the company. Following the adoption of a financial consolidation plan in February 2016, payment collection by Srbijagas has improved. However, its debt is significant and still needs to be restructured. A plan to optimise the workforce of the public electricity utility EPS' was put in place, but the company needs to strengthen its management, further improve collection rates and adjust electricity prices to further improve its financial performance. Financial compensations have helped to mitigate the social effects of these reforms. Their finalisation remains essential in order to ensure the long-term viability of these public utilities. The restructuring of the other utilities, in particular large loss-making ones such as Roads of Serbia, should be considered as well.

The rolled-over measure to reduce the administrative burden for businesses through a reform of parafiscal charges has faced significant implementation delays. The programme advances a plan to establish a unified system of public registry of administrative procedures for doing business, but no meaningful progress in its implementation has been achieved yet. While this mapping exercise will increase transparency and thus facilitate businesses' compliance with administrative requirements, the main challenge will be to ensure that this also results in simplification of the identified procedures. No progress has been made on reforming parafiscal charges. The law on fees, planned for adoption in 2016, is still under preparation. It should aim at increasing the transparency of parafiscal charges and rationalising and reducing them effectively.

The scope of the proposed measure to fight the informal economy is too narrowly defined. The programme envisages establishing a common information platform for all inspections (e-inspection), but this is only one of the possible measures to combat the informal economy. In addition, further progress is needed to ensure the deployment of this platform by 2018. This platform should be completed by a proper risk assessment system ensuring that inspections are better targeted. Alignment of the general Law on Inspection with the relevant sectoral laws is also needed to improve the efficiency and predictability of the system of controls. A more comprehensive reform would better contribute to the fight against the informal economy and informal employment while reducing the costs of unnecessary and frequent inspections.

Research and innovation

Cooperation between the public and private sector is weak and not systemically supported. The ERP analysis is clear and identifies the main weaknesses and obstacles to innovation. There is increasing interest in finding ways to improve research cooperation between the public and private sectors; this is also reflected in the recent adoption of the Research for innovation strategy. However, so far, the majority of public funds for research end up in research institutes while companies receive a very small share. The public institutions have opened technology transfer offices and new science parks have been established, both with the aim of supporting high tech start-ups. The Ministry of Science established the Innovation Fund which has shown how support instruments should be prepared and implemented. However, it is lacking the critical amount of funds to have a systemic impact. Significant efforts are required to further support innovation.

The focus of the measure to improve cooperation between public and private innovators mainly via financing of the Innovation Fund is too narrow. The majority of funds will continue to be disbursed through old structures that are not presented in the ERP. The innovation system needs transparency and predictability, so that its good practices can be mainstreamed and bad ones abolished. A multiannual action plan for implementation of the Research for innovation strategy is therefore needed. The finalisation of the smart specialisation process will provide further guidance on capacities for innovation that merit increased public support. The linkages to growing export and diversifying high technology sectors would become more visible. A proper system of support for innovative firms could help reduce the brain drain. According to a recent survey by the Statistical Office, 15% of all current Serbian migrants leave Serbia with the ambition of studying and later finding a job abroad. The ideas proposed for improving the innovation environment in the law on higher education seem largely appropriate.

External trade and investment facilitation

The Serbian economy still has a relatively low level of trade openness and integration into European industrial value chains. Determined political and technical action is needed to work better with incoming investors so that they can develop the country's potential to expand to other markets. For example, more reflection is needed on how to support clustering of companies around existing FDI, which has so far only started in the automotive sector. Similarly, the ongoing programmes to internationalise SMEs need to be stepped up and expanded to a greater number of beneficiaries.

The measure to improve the national quality infrastructure system is relevant to tackle technical barriers to trade, but more ambitious measures could be considered in order to further boost external trade. A thorough review of all legislation, technical regulations and standards still needs to be completed. So does the removal of distortive non-tariff barriers to trade that do not derive from the use of certificates of conformity, standards or other technical requirements. The national referencing laboratory is not yet fully functional. Trade with the EU could also be further facilitated by removing unnecessary costs at borders and beyond border, in a similar manner as envisaged by the Central European Free Trade Agreement's ambitious trade facilitation agenda. In parallel, and as underlined in last year's assessment, better services could be offered to help companies, in particular SMEs, to internationalise. This could be done through consultancy or participation in international fairs.

Education and skills

The education system in Serbia faces key structural challenges at all levels. The ERP diagnostic highlights the lack of pre-school education for 3-5.5 year old children; kindergarten enrolment is 52% in 2016 compared to the national Education Strategy target of 75% by 2020. Outdated teaching methods and curricula in primary and secondary education lead to low basic skills levels among 30-40% of pupils, as evidenced by PISA results. Vocational education and training and higher education are often not adequate for a swift transition to the labour market; recent studies point to up to three years long transition periods.

The development of a National Qualifications Framework (NQF) and its implementation through a review of occupational profiles has advanced at a rather slow pace. The measure is partly rolled over into the 2017-2019 ERP, but the main step for enacting the whole reform package, the drafting and adoption of a legal base for the NQF compatible with other relevant legislation and supplemented by secondary legislative provisions on operational and institutional arrangements, foreseen in 2016, is not yet completed. Work on defining occupational profiles is undertaken in ad-hoc projects with external expertise, but lacks a structured involvement of the business sector and Social Partners, which is indispensable for the success of the reform.

In this year's ERP, the measure on the NQF has been expanded to include a new component for establishing a national model of dual and entrepreneurial education. This model is based on two pillars, introducing entrepreneurship education elements in the general education system during years 5-9, and apprenticeship-type vocational training as an alternative to school-based training. It has a potential to close the skills gaps in the future and to improve the labour market integration of young people and should be aligned to the ongoing development of the NQF, which similarly foresees the definition of occupational profiles. However, the ERP does not include a timeline for the measure, and the budgetary implications appear unrealistically low.

Employment and labour markets

Despite some positive developments, the labour market continues to be characterised by low activity rates, low level of skills and skills mismatches. The unemployment rate fell by 2.4 pps to a still high 15.3%, while activity and employment rates increased. Although most of the gains were in informal employment, related mainly to agricultural activity, there was also a noticeable increase by 3.4% of formal employment. The diagnostic presented in the programme is primarily focussed on the key labour market indicators and on supply-side factors, such as education, while other root causes for the generally still low labour market participation (around 53% for the population above 15) are not explored.

The demographic trends with a declining and ageing population require further stimulation of labour market participation and labour demand. Improving prospects for young people is particularly important in this regard. Serbia should envisage addressing structural problems in the labour market, including informality, through systemic reforms going beyond the provision of active labour market measures for the unemployed. Potential areas for reform are the high tax wedge on labour at the lower end of the earning scale and the level of the minimum social security contribution applicable to all formal jobs, irrespective of whether they are full or part time.

Raising labour market participation should be supported by more intense activation and mediation services. The measure on improving active labour market policies is rolled over from last year's ERP and has so far only been partially implemented. The budget for active labour market measures in 2017 remains stable compared to 2016. A large part of active measures is of rather general supportive nature. More tailor-made programmes responding to labour market needs should be envisaged.

Social inclusion, poverty reduction and equal opportunities

The level of income inequality is higher than in all EU countries. The GINI coefficient in Serbia is 38.2 (2015) compared to the EU-28 average of 30.5. The Poverty Map of Serbia established in 2016 by the Statistical Office and the World Bank shows strong regional discrepancies. The poverty risk is at least two times higher in nearly all of the country compared to the capital, and in the South-eastern part it is up to four times higher. The ERP identifies this challenge to a limited extent. More attention should be paid to the intergenerational inequality in Serbia. Children and young people under 25 years have the highest risk and incidence of poverty, whereas poverty risk is lowest for older people.

The coverage and adequacy of social benefits is not satisfactory. The reform measure included in the previous ERP on improving the adequacy, quality and targeting of social protection measures will continue over a prolonged time frame until 2019. The measure includes two main components. A number of administrative measures will be taken to improve the targeting of eligible beneficiaries and the offer of social services at local level. The level of benefits for some specific categories of beneficiaries is planned to be increased, which requires legislative changes. For this purpose, a new Law on Social Protection is envisaged to be adopted in 2017. These changes would be beneficial to some smaller target groups, but are not likely to have a more widespread and substantial effect of alleviating poverty.

4.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2016

2016 policy guidance	Summary assessment
PG 1: Further strengthen fiscal consolidation by using any excess revenue and current expenditure savings, and take additional measures, if needed, in order to achieve a primary surplus in 2016 and reduce overall budget deficits in the following years.	Serbia has **fully implemented** PG 1: • The 2016 primary surplus was 1.7 % of GDP, surpassing by far the initially planned deficit of 0.4 % of GDP. The 2017 ERP targets much lower deficits over the medium term than last year's programme.
PG 2: Support fiscal consolidation by taking steps to find a sustainable resolution of the remaining state-owned enterprises and continuing the organisational and financial restructuring of large utility companies. Advance the reform of the public administration as envisaged. Further improve revenue collection in a systematic and business-friendly way by implementing the tax administration transformation programme.	Serbia has **partially implemented** PG 2: • Around two-thirds of the companies in the portfolio of the former privatisation agency have been resolved through privatisation or bankruptcy. However, some large and strategically important enterprises, which represent significant fiscal risk, have not been resolved yet. • The organisational and financial restructuring of large utility companies has advanced unevenly. While successful steps were taken in the case of the railways, the reform of EPS and Srbijagas lags behind. • The public administration reform advanced as well, although it continues to suffer implementation delays. • Revenue collection improved significantly in 2016, despite major delays in implementation of the tax administration transformation programme.
PG 3: Continue to address risks to financial stability and the real economy by following-up on the NPL action plans which have been adopted, reinforcing the strategy already in place to promote the use of the local currency ('dinarisation strategy') in the financial system and shedding increased light on the asset quality of smaller banks that were not covered by the special diagnostic studies. Throughout this process, the central bank's monetary policy stance may remain accommodative insofar as both inflation expectations remain anchored and a favourable fiscal consolidation path is maintained.	Serbia has **partially implemented** PG 3: • The monetary policy stance remained accommodative, supported by low inflation expectations and continued strong fiscal consolidation. • The implementation of the NPL resolution strategy and action plans have helped reduce the NPL ratio by 4.5 percentage points to 17% in 2016. • No new steps were taken to provide additional information on the asset quality of smaller banks. • Existing efforts to promote the use of the local currency have continued but no new measures were taken.
PG 4: Address the under-execution of public capital expenditure by improving its prioritisation and management; as a priority, make significant progress in the preparation of the construction of the Bulgaria-Serbia gas interconnector project and finish road works on	Serbia has **partially implemented** PG 4: • The preparation of the construction of the Bulgaria-Serbia gas interconnector has progressed. The spatial plan for the gas corridor has been adopted. The new Memorandum of Understanding between the governments of Serbia and Bulgaria were signed.

Corridor X by end of 2017.	• Road works on Corridor X have progressed but have not been finalised. The causes for the delay are design deficiencies, land expropriation and the inefficiency of the contractor. • A draft decree on the content, method and assessment of capital projects is being prepared, but the first draft has not addressed all challenges in this area.
PG 5: Improve the business environment and promote private investment by developing a more transparent and less burdensome system of para-fiscal charges, putting in place a guarantee scheme for loans to SMEs and re-launching the 'regulatory guillotine.'	There has been **limited implementation** of PG 5: • There was no progress in the regulation of parafiscal charges. • The regulatory guillotine has not been re-launched. • The preparation for a guarantee scheme has advanced. The scheme, financed by the European Investment Bank, will be in place later in 2017.
PG 6: Step up the provision of targeted active labour market policies to facilitate in particular the reintegration of workers made redundant in the resolution of state-owned enterprises and public administration rightsizing. Increase the capacity of the National Employment Services to roll out such measures to larger numbers of beneficiaries.	Serbia has **partially implemented** PG 6: • The budget for active labour market measures is stable over 2016 and 2017 and has allowed for an increase in the number of beneficiaries compared to earlier years. • The functional review of the National Employment Agency has been finalised and has increased the capacity of local employment offices to provide client-oriented services.

4.6. THE 2017 POLICY GUIDANCE

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

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

Brussels, 23 May 2017

[…]

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

1. Ensure a continuous reduction of the budget deficit in 2017 and over the medium term. Use any additional fiscal space to lower the deficit beyond the targets that are currently envisaged, while continuing to increase capital expenditure. Adopt a credible and binding system of fiscal rules, capable of anchoring consolidation efforts.

2. Support the fiscal scenario by reinvigorating reforms of the state owned enterprises and of the tax administration. Improve the composition of budget expenditure by further reducing public spending on wages and pensions as a share of GDP.

3. Implement the remaining measures of the NPL resolution strategy. Continue efforts to promote the use of the dinar, inter alia by maintaining a spread between reserve requirements in foreign currency and local currency also going forward. Finalise the reform and privatisation of the two large state-owned banks and find a solution for the remaining small state-owned banks. The monetary policy stance should be in line with achieving the new inflation target.

4. Gradually adjust electricity tariffs to reflect actual costs. Further improve payment collection and avoid future accumulation of arrears in the energy sector. Advance the announced restructuring of Srbijagas debt and the implementation of EPS's optimisation plan. Expand the scope of the Single Project Pipeline to cover all large investment projects regardless of their source of funding and establish clear links to the budgetary process.

5. Regulate the amount and number of para-fiscal charges at state level. Develop the regulatory framework for new financial instruments, and improve the access to finance. Put in place risk management systems in order to improve the functioning of the Tax Administration and to ensure better targeting and efficiency of inspections.

6. Increase labour market participation and reduce the high non-wage labour cost of jobs at the lower sections of the wage distribution in a fiscally neutral way. Target active labour market measures to vulnerable groups, including social assistance beneficiaries. Develop dual learning in vocational education and training in close cooperation with social partners.

ANNEX: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government adopted the economic reform programme on 3 March 2017 and formally submitted it to the European Commission on 20 March 2017.[2] The programme is in line with the medium-term fiscal strategy and the 2017 budget and covers 2017-2019. In conformity with the new approach to economic governance, the programme includes an expanded description of structural reform priorities. However, the programme's structure does not always fully follow the guidance provided by the Commission.

Inter-ministerial coordination

The programme was prepared with the involvement of key line ministries, although some of the reforms do not necessarily reflect their latest internal documents and priorities.

Stakeholder consultation

A public consultation was organised at short notice and at a late stage just before the adoption of the programme. Therefore, stakeholders could not influence the prioritisation or the content of reforms. This reduces the ownership of the reforms and the potential for their successful implementation.

Macroeconomic framework

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

Fiscal framework

The fiscal framework is based on the presented medium-term macroeconomic scenario and is coherent, consistent, sufficiently comprehensive and integrated with the overall policy objectives. Revenue and expenditure measures, underlying the fiscal scenario are well explained. The programme would have benefited from integrating the identified fiscal space in the baseline fiscal scenario and incorporating the envisaged assumption of restitution related debt in 2018. The section on fiscal risks has been expanded and provides an elaborate analysis. The programme does not present long-term projections of population trends or of the implications of an ageing population on the labour market and public finances, in particular on health and pension systems. Significant further efforts would be needed to make fiscal data compatible with ESA 2010, the European system of accounts.

Structural reforms

The structural reform measures are based on credible diagnostics with indications of progress in the reforms and in particular the policy guidance from the previous ERP cycle. The measures are focused and planned with good detail; however, their scope of ambition often refers to a single procedural reform rather than a systemic long-term reform. In view of this, budgetary contributions are assessed realistically but remain modest and cannot support long-term growth.

The number of reforms is in line with the guidance note, but the length far exceeds the requirement of maximum 40 pages. Tables 9-12 in the annex are filled in appropriately. The Commission's 2016 guidance note states that individual infrastructure projects should be kept separate and not as sub-measures of one large measure. The ERP does not adhere to this request.

[2] The authorities submitted the programme to the European Commission informally on 17 February 2017.

5. TURKEY

5.1. EXECUTIVE SUMMARY

The Turkish economy registered high growth until 2015 but lost momentum going into 2016. The loss in momentum became worse during the year and was particular strong in the third quarter when the political and policy uncertainty following the attempted coup d'etat had a large impact on the business environment. The same uncertainty has weighed on economic growth, which will only slowly start to recover in the second half of 2017 as monetary conditions start to improve. However, a return to normal global monetary conditions and earlier strong loan growth will temper investment while high unemployment and inflation will initially be a drag on private consumption. Net trade, as a consequence of the lira's depreciation and public expenditures will support growth in 2017. Inflation has increased from high single figures over the past five years to low double figures in February and March 2017, largely reflecting the lira's depreciation and entrenched expectations of high inflation.

The economic scenario of a return to high growth rates appears to be overly optimistic. High growth rates were achieved in the past in a context of exceptional global financial conditions, high loan growth, strong investment in construction and increasing indebtedness among Turkish companies. At the same time, structural reforms to raise the potential growth rate have been limited and the business environment has deteriorated. The structural reforms described in the Economic Reform Programme (ERP) and macro-fiscal scenario are difficult to reconcile with Turkey's ambitions to move towards an investment- and export-driven growth path in which it climbs up the global value chain.

The main challenges for economic policy going forward are the following:

- **Domestic savings continue to fall short of investment leading to a sizeable current account deficit while the government has embarked on an expansionary trajectory regardless of the external vulnerabilities that have built up over the years.** Although some counter-cyclical budgetary policy measures are warranted given the adverse cyclical developments, the government would be well advised to build a medium-term budgetary policy framework with more realistic growth assumptions and aiming for structural budget surpluses. A more robust fiscal framework and budget process could help enhance credibility.
- **The persistently high inflation rate implies risks to macroeconomic stability and encourages rising indebtedness as well as distorting resource allocation and leading to a redistribution of wealth.** Lowering Turkey's inflation rate permanently will not only alleviate these concerns but will also benefit the development of domestic financial markets. A transparent monetary policy framework with price stability as its focus is the least costly option for transiting to a low-inflation environment. A simpler monetary policy framework in line with the central bank’s own forward guidance, published in August 2015, would go a long way in that direction.
- **The business environment has deteriorated over the past year following targeted government actions against companies, the large scale dismissal of judges and public prosecutors and political pressure on economic regulators.** Companies structurally face a considerable administrative burden in doing business. The Economic Reform Programme (ERP) includes reform plans for the recruitment of additional judges and prosecutors, along with measures to lower the cost of doing business. However, it gives no details about activities, budgets or expected outcomes.
- **Turkey's current innovation capacity is too weak to improve its industry's standing in global value chains.** Expenditure on R&D, although on the rise, is lagging behind the EU average and commercialisation of innovation is problematic. The ERP includes support for private sector technology investments, performance-based support for research institutes and the use of public procurement to stimulate R&D. A national science strategy to run until 2023 is scheduled for

adoption in 2017. These plans are expected to improve innovation capacity, but budgets seem too low to guarantee a substantial impact.

- **Low skills levels of the workforce and education and training of the youth not matching labour market needs are part of Turkey's structural obstacles impeding the job creation and productivity increases necessary for upgrading the country's productive system.** The increase in the labour force is only partly absorbed by the labour market, and unemployment has increased in particular among young people including higher education graduates. Education reforms foresee a full day school system and apprenticeship-type vocational training. The large scale short term stimulation of labour demand needs to be complemented by structural reforms fostering labour market flexibility. The social assistance provision is insufficient to cover the needs of the population.

The implementation of the policy guidance jointly adopted at the Economic and Financial Dialogue of 25 May 2016 has been limited. The ERP itself provides no information on the degree of implementation, but conclusions can be drawn from other sources. The budget deficit increased and the structural balance deteriorated. A fiscal rule has not been implemented and fiscal policy making has been rather ad hoc as of recent. The monetary policy framework has not been enhanced. The Turkish central bank has used its different policy tools to raise the interest rate and tighten monetary conditions, but it has not been able to anchor inflation at a permanently lower level. Rather, the inflation rate has increased following the depreciation of the lira and lira volatility has continued. The rule of law has not been strengthened. The guidance on innovation has been partially addressed, with total R&D spending rising last year from 0.95% to 1.01 % of GDP. The labour inspectorates' capacity to tackle informal employment has not improved. On the contrary, informal employment slightly increased. Turkey has pursued the education agenda by adopting legislation on the first Turkey Qualifications Framework, for introducing the full day school system and introducing apprenticeship-type vocational training.

Overall, the programme's macro-fiscal framework seems overly optimistic. The combination of a reduction in the current account balance, a reduction in the government deficit, strong growth, sharply declining inflation and increasing investment with a shift to an investment- and export-led growth seems more like an aggregation of policy targets than a realistic scenario. The structural reform part of the ERP is limited in scope, making it difficult to assess whether the ERP matches the reform priorities identified by the European Commission. Some diagnostic elements are presented, as are some recent policy initiatives. However, the ERP contains no specific and delineated measures; it is rather a list of objectives covering the nine areas. It is unclear which priority areas Turkey considers necessary for improving inclusive growth and competitiveness.

5.2. ECONOMIC OUTLOOK AND RISKS

The ERP's macroeconomic scenario does not incorporate the new national accounting methodology which points to a larger but more fragile economy. According to the new methodology, the Turkish economy is about 20 % larger and has recorded significantly higher growth rates in the past five years, but slowed markedly during 2016. It is less integrated into the world economy. It has more solid headline public finance figures (a general government surplus of +1.3% of GDP and a government debt of 27.5% of GDP) and continues to post a sizeable current account deficit (3.7% of GDP). The ERP gives an overview of the main changes in the national accounting methodology but does not discuss the impact on the medium-term policy agenda and outlook. Although this is understandable given the short time between the publication of the new national accounts (12 December 2016) and the deadline for submitting the ERP (31 January 2017), a qualitative appraisal of its impact would have provided a justification for the presented medium-term economic policy programme, one reason being that the now recorded increase in savings could alleviate some earlier concerns on low domestic savings (as raised in last year's policy guidance).

The impact of the national accounts revision is most apparent in the construction sector. Before the revision, it was the sixth largest economic sector in Turkey (accounting for 4.4% of GDP). In the new accounts it has more than doubled in size and has become the economy's third largest sector (accounting for 8.2% of GDP). The share of manufacturing has risen slightly from 16% to 17% of GDP while the wholesale and retail trade have remained stable at 12% of GDP. Another notable change is the sector comprising professional, scientific and technical activities. This sector, usually associated with higher productivity and competitiveness, was 22% smaller in 2015 under the new methodology (2.4% of new GDP, previously 3.6%). These changes give the Turkish government a stiffer challenge to fulfil its ambition of pursuing an investment- and export-led growth path and of climbing up the global value chain.

The ERP projects increasing growth rates throughout the programme timeline which appear to be on the optimistic side. The ERP projects growth of 4.4% in 2017 and 5% in both 2018 and 2019. This is well above the European Commission's winter forecast and predictions from international financial institutions and market participants. The difference over the longer term is due mostly to a different estimate of the potential growth rate of the Turkish economy whereas in the nearer future Turkish authorities expect to see a larger contribution from domestic demand. The new national accounts data show private domestic demand and net foreign trade as the main reasons for the slowdown going from 2015 into 2016. In the third quarter of 2016 they together shrank the Turkish economy by 4.6% year-on year. These events aggravated a process that had started back in 2015 with a sharp deterioration in consumer confidence in the second half of 2015 and gradual but constant erosion of business confidence.

The current uncertain situation in emerging economies, which is worrying investors more generally, applies in particular to Turkey with its security issues, political and policy uncertainty and sizeable current account deficit. Moreover, the European Commission expects the significant monetary tightening that has carried on into 2017 in response to the lira's depreciation to have an impact on investment and private consumption. As political and policy uncertainty recede in the second half of 2017, after the referendum on amendments to the Turkish constitution, the European Commission expects private domestic demand to start growing again albeit at a more moderate pace then the ERP predicts. The upside risks to economic growth are private consumption, which so far has not benefited greatly from the increase in wage income in 2016, and the balance of services with tourists potentially returning more quickly to the country than currently predicted. Government consumption is expected to be the only spending category in 2017 to register growth above the historical average. The downside risks are the past high loan growth and high external debt in particular in the non-financial corporate sector at a time when very loose global monetary conditions look set to be tightened. The Turkish economy depends on foreign capital to finance its current account deficit, leaving it vulnerable to foreign financing conditions.

Box: First preliminary outlook on the basis of the available data under the new national accounts methodology (%)

	2016		2017		2018		2019	
	Prel	ERP	Prel	ERP	Prel	ERP	Prel	ERP
GDP growth	**2.9**	**3.2**	**3.0**	**4.4**	**3.3**	**5.0**	**4.1**	**5.0**
Contributions:								
-Final domestic demand	3.3	4.6	2.5	4.2	3.6	4.8	4.6	4.7
-Inventories	1.0	-0.2	0.0	-0.1	0.0	-0.1	0.0	-0.1
-Net trade	-1.5	-1.1	0.5	0.2	-0.3	0.4	-0.6	0.5
Budget balance (% of GDP)	-0.9	-1.9	-1.4	-1.6	-1.6	-1.6	-1.5	-1.0
Government debt (% of GDP)	26.4	32.8	24.0	31.9	26.5	31.0	22.5	29.9
Current account balance (% of GDP)	-4.4	-4.3	-4.6	-4.2	-4.3	-3.9	-4.4	-3.5

Source: Economic and Reform Programme (ERP) 2017.

The preliminary medium-term scenario under the new national accounts methodology is based on the first set of data made available by Turkstat. This dataset is neither complete nor verified. Turkstat expects to complete the gross national income registry by June 2017 after which it will be shared with the European institutions. Irrespective of the highly tentative nature and strong underlying assumptions, discussing the future development of the Turkish economy must take account of the new national accounting methodology, the new benchmark for assessing progress made by Turkey over the programme's horizon.

In this preliminary medium-term scenario for Turkey, the output gap is not expected to improve before 2018. The government balance is expected to post better figures in 2016 and 2017 mostly because weapon systems and R&D expenditures are now accounted for as investments. Under the old national accounts methodology used in the ERP, these expenditures were treated as one-time payments that could not be depreciated. The shares of these items in total expenditures are expected to increase as those of other decline.

In a rather optimistic scenario, the ERP predicts that the current account deficit will decline to 3.5% of GDP in 2019. According to the new national accounting methodology the current account deficit was 3.7% in 2016 rather than the 4.3% forecast in the ERP. The expected decline in the current account deficit between 2016 and 2019 is driven by an improvement in the trade balance. The lira's strong depreciation in late 2016 and early 2017 is indeed likely to support the trade balance and reduce the trade deficit. However, one fifth of Turkish imports consist of energy goods which have low price elasticity and risk increasing above the current forecasts. The oil price assumptions are slightly more benign than in the Winter Forecast and there is a risk of rising oil prices worsening the trade balance. In addition, according to the OECD a sizeable share of Turkish imports – around one quarter, mostly from the euro area – relates to the global value chain. Higher import prices triggered by the lira’s depreciation will raise the cost price of these goods and this will partly offset any price competitiveness gains from the depreciation. Next year, assuming the lira is less volatile, the Commission’s Winter Forecast expects a resurgence in the current account deficit on the back of stronger domestic demand and rising imports.

External financing has shifted to more volatile types of capital flows. The ERP forecasts that direct investments in Turkey will strengthen over the programme horizon and that foreign currency reserves will grow, this appears unlikely, given the deteriorating business and investment climate. The country's large net foreign liabilities (negative Net International Investment of 41% of GDP, gross external debt at 46.3% of GDP according to IMF) are among the highest in large emerging market economies. In 2016 FDI inflows were 11.4% lower than in 2015. Inflows peaked in 2012 with the 2016 FDI stock 30% lower than in 2012. Portfolio flows have been volatile with equity investments displaying the highest volatility. The only foreign investment subcategories to have registered a surplus in the past two years have been loans to the non-financial corporate sector (predominantly long-term) and trade credits. Adding to the external vulnerability is the fact that foreign currency reserves are only two thirds of short-term external debt and their size has been declining since 2013. Given that funding the current account deficit is becoming more volatile, it will be challenging to reconcile the investment-led growth envisioned in the ERP with a return to normal global monetary conditions.

Monetary policy making has been challenging due to the Lira's high volatility, a strong loss in momentum in the domestic economy, high wage rises and tax-induced price increases. Inflation has exceeded the end-of-year upper band target for five consecutive years. Although the ERP expects inflation to hit the upper band on average over this year, the central bank revised its inflation forecast at the beginning of 2017. Inflation is expected to overshoot the upper target by the end of this year by 1 %pps (3 %pps above the 5 % target). The planned monetary policy reform has still been implemented only partially, resulting in an overly complex policy tool set preventing the central bank from giving clear policy signals. The central bank has used a range of policy instruments, including guiding banks towards more expensive interest rate channels (such as the late liquidity window) and quantitative tightening. The effective interest rate paid by banks for lira liquidity from the central bank increased by 200 bps between mid-January and mid-February 2017. Regardless of the negative impact on aggregate demand from the interest rate hike, inflation will experience upward pressure as a consequence of the lira’s depreciation. Inflation reached double figures in February 2017. This strengthens the case for reforming the monetary policy framework. The persistently high inflation rate implies risks to macroeconomic stability and encourages rising indebtedness, as well as distorting resource allocation and leading to a redistribution of wealth. Lowering Turkey’s inflation rate permanently will not only alleviate these concerns but will also benefit domestic financial markets. A transparent monetary policy framework with price stability as its focus is the least costly option for transiting to a low-inflation environment.

Turkish banks continue to have relatively sound headline risk metrics but some erosion can be expected from the recent loosening of macro-prudential regulation, exceptionally strong loan growth over recent years and deteriorating economic conditions. The capital adequacy ratio registered a solid 15 % in 2016, well above the regulatory floor of 8 %, and the ratio of non-performing loans to total loans is not high at just over 3%. Still, over the last six years bank profitability has almost halved and the International Monetary Fund suggests it is now below the cost of bank capital. The strong build-up of debt by non-financial corporations is especially worrying. These corporations have seen their liabilities surge from 30% of GDP in 2007 to over 60% in 2015 with about 45% of this borrowing in foreign currency. Less than half of these foreign exchange (FX) liabilities (40% according to the IMF) are covered by FX assets. A deterioration in the non-performing loans (NPL) ratio can be expected after years of exceptionally high loan growth. For instance, the two largest corporate sectors in terms of banks loans - manufacturing and wholesale/retail trade - have seen average annual loan growth of 21% and 34% respectively since 2005. Their NPL ratios had decreased as NPL growth was below loan growth (11% for manufacturing and 27% for wholesale/retail trade). This changed in 2016, as NPL growth was 25 pps higher in manufacturing and 29 pps higher in wholesale/retail trade. An increase in NPL's would be a sizeable risk to Turkish banks given the high loans-to-deposits ratio of around 120%. In addition, the share of restructured loans has increased which doubles the problematic assets of the banks compared to NPL's also. It is also unclear what impact the new credit guarantee fund will have on loan growth and how it is expected to affect capital adequacy in the short and long term. Given the high indebtedness it is important to guarantee the independence of the regulatory and supervisory authorities and to avoid using macro-prudential regulation for demand management.

Table 1:

Macroeconomic developments and forecasts

	2015		2016		2017		2018		2019	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	4.0	**4.0**	2.2	**3.2**	2.8	**4.4**	3.2	**5.0**	NA	**5.0**
Contributions:										
- Final domestic demand	4.8	**4.8**	3.8	**4.6**	2.8	**4.2**	3.5	**4.8**	NA	**4.7**
- Change in inventories	-0.6	**-0.6**	0.2	**-0.2**	0.2	**-0.1**	0.1	**-0.1**	NA	**-0.2**
- External balance of goods and services	-0.3	**-0.3**	-1.8	**-1.1**	-0.3	**0.2**	-0.4	**0.4**	NA	**0.5**
Employment (% change)	2.5	**2.7**	2.3	**2.2**	2.2	**2.7**	2.7	**2.8**	NA	**2.8**
Unemployment rate (%)	10.5	**10.3**	10.7	**10.5**	11.2	**10.2**	11.5	**10.1**	NA	**9.8**
GDP deflator (% change)	7.5	**7.4**	10.1	**6.6**	9.0	**7.2**	7.4	**6.4**	NA	**5.9**
CPI inflation, annual average (%)	7.7	**7.7**	7.8	**7.8**	8.0	**7.0**	7.6	**5.6**	NA	**5.0**
Current account balance (% of GDP)	-4.5	**-4.5**	-5.2	**-4.3**	-4.3	**-4.2**	-4.9	**-3.9**	NA	**-3.5**
Budget deficit (% of GDP)	-0.1	**-0.1**	-1.1	**-1.9**	-2.0	**-1.7**	-1.8	**-1.6**	NA	**-1.0**
Government debt (% of GDP)	32.9	**32.9**	31.6	**32.8**	31.2	**31.9**	30.8	**31.0**	NA	**29.9**

Sources: Economic Reform Programme (ERP) 2017; Commission Winter 2016 Forecast

5.3. PUBLIC FINANCE

In 2016, the general government's budget deficit is estimated to have worsened. It rose from -0.1% of GDP in 2015 to an estimated -1.1% of GDP according to the ERP. The government provided sizeable stimulus to the economy and significantly increased its expenditures in the course of 2016, with government consumption rising on average by 16.2 % year on year in the first three quarters. In the third quarter, government consumption contributed 2.8 pps to GDP growth. This was a sizeable increase over the already high 1.4 pps in Q1-2016 and 1.8 % pps in Q2-2016 and offset part of the slump in private domestic demand. Still, the increase in the government budget deficit remained limited due to unexpectedly high tax revenues.

The general government expects to improve its budget balance in 2017 compared to 2016; this would seem difficult to achieve. The Grand National Assembly of Turkey adopted the 2017 budget on 16 December 2016. It is the same as the draft budget included in the Medium-Term Programme and the ERP. The general government is expected to run a deficit of 1.7 % of GDP in 2017. Government revenue will grow less steeply than last year, because of the slower pace at which the domestic tax base has been growing and because of tax rate policies. Still, the government budget and ERP are expecting nominal year-on-year increases of 13.1 % in direct taxes and 14.5 % in indirect taxes in 2017. These increases are even above the optimistic GDP growth rate forecasts (4.4 % for real GDP and 11.9 % for nominal GDP, year on year). The budget and the ERP are forecasting that social fund revenues will increase nominally by 10.6 % year on year, but they are more likely to decrease after the cut in social security contributions. The projected decline in factor incomes may be frontloaded, given that privatisation revenues are expected to peak only in 2017.

The government budget figures in the ERP do not include the impact of the new national accounting methodology. Whereas the ERP and the budget suggest the general government ran a deficit of 0.1% of GDP in 2015, Turkstat reported on 12 December that it had run a surplus of 1.3% of GDP under the new national accounting methodology (see also the text box above on the tentative preliminary outlook based on the new national accounting methodology). Given the structural nature of the accounting change, the general government budget is likely to record better figures in 2017 than those in the budget for 2017. Government expenditures are likely to increase further as the government continues its expansionary stance in public finances. Already, since the budget's adoption, the government has taken measures that will worsen its budget balance, such as a reduction in social security contributions for those employers hiring new employees in the context of the ‘employment mobilisation campaign’. As a consequence, the central government’s budget transfer to the social security institutions is likely to increase significantly. The wage increases agreed for this year (totalling 7.1% year-on-year) are aligned with the projected increase in staff costs of 8.0% that underlies the expenditure development. Beyond the broader political implications, the lay-offs of government employees in the second half of 2016 put government wages under downward pressure.

The cyclical component of public finance is hard to assess because of the new national accounts data. The ERP contains a broad discussion of the structural and cyclical general government balances. However, this is based on the Medium-Term Programme from October 2016. The revision of the national accounts gives a very different picture of cyclical developments. In particular, the size and volatility of the contribution of inventories to GDP growth (on the expenditure side) make it difficult to assess the appropriateness of demand management. For instance, the output gap in 2015 was -1.0% of potential GDP. However, in 2015 inventories deducted 1.1 pps from GDP growth. Therefore, without inventories the output gap would have been closed. Over the first three quarters of 2016, the opposite was the case as inventories added 1.3 pps to GDP growth. This makes it hard to assess the cyclical component of public finances.

Since it is based on a very optimistic macroeconomic scenario, the outlined fiscal strategy does not seem to be the most likely public finances trajectory in the medium term. According to the ERP, total government revenues will decline by 2.2 % of GDP over the programme horizon (from 41.9% of GDP in 2016 to 39.7% in 2019). Taxes form the lion's share of revenues and are expected to increase marginally from 21.5% of GDP in 2016 to 21.6% of GDP in 2019, having first risen to 21.9% in 2017. However, the government underestimated the slowdown in the economy, which will impact tax collection. If the economy recovers, the projected growth in revenues in 2018 and 2019 may turn out to be conservative, as it is below projected economic growth. That would, however, presume that the recovery follows a consumption-led growth path. Such a path is more consistent with Turkey’s economic history but does not reflect the investment-led growth the Turkish authorities envision.

The ERP does not sufficiently substantiate the revenue impact of the major changes announced. For instance, the government wants to increase the tax base by taking measures to reduce losses in intensive tax-loss areas and by reviewing tax exceptions and exemptions. But it does not present the expected impact or any detail. For the envisioned updating of lump-sum taxes and fees in light of the overall economic conditions and price developments, it is even unclear whether this will improve or worsen government revenues. Lastly, the biggest decline is in factor incomes, relating to income earned from assets held by the state. In the past four years this category has been relatively stable but in the medium-term scenario it is expected to be the largest driver of the decline in the tax burden. There is no explanation given for this decline. Although privatisation revenues, averaging 0.7 % of GDP per year between 2012 and 2015, suggest some divesting, the state still has large holdings of corporate assets (the Sovereign Wealth Fund alone is expected to hold USD 200 billion in state assets in the future).

The drop in total expenditures is hard to reconcile with the government’s stated ambition to shift to an investment- and export-led growth path with gradual scaling-up of the value added in Turkish exports. Total expenditures are projected to drop by around 3 pps (from 43.7 % to 40.6 % of GDP). Much of this is expected to come from lower government consumption (2 % of GDP). This seems difficult to reconcile with the ambitions regarding the growth shift. Such a shift would likely necessitate an increase in expenditures in areas such as schooling, which accounts for 16 % of expenditures. In addition, the high growth in public investment implies a capital stock that will need maintenance. It is also unclear from the ERP what impact the large increase in the migrant population is having on government expenditures. Moreover, the increase in population and the economy are likely to necessitate further investment in infrastructure in the coming years, which contrasts with slowing public investments as projected by the programme. Some infrastructure funding may take place without affecting the government balance, for instance through the new Sovereign Wealth Fund. The ERP does not give information on the Fund's impact on investment.

Lower social security contributions are likely to have an impact on the social security fund beyond 2017. In addition, the falling elasticity of social spending on health and insurance with respect to nominal GDP seems incongruent with the general tendency for this elasticity to be positively correlated with nominal GDP. In 2016, social spending increased by 16.3 % year on year.

Given the downturn in the business cycle, the very optimistic underlying economic scenario, the risks to the financial system and the already mounting pressure on the budget, the challenges to Turkish budgetary policy-making have increased. The challenges are to combine prudent fiscal policy with sound structural policy measures to raise the savings rate, increase employment and strengthen Turkish competitiveness.

Table 2:

Composition of the budgetary adjustment (% of GDP)

	2015	2016	2017	2018	2019	Change: 2016-19
Revenues	40.9	41.9	41.4	40.3	39.7	-2.2
- Taxes and social security contributions	32.3	33.1	33.4	33.0	32.7	-0.4
- Other (residual)	8.6	8.7	8.0	7.2	7.1	-1.6
Expenditure	41.0	43.7	43.0	42.0	40.6	-3.1
- Primary expenditure	38.2	41.2	40.5	39.6	38.1	-3.1
of which:						
Gross fixed capital formation	4.2	4.1	4.3	4.3	4.0	-0.1
Consumption	18.3	20.0	19.2	18.6	18.0	-2.0
Transfers & subsidies	8.9	9.0	10.0	9.9	9.7	0.7
Other (residual)	6.9	8.1	7.1	6.8	6.5	-1.6
- Interest payments	2.8	2.5	2.5	2.4	2.5	0.0
Budget balance	-0.1	-1.9	-1.7	-1.6	-1.0	0.9
- Cyclically adjusted	-0.1	1.6	1.4	1.6	1.2	-0.4
Primary balance	2.7	0.6	0.8	0.8	1.6	1.0
Gross debt level	32.9	32.8	31.9	31.0	29.9	-2.9

Sources: ERP 2017, Commission calculations.

Several risks to public finances are not fully recognised. The ERP reports a limited amount of identified contingent liabilities and presents a list of risks to fiscal sustainability. The size of these risks to government debt is also limited, thanks to the good starting position (27.5 % of GDP in 2015, according to the new national accounts). Nonetheless, recent policy actions such as social security contribution reductions and the new credit guarantee fund have not been taken into account. Moreover, with one third of total bank assets held by state-owned banks, the risks stemming from high loan and NPL growth are a risk to the government budget, both on the revenue side (profits from state holdings) and on the expenditure side (support for state-owned banks). The ERP does not mention the Sovereign Wealth Fund established in 2016. Still, the government wants the Fund to reach up to USD 200 billion and major state holdings have been transferred to it before any investment plan has been published. Transparent investment project appraisal and auditing will be essential to understand the risks that the Sovereign Wealth Fund may pose to Turkish public finances. All of the above risks have to be assessed in the context of adverse business cycle developments that will limit the growth of the tax base in any case.

Government debt is relatively low as a share of GDP (27.5 %) and is expected to decline over the ERP's lifetime. Although the government finances are likely to deteriorate, they are unlikely to lead to unsustainable debt dynamics. The ERP presents a sustainability analysis showing a general improvement in the sensitivity of government debt to developments in the exchange rate and in the GDP growth rate.

Central government debt has reportedly also become less sensitive to interest rate changes, while at the same time increasing its remaining maturity. This strong improvement in bond characteristics might be difficult to maintain when the bonds need to be rolled over. Since the budget was presented the yield on US dollar-denominated debt has already increased by about 130 bps and on domestic government debt by about 170 bps. These yields are now at the high end of past five-year range. Finally, the Turkish government lost its last investment grade rating on 27 January 2017. This change increases the challenges for funding Turkish debt. Foreign debt was 35 % of total debt in the third quarter of 2016.

Box: Debt dynamics

Government debt is forecast to decline over the programme's horizon. The growth effect reported by the Turkish authorities in the ERP is based on nominal GDP and, therefore, incorporates the development of the GDP deflator. Since the expectation for inflation appears to be more optimistic than the expectation for GDP growth, the nominal growth effect is likely to be larger than estimated in the ERP.

Table 3:

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

	2015	2016	2017	2018	2019
Gross debt ratio	**32.9**	**32.8**	**31.9**	**31.0**	**29.9**
Change in the ratio	-0.6	-0.1	-0.9	-0.9	-1.1
Contributions [1]:					
1. Primary balance	**-2.7**	**-0.6**	**-0.8**	**-0.8**	**-1.6**
2. 'Snow-ball' effect	**-1.2**	**-1.2**	**-1.3**	**-1.2**	**-0.7**
of which:					
Interest expenditure	2.8	2.5	2.5	2.4	2.6
Growth effect	-3.9	-3.3	-3.8	-3.6	-3.3
3. Other	**3.2**	**1.3**	**1.2**	**1.1**	**1.2**

[1] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences between cash and accrual data. Turkey has not provided the impact of inflation and the stock-flow adjustment but only a rest category "Other".
Source: ERP 2017, Commission calculations

The effect of the primary balance seems to be on the optimistic side. The Winter Forecast actually predicts a slight deterioration in the primary balance due to increased expenditure. The development in the 'other' category is not synchronised with privatisation revenues which are set to increase in 2017 before declining. No explanations are given in the ERP.

5.4. STRUCTURAL REFORMS

The ERP does not adequately analyse the main obstacles to improving competitiveness in each area it covers. The obstacles are identified in broad terms and should have been explained further. The overall diagnostic lists a number of areas in which action should be undertaken, but includes objectives rather than key obstacles. Nonetheless, the weak business and investment environment is highlighted, as are the low productivity level of the economy due to outdated production processes, the private sector's low innovation capability and low work force skills not matching labour market demands.

No specific and delineated measures have been included in the ERP, but rather a list of objectives covering the nine areas. Section 4.2 of the ERP lists 18 measures, but these do not correspond to what is outlined in other parts of the ERP. The lack of detail in terms of budget, timelines and expected outcomes make it difficult to determine what the reforms are meant to address, whether they will be effective in increasing competitiveness and on what basis prioritisation of reforms took place. The Commission assessment from 2016, in which this was also mentioned, has not been taken into account. Given the above, the reform assessments below are to a large extent based on information provided by Turkey during the Commission services assessment mission in February 2017 and other available data. As such, the area assessments are limited in scope.

One of the main obstacles to further growth and competitiveness is the further deterioration of the business and investment environment since last year due to targeted government actions against critical media, business people and political opponents through the active use of the tax authority, the financial crimes unit and courts. In addition, the government acquired effective control of a considerable number of companies by appointing trustees in their management. The large-scale dismissal of judges and public prosecutors following the attempted coup risks affecting the administrative capacity of the judicial system and its overall functioning. Market entry and exit procedures for companies are relatively lengthy and costly. Procedures for paying taxes and obtaining construction permits pose a considerable administrative burden for enterprises.

Turkey needs to create one million additional jobs per year to absorb the increase in the working age population due to large youth cohorts and increasing female labour market participation. This requires continuing high GDP growth rates which are most likely to be achieved by upgrading entire parts of the economy through further integration into the global value chains, based on innovation and a skilled workforce. Turkish companies do not benefit sufficiently from knowledge and innovations generated in the country's research institutes. Although previous reforms and increased spending on education have had a positive impact on educational attainment and enrolment rates, problems remain regarding the quality of education and the mismatch between requirements of the labour market and skills produced by the educational system. The efficient functioning of the labour market is impeded by a lack of flexibility, and undeclared work is widespread.

As the ERP provides no information on the implementation of last year's policy guidance, it is difficult to provide an assessment. However, from other available information we conclude that the policy guidance on strengthening the rule of law and the judiciary was not addressed, while the recommendations concerning research and development and employment and skills were partially implemented.

Public finance management

Turkey's institutional capacity for planning and executing the budget is relatively strong, but the process suffers from a lack of transparency. Overall, transparency of public finances is weak. The structure of budget implementation reports does not allow for a comparison with the original budget and in-year reporting is insufficient. Concerns exist over the accountability of the recently created, off-budget Sovereign Wealth Fund, which is exempt from public auditing. Overall, however, fiscal discipline has remained strong in recent years. The ERP does not include an analysis of obstacles to competitiveness and growth in the area of public finance management.

For the measure on 'rationalisation of public expenditure', performance programmes have been implemented by a large number of central and local public bodies. It is not clear whether this has resulted in more efficient and effective spending. The planned preparation of a guide for implementing cost-benefit analyses by public bodies prior to the budget allocation process may increase scrutiny on public spending. However, no information has been provided on which bodies would use the guide or the timelines for its use.

Performance based budgeting is expected to receive a boost from what the ERP defines as "transmission of central government institutions to a budget structure involving public service programmes". The success of this measure will depend on all central government institutions implementing appropriate monitoring and evaluation procedures. Pilot projects in risk management will be organised in municipalities. Best practices will be used for the preparation of a risk management guide to be used by other municipalities. This could help in rationalising public expenditure at local level, but will depend on the extent to which the use of the guide is mandatory for all municipalities. No timelines are given for this. The ERP does not provide further information on its reform described as "public revenue quality enhancement".

Transport, energy and telecommunications markets

Turkey's transport sector is characterised by a relative lack of diversification in transport modes, whereas its energy sector relies to a large extent on imports and suffers from a lack of price competition. The ERP includes only a limited analysis of obstacles to the transport sector, but highlights the dominance in Turkey of road transport as opposed to other modes, generating environmental and traffic safety problems. Urban mobility issues constituting an increasing threat to economic efficiency are not mentioned. The diagnostic for the energy sector is very short and lacks concrete data. It focuses on the supply side and recent developments in power generation and mentions the need for more renewable energy and energy efficiency, but not the ongoing nuclear power projects. The ERP provides concrete data to describe the situation in the telecommunications market, such as telephone/broadband penetration rates and number of operators. However, it does not identify obstacles hindering growth, such as market access problems, insufficient competition in fixed markets, overregulation, high taxation and questionable cost burdens on operators and consumers.

For the transport sector, the programme envisages the preparation of a logistics outlook report suggesting actions for establishing a better logistics infrastructure and the preparation of bylaws to support railway transport liberalisation. Both measures serve relevant purposes to increase competitiveness (a multi-modal logistics system and railway liberalisation). However, no concrete information is provided on timelines for implementation and desired/measurable outcomes. As for energy, the measures are pertinent (although lacking detail) and relate to the need to decrease import dependency by increasing gas storage capacity, institutional strengthening to support energy efficiency and extending the use of equipment to make engines more energy efficient. The ERP does not provide information on the enforcement mechanism for the new law on the natural gas market, designed to deliver much-needed liberalisation in this area. There are no concrete measures for the telecom sector and the importance of eSkills for citizens and businesses is not acknowledged.

Sector development

Agricultural sector development

Key obstacles to growth and competitiveness in the agricultural sector are low productivity, lack of reliable agricultural data, as well as land fragmentation and water losses in irrigation systems. In addition, there is no overall strategy on agriculture to identify and address these shortcomings. Rural development and the impact of IPARD funds (50,000 jobs created 2011-2016) are mentioned. The diagnostic on the agricultural sector is short, but mentions some relevant obstacles to competitiveness.

The measures focus on reforming the support system from production to land-based payments and on enhancing efficiency of water use through investments in the irrigation system. The reform of the support system is meant inter alia to provide necessary greater alignment with the system of decoupled direct payments under the Common Agricultural Policy (CAP), whereas the irrigation-related measures aim to increase productivity. However, no information is provided on budgets, timelines or desired outputs. The ERP does not address protectionist aspects of Turkey's agricultural policy, an important issue not only for CAP alignment, but also for further possible liberalisation of agriculture in the framework of possible negotiations on the modernisation of the EU-Turkey Customs Union.

Industry sector development

The industrial sector suffers mainly from low productivity, low share of high value-added products and regional disparities in industrial development. The ERP identifies these as the main bottlenecks to growth in Turkey's industry sector. The ERP, however, does not contain new policy measures in this area. Instead, it mentions ongoing programmes to address differences in productivity between large firms and SMEs, the uneven regional distribution of manufacturing activity, the transformation of healthcare industries and reduction in import dependency for energy and raw materials and intermediate goods. No link is made with the issue of the skills mismatch (as covered under the education heading) and the insufficient R&D performance of business.

Services sector development

The services sector accounts for almost 70% of Turkish GDP. Its importance is also highlighted by the ERP, but it only briefly notes the drop in the substantial tourism revenues due to regional and political events and does not contain a diagnostic on structural obstacles.

Health tourism may be a market for which Turkey's services sector has a comparative advantage. However, it is disproportionately targeted in the ERP with five separate measures. No information is given on further alignment with EU legislation on the right of establishment and freedom to provide services, despite possible upcoming negotiations on modernisation of the Customs Union, including further liberalisation of the services market.

Business environment and reduction of the informal economy

The large informal economy, weak rule of law, widespread corruption and political instability remain concerns for the business environment. The ERP only recognises the informal economy as a main obstacle together with the bureaucratic processes companies face in areas such as paying taxes, dealing with construction permits, starting a business and resolving insolvency. Moreover, the ERP ignores the fundamental problem related to the Government's recent targeted actions against business people, the seizure of private companies and dismissal of large numbers of judges and prosecutors. These actions have a detrimental effect on the investment climate in Turkey. Concerns also exist over the executive branch's respect for the independence of regulatory bodies, especially in the financial sector with the use of macro-prudential regulation as a counter-cyclical policy instrument a case in point. Issues such as better regulation and the use of regulatory impact assessments are not mentioned in the ERP.

Initiatives referenced in the ERP to simplify administrative and judicial procedures have the potential to improve the business environment. To reduce the administrative burden for investors, the government plans to create a mechanism to streamline processes related to registration, land allocation and construction permits. The cost and timelines are, however, not specified.

To improve the judicial process, until the end of 2018, Turkey plans to increase the number of judges and prosecutors to levels matching international standards and create positions for judicial experts to assist with decision-making. The success of this measure will depend on the quality of the training and testing to assure that future judges and prosecutors will have the required knowledge, necessary for well-founded and impartial decision-making, also in more specific business-related areas (competition, intellectual property rights, tax law, etc.). In addition, in order to restore investors' confidence, allegations of wrongdoings by individual companies or business people need to be subject to due process with respect for the separation of powers and the independence of the judiciary.

Plans to reduce the informal economy to 21.5% of GDP by the end of 2018 (compared to 26.8% currently) seem overambitious. The action plan to achieve this contains logical measures. It is, however, not clear which measures have already been completed and which ones are still to be implemented, by when and at what cost.

Research and innovation

Turkey lacks a comprehensive strategy in support of research and development and is in need of closer cooperation between universities and economic operators to encourage innovation. The ERP highlights the relatively low (albeit growing since 2005) level of R&D spending and problems in the commercialisation of new technology. However, there is no mention of Turkey's low private sector share in total R&D expenditure (lagging more than 30% behind the EU average), despite the importance the ERP gives to technology production. The ERP does not mention the recent adoption of a new law on intellectual property rights, despite the positive effect this may have on innovation.

The ERP includes measures to support technology investments by the private sector (albeit with a low budget), performance-based support for research institutes and the use of public procurement as an instrument to stimulate R&D. A national science strategy to run until 2023 is scheduled for adoption in 2017. However, the ERP neglects the importance of the demand side. Increased cooperation between research institutes and the private sector, and the introduction by companies of new production means and related organisational measures by companies are of particular importance for the commercialisation of R&D. Using price preferences and exemptions in public procurement to stimulate R&D may be at odds with competition rules and does not seem to target SMEs and start-ups which can be important drivers of new technology.

External trade and investment facilitation

Ad hoc barriers to trade and a weak logistics infrastructure prevent further integration into global value chains. These obstacles limit the competitiveness of domestically produced intermediate goods, resulting in a preference for imported inputs over domestic ones. The ERP does not mention these challenges, but focuses on the importance of reducing import dependency.

The ERP mentions a number of general measures to reduce import dependency (without specifying timelines, budgets or expected outcomes). These include improving technological capacity and quality of domestic products, increasing consumer awareness of domestic products, encouraging preference for domestic products in public procurement, utilising domestic natural resources efficiently and decreasing production costs for energy, transport and labour. No distinction is made between sectors based on Turkey's possible comparative advantage. Whereas some of these measures may be effective, others (stimulating preferences for domestic products) may be at odds with competition legislation and Turkey's existing international obligations, such as the Customs Union with the EU. The possible upcoming negotiations on the modernisation of the latter are mentioned to stimulate trade in agriculture and services and to further open public procurement markets. If successful, this could indeed provide a stimulus for supplementary reform measures to increase competitiveness. No mention is made of the recent entry-into-force of the WTO trade facilitation agreement and the way the reduced import/export formalities foreseen by this agreement will affect Turkey's ad hoc barriers to trade noted above.

Education and skills

Low skills levels of the workforce and education and training of the youth not matching labour market needs are part of Turkey's structural obstacles impeding job creation and a productivity increase necessary for upgrading the country's production system. The ERP rightly identifies some key challenges in education, such as low levels of basic education, skills mismatch and low levels of lifelong learning, but does not link the skills dimension strategically to the development of growth sectors discussed in other parts of the ERP.

Plans to introduce the full day school system for all pupils are an important step, but should be complemented by investments in teacher training. A reform package adopted in October 2016 foresees the implementation of the full day school system for all pupils as of 2019 (currently 37% of pupils are in the two-shift system). Pre-school is planned to become mandatory, and will be introduced as a pilot in selected provinces. The package also includes new provisions on foreign language teaching. The reforms are important steps forward to give better access to education for all; however, more investments into teacher training would be necessary as well in order to ensure better education outcomes.

The forthcoming introduction of apprenticeship training can be expected to improve the school-to-work transition of young people at medium qualification level. Supportive mechanisms for quality assurance and recognition of qualifications need to be put in place. Legislation on this new type of apprenticeship training was adopted in December 2016. It provides an alternative pathway to school-based vocational education; apprentices follow five days workplace training and one day formal schooling per week, and receive a monthly salary at the level of minimum 30% of the minimum wage (around EURO 100). Two thirds of the salary is covered by the government.

The adoption of the first Turkey Qualifications Framework and relevant sub-legislation is an important step in defining common standards for all levels of the education system. The ERP however presents only one measure for the period 2017-2019 related to the evaluation of the results of the Program for the International Assessment of Adult Competencies (PIAAC).

Employment and labour markets

The Turkish demography requires the creation of one million new jobs per year. Job creation dynamics of the economy have markedly weakened in 2016 compared to previous years. The number of employed persons rose by around 400.000 during the period November 2015 – November 2016. Unemployment has steadily increased since April 2016 and reached 12.7 % in December 2016, compared to 8.2% in EU-28, with more pronounced increases for women (+3 pps) than men (+0.8 pps).

Youth (15-24) unemployment recently increased over-proportionately by 3.5 pps, pointing to particular difficulties of young labour market entrants. At 22.6% it is markedly higher than in the EU-28 (18.6%). Particularly worrying is the high share of young people not in employment, education or training (23.9 % in 2015), pointing to structural gaps in the transition from education to the labour market, especially for females (33.7% compared to 14.1% for males). Unemployment also markedly increased among higher education graduates.

Informal employment is very high; one-third of the workforce (9 million workers) does not have access to social security and no labour taxes are collected. The unregistered work rate increased between 2015 and 2016 by 1.1 pps to 33.3%. Informal employment is traditionally most pronounced in agriculture (81.7%) and on the increase in the non-agricultural sector (22.2%).

The ERP reports on a number of legislative changes introduced in 2016 for increasing labour market flexibility. A legal framework has been created for the operation of private employment agencies. Provisions on remote teleworking and the right to part time work for civil servants with small children have been introduced. Some positive effects of these measures are expected, but they might not yet be sufficient enough to further stimulate job creation.

The large scale "employment mobilisation campaign" to contain the rise in unemployment aims to create at least 1.5 million additional jobs through rebates on the social security contribution for newly recruited employees. It was put in place after the ERP submission. While this measure could improve the employment situation in the short term, structural reforms for supporting the upgrading of the labour market are needed in the longer term. In this respect, the ERP indicates as a priority the reform of the severance pay system, which impedes employees' career progression and limits companies' opportunities for recruiting experienced workers.

Social inclusion, poverty reduction and equal opportunities

Turkey continues to face significant challenges in terms of poverty and income/wealth inequality. The ERP diagnostic underlines that substantial progress has been made over the past fifteen years in reducing absolute poverty. The strong GDP increase raised prosperity levels. Average household incomes saw a real increase of 4.3% between 2014 and 2015. However, compared to the EU, Turkey's per capita income level is stagnating; after reaching 54% of the EU average in 2012, it stood at 53 % in 2015, placing the country at the bottom end of EU Member States. The GINI coefficient increased from 0.391 in 2014 to 0.397 in 2015, higher than in EU-28 and all candidate countries and potential candidates except Serbia. Regional disparities in income are strongly pronounced in Turkey, and low educational level is strongly correlated to poverty.

The current system of providing social assistance appears to leave a large proportion of poor households outside its coverage. Beneficiaries of social assistance represent only one sixth of individuals below the relative poverty rate. The link between social assistance and labour market activation measures is weak. The announced reform measures on enhancing the effectiveness of the services provided by the Public Employment Service offices to social assistance beneficiaries is thus very relevant; however, no detailed information on the content, timing and budget of the initiative is provided in the ERP.

The ERP reconfirms the government's ambition to transform the current provision of social protection into a universal system covering the whole population. No further details on developing the content and timing of such a reform are given. The Family Social Support Programme included in the ERP 2016 continues to be rolled out.

5.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2016

2016 policy guidance	Summary assessment
PG 1: Promote domestic saving by following a sufficiently restrictive fiscal stance in view of the large current account deficit.	Turkey has **not implemented** PG 1: • The primary surplus decreased from 2.7% of GDP in 2015 to 0.6% in 2016 and the structural government balance decreased from -2.0% of GDP to -3.4% of GDP.
PG 2: Reinforce the central bank's focus on price stability and credibility by simplifying the monetary policy framework.	Turkey has **not implemented** PG 2: • The central bank has used increasingly irregular policy tools, creating liquidity shortages to force banks to use the late liquidity window for higher interest rate funding.
PG 3: Strengthen the rule of law and the judiciary with a view to restoring investors' confidence.	Turkey has **not implemented** PG 3: • The rule of law and the judiciary were not strengthened. Following the failed coup, a considerable number of judges and public prosecutors were dismissed and the government took active control of some 500 companies over accusations of alleged links with forces behind the failed coup. Investigations for these companies continue.
PG 4: Enhance the comprehensive strategy in support of research and development; this should target an increase of total spending on research and development and build closer cooperation between research institutions and economic operators.	There has been **limited implementation** of PG 4: • Last year, total spending on research and development increased slightly from 0.95% to 1.01% of GDP. • However, the comprehensive strategy in support of research and development was not enhanced. • There is no evidence that closer cooperation between research institutions and economic operators was attempted or achieved.
PG 5: Enhance further the control capacity of the labour inspectorate and enable tax authorities and the social security institution to ensure a correct declaration of wages in order to reduce informality. Pursue the education agenda and improve the qualifications of low-skilled workers in order to make better use of human capital, in particular of young people.	Turkey has **partially implemented** PG 5: • The Action Plan of the Programme for Reducing Informal Economy currently being implemented does not include specific actions for enhancing the control capacities of the labour inspectorate. • The adoption of the first Turkey Qualifications Framework and relevant sub-legislation constitute an important step in defining common standards for the quality of primary, secondary and tertiary education. • Legislation has been adopted for introducing the full day school system by 2019. • The adoption of legal provisions for introducing apprenticeship-type training as an alternative to school-based vocational education and training provides the basis for preparing young people better for the needs of the labour market, thus increasing their employment prospects.

5.6. THE 2017 POLICY GUIDANCE

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

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

Brussels, 23 May 2017

[…]

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

1. Lower external imbalances in light of high external funding needs constituting a substantial risk for the Turkish economy. Promote domestic savings by incentivising higher private sector savings and by following a sufficiently tight fiscal stance over the medium term in light of external vulnerabilities built up over the years. The adoption of a fiscal rule would enhance budget transparency, provide an important fiscal anchor and enhance credibility.

2. Update the macro-fiscal scenario taking into account the revised national accounting methodology as well as the budgetary impact of new policy initiatives, such as the Turkish sovereign wealth fund and the new credit guarantee scheme.

3. Intensify efforts to sustainably achieve price stability. Better anchor inflation expectations by pursuing a more credible and tighter monetary policy stance as soon as GDP growth rebounds and by clearly communicating this to the public. Furthermore, the central bank should not step backwards in terms of its self-imposed objective to simplify the monetary policy framework.

4. Strengthen the rule of law and the judiciary with a view to improving the business environment and investors' confidence.

5. Update the strategy in support of research and development; this should target an increase in total spending on research and development and include financial and legislative initiatives to support the capacity of companies, notably SMEs, to adopt and implement innovative production processes.

6. Focus skills development on sectors with growth potential and skills needs, and expand provision of relevant vocational training. Reform the severance pay system in order to reduce labour market rigidity. Reduce informal employment through, *inter alia*, increase of inspection capacities, with particular focus on non-agricultural employment. Improve teacher training and improve the performance of the education system towards international best practices. Promote the professional education and labour participation of women.

ANNEX: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Economic Reform Programme 2017-2019 was approved by the High Planning Council on 7 February 2017 and submitted to the Commission on the same day, one week after the deadline. Overall, adherence to the Commission Guidance note is very weak. The ERP does not contain any information on the implementation of the policy guidance from 25 May 2016, nor on the structural reform measures included in the ERP 2016-2018. The area diagnostics are largely missing from section 4.3, as are clearly delineated structural reform measures. Section 5 on budgetary implications of structural reforms is completely missing, as is table 9 on selected employment and social indicators. No written contributions from external stakeholders have been annexed to the programme.

Inter-ministerial coordination

The preparation of the ERP was centrally coordinated by the Ministry of Development. For the structural reforms part, coordination with line ministries took place. However, proposed reform priorities of line ministries were only partially taken over by the Ministry of Development, mostly in cases where these were already included in Turkey's Medium-Term Programme (on which the ERP is largely based). Line ministries were not consistently informed by the Ministry of Development on reasons why their proposed priorities were not taken over. Communication should therefore be improved.

Stakeholder consultation

No consultation with external stakeholders took place. External stakeholders should be given the possibility to comment on a draft ERP before it is finalised and adopted.

Macroeconomic framework

The set-up of the chapter on the macroeconomic framework broadly follows the outline given by the guidance note. It covers all of the main elements and goes into significant detail which helps assessing the state of the Turkish economy and its medium-term scenario. The medium-term scenario is not the most realistic scenario and does not explain differences with the Commission services forecast. The oil price assumption is broadly aligned with that of the European Commission. The statistics provided are not up-to-date with the revision of the national accounts methodology but there is a relatively detailed coverage of the situation existing before the revision.

Fiscal framework

The set-up of the chapter on the fiscal framework closely follows the outline given by the guidance note. It covers all of the main elements and goes into significant detail which helps assessing the state of the Turkish public finances and its medium-term scenario. Some more detail on parameters, data and methodology (or a reference) would be useful regarding the estimation of potential growth and the output gap as well as the government debt sensitivity analysis. The link between the reform agenda, policy priorities and public finance could have been developed significantly better.

Structural reforms

The structural reforms priorities section does not follow the guidance note and for most areas does not include a thorough diagnostic. The reporting on the implementation of the policy guidance is completely missing, whereas the reporting on the implementation of the structural reform measures for 2016-2018 is inconsistent with last year's programme. The 2016-2018 ERP includes 18 reform measures, while the current implementation table lists 32 measures that do not correspond to those listed in the 2016-2018 ERP. The number of the reform measures in this year’s ERP text itself is limited to 18, but the summary table on structural reforms contains 25 measures, exceeding the limit of 20. The reform measures are not clearly delineated, nor are they accompanied by well-defined activities planned over the programme's three-year lifetime. Clear timelines and budget information are lacking. Table 9 is completely missing and tables 10 to 12 are not appropriately filled in. Substantial information on cost, budgets and the expected impact on competitiveness is missing and the level of concrete detail is low.

6. BOSNIA AND HERZEGOVINA

6.1. EXECUTIVE SUMMARY

Bosnia and Herzegovina's economic reform programme (ERP) envisages a moderate acceleration of annual output growth in 2017-2019. GDP growth is expected to reach 4 % by the end of the programme period. This acceleration in growth is forecast to be driven by investment, which is seen as picking up substantially after years of weak performance. Private consumption is also forecast to increase as a result of rising employment and low inflation. Net exports are expected to subtract from growth as a pick-up in exports will be outweighed by the impact of growing imports. The risks to this scenario are mainly on the downside. The extent of the picking-up in investment depends on a clear improvement in the country's investment climate and on progress with public investment, both of which have long been a challenge.

Bosnia and Herzegovina needs to improve its growth prospects by strengthening its capacity to finance investments and implement structural reforms. The country suffers from below-potential growth, which is delaying a swift reduction of the unacceptably high unemployment rate. Frequent political stalemates impede progress with long-overdue structural reforms. The main challenges include the following:

- **Fiscal policy is impeded by insufficient fiscal space which limits the country's ability to spend on growth-enhancing activities such as public investment and education.** The country's access to international financing is limited, while domestic sources are already stretched. This is a major constraint on the country's capacity to finance overdue public investment projects. Public spending remains heavily biased towards consumption and redistribution, notoriously neglecting investment needs. Furthermore, debt roll-over requirements are substantial in some cases, creating additional pressure on public finances and leaving limited room for manoeuvre.

- **The quality of short and medium-term fiscal planning remains weak.** Besides insufficient political attention to medium-term policy challenges, limited administrative capacity is a key constraint. Weak statistics and outdated accounting approaches are also crucial impediments to better policy design. The country's debt management is negatively affected by fragmented responsibilities, limited capacity and an insufficient information flow from local data providers to central ones.

- **The country lacks a country-wide energy strategy and a legal framework in compliance with its obligations under the Energy Community Treaty.** Shortcomings in coordination and cooperation between government levels in setting up a functioning energy market and a single or harmonised legal and regulatory framework limits opportunities for growth in this sector. At various government levels, the ERP largely recognises this need.

- **Bosnia and Herzegovina's competitiveness continues to be hampered by the fact that it is not a single economic space with a unified approach to enterprise policy.** The oversized and inefficient public sector, which is running up considerable payment arrears, leaves little room for enhancing growth-friendly public investment. Non-recognition of business registration across the country is a particular problem. The ERP recognises this as a challenge, but does not offer a comprehensive way of addressing it, leaving the entities with companies of reduced growth prospects. By contrast, the Reform Agenda[1] includes more relevant reforms in this regard, such as standardising of corporate

[1] In July 2015, the country adopted a Reform Agenda aimed at tackling the difficult socio-economic situation and advancing the rule of law and public administration reforms.

taxation, completing the registers of para-fiscal fees and charges and continuing to simplify and harmonise business registration procedures.

- **The labour market situation in Bosnia and Herzegovina remains one of the most challenging in the region.** Young people, women and long-term unemployed are in a particularly vulnerable position. High inactivity levels and widespread informal work further exacerbate the situation. Addressing the skills mismatches should start with the modernisation of the education system at all levels, including through teacher training and better cooperation between education institutions and the employers. Recent labour law reforms aimed at improving labour market functioning, but the lowering of the tax wedge is still pending. Employment offices suffer from insufficient capacities to assist in providing employment and bring people into the labour force. Disincentives to take up formal work are exacerbated by weak employment support and non-targeted social assistance. Low implementation capacities hinder making substantial progress in addressing the challenges.

The implementation of the policy guidance jointly adopted in the Economic and Financial Dialogue of 25 May 2016 has been limited. Progress on improving the quality of public finances has been limited. Political tensions have delayed progress with necessary reforms and have also hindered access to available international financing, which is needed to proceed with growth-enhancing investment. Adopting a country-wide transport strategy based on related entity strategies is a step forward towards a more systematic coordination between government levels in this sector. However, a country-wide energy sector reform strategy and a legal framework in compliance with the country's obligations under the Energy Community Treaty have yet to be adopted. There has been little progress in aligning education with the labour market needs. New labour laws are being implemented and the targeting of the labour market policies has improved. Actions to reduce the tax wedge are still pending, and measures to link employment and social services are mainly in the preparatory phase. The structural reform measures planned in last year's ERP were only partially implemented.

The macro-fiscal framework is on the optimistic side, although achieving the higher growth rate envisaged largely depends on the swift implementation of structural reforms. The fiscal framework fails to rebalance fiscal policy towards a more growth-enhancing spending structure. The analysis of structural obstacles to competitiveness and the envisaged reform measures largely matches the bottlenecks and reform needs identified by the Commission. However, the analysis mostly focuses on the entity level and the country-wide perspective is limited. The structural reform measures also mostly cover the entity level and lack clear coordination and prioritisation. It is therefore not possible to assess whether the country-wide priorities match those identified by the Commission. The weak country-wide co-operation reduces the benefit from reforms for each entity. Overall, there is little progress in the quality and relevance of the ERP, despite some real progress in the process of its preparation.

6.2. ECONOMIC OUTLOOK AND RISKS

Under the Economic Reform Programme (ERP), there is expected to be a moderate acceleration in economic growth, driven by stronger investment, external demand and private consumption. Private consumption, which accounts for about three quarters of overall growth, is projected to be supported by solid employment growth and low inflationary pressures, while investment is forecast to make the main contribution to speeding up growth. Investment is picking up substantially after years of weak performance, especially in infrastructure and the energy sector. Growth of government consumption is projected to remain well below overall growth (at some 0.6 % on average), reflecting commitments to reduce the share of public spending in GDP. Exports are expected to grow by an average of 5.5 % annually, benefitting from stronger expected growth in neighbouring countries. Import growth is forecast to remain slightly lower, at an average of 5.1 % annually. Given the high import content of expected investment, net-exports will continue to make a negative contribution to growth, of around 0.8 percentage points. On the basis of the programme's underlying macroeconomic framework, growth is projected to increase from 3.1 % in 2016 to 4 % in 2019. This brings average annual growth to 3.7 % during the programme period, compared to 1.6 % over the last three years.

The macroeconomic scenario is on the optimistic side, relying on a marked acceleration of investment and a significant improvement in the business environment. As in last year's programme, the macroeconomic scenario presupposes a significant increase in public investment (by between 23 % and 33 % annually). This strong increase mainly results from the low historic base, but nevertheless looks optimistic, given the country's track record in this respect. Furthermore, this strong increase is not consistent with the fiscal framework which projects a declining ratio of public investment spending, from 2.3 % of GDP in 2016 to 1.3 % in 2019. The assumptions on private investment are more plausible, given the country's potential in electricity production and tourism. However, the extent of the investment pick-up depends on a clear improvement in the country's investment climate, which has been a long-standing challenge. The ERP's alternative scenario acknowledges both downside risks stemming from a less favourable international environment and risks related to carrying out the planned reforms, which would imply less public investment, but higher spending on public sector employment and social security. As a result, the level of GDP would be 1.8 % lower than in the reference scenario. Unfortunately, the alternative scenario does not calculate the impact on the labour market or on public finances. Given the country's track record, the alternative scenario appears more realistic than the reference scenario. Overall, it seems essential – as it did last year – to have a strong policy commitment to pursuing the country reform programme if Bosnia and Herzegovina is to achieve the economic outlook presented in the Programme.

Improvements on the labour market remain limited. After an average of 1.5 % increase in registered employment in 2016, the macroeconomic framework forecasts a slight acceleration in employment growth, reaching 2.1 % in 2019. Though unemployment fell to 25.4 % in 2016, it remains high. The registered unemployment rate (national definition) fell to 42.1 % in 2016, and is expected to decline to 39.2 % by 2019. Factors including a large difference between net wages and labour costs (tax wedge) and rigid labour market regulations impeded a more dynamic employment growth. They also help perpetuate a large informal economy. Youth unemployment remained above 60 %. The difficult labour market situation is also reflected in broadly stagnating gross nominal wages. The expected average increase in employment by some 1.9 % per year is largely consistent with the underlying macroeconomic outlook. However, achieving higher employment growth strongly depends on addressing key constraints on employment generation, such as poor education and a significant tax wedge on labour.

Table 1:

Macroeconomic developments and forecasts

	2015	2016	2017	2018	2019
Real GDP (% change)	3.0	3.1	3.4	3.8	4.0
Contributions:					
- Final domestic demand	0.3	2.7	4.2	4.6	4.8
- Change in inventories	1.0	0.0	-0.2	0.0	0.0
- External balance of goods and services	1.7	0.4	-0.7	-0.8	-0.8
Employment (% change)	1.2	-2.6	1.6	1.9	2.1
Unemployment rate (%), LFS definition	27.7	25.4	24.7	24.0	23.2
GDP deflator (% change)	0.9	0.1	1.2	1.3	1.2
CPI inflation (%)	-1.0	-1.0	0.5	1.0	1.2
Current account balance (% of GDP)	-5.6	-2.9	-5.3	-5.8	-6.5

Sources: Economic Reform Programme (ERP) 2017

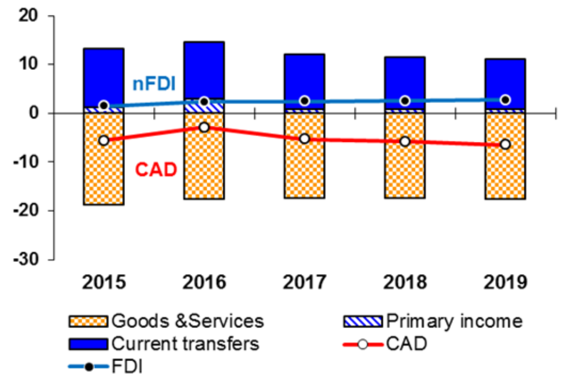
The programme's inflation scenario is largely plausible, envisaging only a moderate build-up of inflationary pressures in the coming years. As a small economy in which imports account for a substantial share, the country's inflation profile is strongly influenced by developments in international prices. The programme's expectations of price developments are in line with external forecasts of moderate increases in the prices of energy and raw materials. Domestic price pressures are expected to remain moderate, given the country's high unemployment and growth expectations, which, though improving, remain moderate. However, in the later years of the programme, price pressures could rise, as the output gap is expected to close.

Driven by higher investment, the ERP expects the current account deficit to deteriorate, but the extent of this deterioration is not fully in line with the strong growth in investment, which is projected. After a slight improvement in the current account deficit to 4.5 % of GDP in 2016, the medium-term projection expects that the deficit will widen to 6.5 % of GDP in 2019. This appears optimistic should the expected strong increase in investment materialise, along with the projected worsening terms of trade due to the pick-up in oil prices. The programme attributes this limited deterioration in the current account to the expected improvement in the country's export performance following earlier investments in the manufacturing and electricity sectors. However, there is a significant risk that the expected positive export effect will materialise with a delay. Therefore, in the context of the forecast investment-driven growth recovery, the expected improvement in the trade balance appears optimistic. If the trade balance were to widen, a sharper than projected deterioration in the country's external balance could further elevate external financing needs. Unfortunately, the programme does not provide sufficiently detailed information on other balance of payments components.

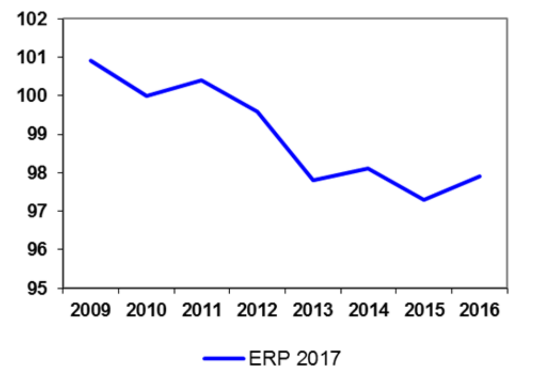
The financing of the current account deficit appears to rely largely on foreign investment inflows, privatisation revenues and increasing capital transfers. Foreign direct investment (FDI), which dropped markedly during 2016 to 1.2 % of GDP, is expected to increase to about 2.5 % of GDP annually during the programme period. The main sources are expected to be privatisation projects and greenfield investment in infrastructure and electricity. However, this also points to the need to tap other international source for financing the expected widening of the current account deficit. Unfortunately, the programme provides no quantitative details of how the current account deficit is to be financed throughout the programme period.

Chart 1: **External competitiveness and the current account**

Changes in the current account balance (% of GDP)	**Real effective exchange rate** (CPI based, total economy)



Source: Economic Reform Programme (ERP) 2017, ECFIN calculations



The banking system appears broadly stable, but pockets of vulnerabilities remain. The sector is still well capitalised. The regulatory capital adequacy ratio, at 16.1 % on average, has deteriorated somewhat but remains well above the regulatory minimum of 12 %. Profitability remained positive in 2016 and the liquidity of the system remains at comfortable levels. Partly, this is because precautionary motives appear to be keeping deposit growth high, with average deposit levels 7 % higher in 2016 than in 2015. The banking system's credit risk indicators continue to improve slowly. The share of non-performing loans in total loans continues to decline, reaching 11.8 % at the end of the fourth quarter of 2016, compared to 13.8 % a year before. However, there are significant differences at a lower level of aggregation, with significantly higher levels of non-performing loans at some non-systemic, domestically-owned banks. At the same time, the ratio of provisions to non-performing assets has increased, reaching 74.2 % at the end of the third quarter of 2016, compared to 71.4 % a year before. Nevertheless, legislative changes to facilitate loan restructurings are overdue and further efforts are still needed to encourage the clean-up of banks' balance sheets. Furthermore, banking sector supervision and resolution needs to be improved. So far, credit growth has remained muted despite greater liquidity in the banking sector. In particular, credit to non-financial corporations remained weak, partly because credit demand from private companies appears to be low. To a certain extent, this probably reflects the unfavourable business environment, which is not supportive to local investment.

Table 2:
Financial sector indicators

	2012	2013	2014	2015	2016
Total assets of the banking system, mEUR	11 210	11 794	12 299	12 756	13 344
Credit growth	5.1	2.7	3.7	1.8	2.1
Bank loans to the private sector	49.9	48.8	47.9	45.2	45.5
Deposit growth	2.6	5.1	8.4	6.2	7.7
Loan to deposit ratio	1.2	1.1	1.1	1.0	1.0
Financial soundness indicators					
- non-performing loans	12.7	14.5	15.2	13.9	12.1
- net capital to risk weighted assets	17.0	17.1	17.0	15.9	15.7
- liquid to total assets	25.1	25.4	26.2	25.9	26.3
- return on equity	4.9	-1.4	5.4	2.0	7.3
- forex loans to total loans	63.2	62.9	68.0	67.1	62.6

Sources: Central Bank, DataInsight, IMF

6.3. PUBLIC FINANCE

The 2016 fiscal deficit is estimated to have been lower than expected, largely as a result of higher revenues, while the increase in spending was less pronounced. The ERP estimates that the consolidated fiscal deficit in 2016 amounted to -0.4 % of GDP. This is below the target of -1.2 % of GDP set out in the 2016 ERP. Public expenditure is estimated to have risen slightly, from 42 % of GDP in 2015 to at 42.7 % in 2016. The reported data points to a slight improvement in the composition of expenditure in 2016, as investment spending is estimated to have increased by 0.8 pps. of GDP, while social transfers are reported to have fallen by 0.3 pps. However, the data presented is still provisional, based largely on plans adopted in mid-2016. Public consumption and interest payments have increased by 0.2 pps. each. Overall, non-discretionary current spending is still predominant at 23 % of GDP, while public investment is low at 2.3 % of GDP. Consolidated fiscal revenues are estimated to have risen significantly, from 40.9 % of GDP in 2015 to 42.3 % in 2016. The main factor behind the increase was 'other revenue', which rose by 1.4 pps. of GDP. Indirect taxes rose by 0.3 pps., while social security contributions dropped by 0.3 pps. Due to slow progress on the reforms required, the external financing from the International Monetary Fund (IMF) and the World Bank that had been expected had to be replaced by delaying planned increases in capital spending and by reverting to domestic sources of finance, including the financing through arrears.

Box: The budgets for 2017

Unfortunately, the programme does not provide information on the budgets, adopted for 2017.

Source: Economic Reform Programme (2017)

For 2017, the country's medium-term fiscal programme, the Global Fiscal Framework, is set to result in a consolidated deficit of -0.3 % of GDP. This deficit is mainly caused by local governments and social security funds, (-0.5 % and -0.1 % of GDP respectively), while the central governments are targeting a consolidated surplus of 0.3 % of GDP. On the revenue side, the programme is expected to see a marked increase in income and wealth tax revenues, largely due to better revenue collection. However, it is forecast that this will be largely offset by lower capital tax receipts. Indirect taxes are expected to rise by 1.1 % only, which is relatively low, given the relatively high growth in the underlying tax base, such as private consumption and imports. On the expenditure side, there are plans to reduce public consumption by 1.1 %, while investment spending is expected to be nearly 15 % lower than in 2016. This sharp reduction in investment is not in line with the 2016 ERP recommendations. Overall, the presented efforts to create fiscal space for increasing public investment appear to be quite limited.

Table 3:

Composition of the budgetary adjustment (% of GDP)

	2015	2016	2017	2018	2019	Change: 2016-19
Revenues	**40.9**	**42.3**	**40.1**	**38.8**	**37.5**	**-4.8**
- Taxes	20.6	20.8	20.5	20.1	19.4	-1.4
- Social security contributions	14.9	14.6	13.9	13.3	12.8	-1.8
- Other (residual)	5.4	6.9	5.7	5.4	5.3	-1.6
Expenditure	**42.0**	**42.7**	**40.4**	**37.9**	**36.3**	**-6.4**
- Primary expenditure	41.2	41.7	39.5	37.0	35.4	-6.3
of which:						
Public Consumption	7.1	7.3	6.9	6.6	6.3	-1.0
thereof: compensation of employees	11.7	11.6	11.1	10.6	10.1	-1.5
Social Transfers	16.2	15.9	15.2	14.5	13.8	-2.1
Subsidies	1.2	1.3	1.3	1.1	1.0	-0.3
Gross fixed capital formation	1.5	2.3	1.8	1.3	1.3	-1.0
Other (residual)	16.4	16.2	15.6	14.6	14.0	-2.2
- Interest payments	0.8	1.0	0.9	0.9	0.9	-0.1
Budget balance	**-1.1**	**-0.4**	**-0.3**	**0.9**	**1.2**	**1.6**
- Cyclically adjusted	-1.0	-0.1	-0.4	0.8	1.0	1.1
Primary balance	**-0.3**	**0.6**	**0.6**	**1.8**	**2.1**	**1.5**
Gross debt level	**40.6**	**40.5**	**40.3**	**39.7**	**37.6**	**-2.9**

Sources: Economic Reform Programme (ERP) 2017, ECFIN calculations

Over the medium term, the fiscal framework is based on the expectation of further fiscal restraint and further deterioration in the spending structure. Revenues are expected to increase more slowly than the underlying tax base, mainly because growth in revenue from indirect taxes and in social security contributions is expected to be low. The declining share of revenue from social contributions probably reflects planned reductions in the tax wedge. As a share of GDP, total revenue is expected to fall substantially, from 42.3 % in 2016 to 37.5 % in 2019. However, weak revenue growth is not fully in line with the steps planned to increase excise duties, widen the tax base and reduce tax avoidance. On the expenditure side, nominal spending levels are projected to be maintained for most categories, with the exception of lower investment, resulting in a marked reduction in spending in relation to GDP, from 42.7 % in 2016 to 36.3 % in 2019. No fiscal strategy apart from maintaining nominal spending levels is noticeable in this profile. Unfortunately, as with the previous programme, the document provides no detailed information on the underlying measures. A reduction in both revenues and spending of such a magnitude is quite unprecedented in the country's recent history. More information would have been welcome, in particular on the concrete fiscal effects of planned measures, such as the impact of the envisaged reduction in the tax wedge. In contrast to last year's programme, the planned reduction in the share of spending is spread more evenly over the time horizon, reflecting the programme's approach of keeping nominal spending levels largely unchanged. The link to the internationally supported reform agenda and the overarching policy strategy is still very weak.

The fiscal stance presented for the programme period appears to be based on combining cautious revenue estimates with a freeze of nominal spending. This approach might be a useful technical assumption, but does not necessarily reflect future-oriented key policy challenges, such as increasing public investment or increasing spending in education. The key risk is that this approach is not conducive to accelerating economic growth and does not address the country's key challenges, such as high unemployment, a poor business environment and an underperforming educational system. The projection of revenues is not consistent with the macroeconomic scenario. For example, the underlying economic dynamics and the measures envisaged to increase excise taxes and to broaden the tax base, should allow stronger growth of indirect taxes in 2018-2019. Furthermore, the strong decline of revenues from social security contributions is surprising given the expected solid growth of employment. Planned reforms of the social security contribution system might be one explanation. However, the ERP does not provide sufficient detail on the concrete planned steps, or on the timing of their implementation, or on their fiscal impact. This part of the programme also remains largely silent on areas with pressing reform needs, such as the pension reform and the public administration reform in the Federation as well as the health reform in both entities.

The quality of public finance and budget planning remains weak. The programme mentions a large number of measures planned to improve the quality of public finance – some of which have already been taken – but fails to provide estimates of their fiscal impact. Medium-term budget planning remains weak and is impeded by fragmented responsibilities and the large number of stakeholders involved. If one looks at the composition of expenditure in the medium-term budget framework, growth-conducive spending, such as investment, is falling (from 5.3 % of total spending in 2016 to 3.6 % in 2019). Conversely, there is a slight increase in the share of social transfers and public consumption in total spending, from 37.3 % of total spending in 2016 to 38.1 % in 2019, and from 17.1 % of total spending in 2016 to 17.3 % in 2019.

On the revenue side, the share of indirect taxes in total revenues is increasing, from 41.3 % in 2016 to a projected 43.3 % in 2019, which is largely neutralised by a similar drop in revenue under 'Other'. The programme does not discuss the impact of this change on the revenue side on the country's income distribution. However, there is a risk that greater reliance on indirect taxation will affect lower income groups worse than the more wealthy households. The main challenge to using revenue more efficiently, seems to be lack of strong political commitment to addressing politically sensitive issues, such as the fact that social transfers could be better targeted or the need to make significant cuts in public sector employment.

Despite the limited size of the country's public debt, its trajectory and structure continue to raise concerns. Bosnia and Herzegovina's public debt was slightly over 40 % of GDP in 2016. About 70 % of public debt is foreign-owned and is largely provided on concessional terms by international financial institutions, such as the IMF, the European Investment Bank and the World Bank. The delays in IMF and World Bank lending in 2015 and 2016 caused the share of domestic debt to rise significantly, reaching 11.7 % of GDP in 2016. This was mainly due to the issuing of short-term and long-term government securities, which substituted for the non-disbursement of tranches under the IMF Stand-by arrangement. Domestic public debt is projected to fall to 8.4 % of GDP in 2019 (-3.3 pps.) on the back of a steady decrease of payments related to settling claims related to the war and the compensation for old-currency savings. Foreign public debt rose to 28.9 % of GDP in 2016 and is expected to rise further to 30 % in 2019. The currency structure of the total public debt may be considered to be relatively favourable given the country's currency board arrangement, as nearly 33 % of the outstanding stock is denominated in euro and 38.4 % in the domestic currency. A large share of the debt stock has been contracted on concessional terms, with the average interest rate remaining at 1.5 % and about 51.2 % of total debt under a fixed interest rate. Nevertheless, the maturity structure has worsened, with the average repayment period for the existing loan commitments falling to about at eight years. There is a significant difference in the indebtedness of the two entities, with the RS rapidly approaching a debt ratio of 60 % of its GDP.

Box: Debt dynamics

Table 4:

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

	2015	2016	2017	2018	2019
Gross debt ratio [1]	**40.7**	**40.5**	**40.3**	**39.7**	**37.7**
Change in the ratio	-0.1	-0.2	-0.1	-0.6	-2.0
Contributions [2]:					
1. Primary balance	**0.2**	**-0.6**	**-0.6**	**-1.9**	**-2.0**
2. "Snow-ball" effect	**-0.7**	**-0.3**	**-0.9**	**-1.0**	**-1.1**
Of which:					
Interest expenditure	0.8	1.0	0.9	0.9	0.9
Growth effect	-1.2	-1.2	-1.3	-1.5	-1.5
Inflation effect	-0.4	0.0	-0.5	-0.5	-0.5
3. Stock-flow adjustment	**0.4**	**0.7**	**1.4**	**2.2**	**1.1**

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes other adjustment positions, such as differences in cash and accrual

Source: Economic Reform Programme (ERP) 2017, ECFIN calculations

The programme is based on the expectation that debt reduction will speed up. The key drivers of the drop in the debt ratio are primary surpluses and strong nominal growth, while the costs of debt servicing raise the level of debt by about one percentage point of GDP per year. However, a decomposition of the debt dynamics into various factors also points to a substantial debt-increasing factor, presented in the table as 'Stock-flow adjustment', raising the debt ratio by 1.4% of GDP in 2017, by 2.2 % of GDP in 2018 and 1.1 % of GDP in 2019. Unfortunately, the programme does not provide more details on the underlying assumptions driving this envisaged debt profile.

The risks associated with rolling-over and refinancing public debt remain high. Public debt servicing, which has more than doubled in recent years, reaching over 5 % of GDP in 2015, is projected to surge further in the programme period to reach a peak of over 6 % of GDP in 2018. This poses risks for the refinancing of public debt. Moreover, the already substantial refinancing needs following the multiple issue of government securities in 2015 and 2016 and the limited availability and a partial standstill of other sources of financing could pose risks to the fiscal projections given the tight fiscal space, particularly as the country has only limited access to international capital markets. Furthermore, debt management suffers from decentralised responsibilities and an inadequate flow of information from local data providers to the Central Bank.

Box: Sensitivity analysis and comparison with the previous ERP

The programme does not present a usual sensitivity analysis of fiscal effects of changes in key parameters. Instead, the document lists possible risks to the fiscal projections and provides a rough estimate of the fiscal and non-fiscal effects of possible increases in various excise duties. The resultant estimates amount to about 0.6-0.8 % of GDP, annually. Unfortunately there are no estimates of the effects of different assumptions on GDP growth or of different assumptions on interest rates on the country's fiscal balances.

By comparison with the previous programme, the growth profile of the 2017 programme is slightly more optimistic for 2017, but slightly more cautious for 2018. Overall, the growth profile of the 2017 programme appears more realistic than last year. The 2017 programme also seems more realistic in terms of fiscal balances and the debt profile it predicts.

6.4. STRUCTURAL REFORMS

The quality of the 2017-2019 ERP's structural reform sections has improved only to a limited extent by comparison with the previous year. It still fails to identify country-wide structural reforms within a coherent country-wide common policy framework linked to a comprehensive analysis of key structural challenges. This means that the Commission can only assess the obstacles to competitiveness that affect the country as a whole and the few structural reforms in the programme that at least make an attempt to cover the country as a whole. Assessing reforms identified at entity or state level is outside the scope of this assessment. The overall country-wide diagnostic provides a relevant and correct approach to addressing the economy's shortcomings. The Commission's assessment in 2016 has been largely ignored in terms of its recommendation to provide a comprehensive list of reform priorities within a coherent country-wide common policy framework.

Only a limited number of measures have the ambition of covering the country as a whole. They include one related to Public Finance Management (PFM), one related to the network markets, one on agriculture, one on education and skills and one on the labour market. The measures are scattered, addressing a number of issues at various levels of government while lacking a comprehensive framework of country-wide reforms. Many measures at entity level show little or no coordination between entities or with the state level. Numerous measures are expressed as desired outcomes rather than describing a specific activity and lack information on implementation timelines, cost estimates and/or budgetary implications, the expected impact on competitiveness, projected social outcomes, and/or potential risks with planned mitigating actions. For the ERP 2018-2020, a list of 15-20 reform measures should be identified that correspond to common country-wide obstacles to competitiveness and growth.

Main obstacles to competitiveness are the large, inefficient, complex, and burdensome public sector dominating the economy and the absence of a single economic space. It is important to establish coherent and effective coordination mechanisms and set medium-term common objectives that would effectively overcome the continuing lack of a single economic space with highly fragmented markets, being mostly set at entity or even canton level. The lack of a country-wide energy strategy and of a legal framework in compliance with the country's obligations under the Energy Community Treaty is particularly worrying and limits the growth opportunities in this sector. The education system lacks modernised curricula and teaching to improve the overall quality of qualifications within the country. Skills mismatch, lack of job creation, a high labour tax wedge and weak employment services result in high and largely structural unemployment. The social protection system is fragmented between multiple levels of governments and lacks linkages with employment support to incentivise employment. Last year's policy guidance specifically covered these areas; it was implemented only to a limited extent.

Public finance management

Public finance efficiency and effectiveness remain hampered by weak financial management, lack of a harmonised chart of accounts at state and entity level and low capacity for auditing and monitoring public procurement. Public procurement procedures suffer from high administrative burdens and a lack of transparency while fiscal discipline is low. Most state-owned enterprises are non-viable and accumulate significant arrears to public and private creditors and suppliers. State subsidies and loan guarantees to these companies constitute substantial contingent liabilities impeding the predictability of public expenditure with negative impact on macroeconomic stability and provision of public services. The ERP does not provide a country-wide analysis on public financial management (PFM) and little attempt is made to elaborate on commonly identified obstacles. Bosnia and Herzegovina still lacks a country-wide PFM strategic framework to guide all PFM related reforms.

The ERP presents one measure in this area that aims to find synergies between the different levels of government to achieve one common goal, namely to make public spending sustainable and improve financial accountability. The measure refers to the Reform Agenda but does not report on the expressed commitment of the Ministries of Finance to preparing a country-wide PFM strategy on the basis of the PFM strategies at entities and state level, or on the progress made in 2016 by all levels of government. The activities proposed for public internal financial control (PIFC) and the country-wide PFM strategy development appear consistent with the Principles of Public Administration. Some of the reforms in the PFM strategy – in public procurement or in tax administration for instance – may contribute directly to improving competitiveness. The measure does not include an analysis of the budgetary impact, the impact on competitiveness and social outcomes, possible risks or possible action to mitigate such risks. There is no update on the adoption of the financial management control (FMC) manual.

Transport, energy and telecommunications markets

The country has outdated and poorly maintained infrastructure, especially in transport, while a fragmented and weak regulatory and legal framework leads to one of the lowest investment rates in the region. The ERP diagnostic section on state level is not comprehensive and focuses exclusively on road transport as the main challenge in the transport market. There is no mention of rail or other modes of transport, or of regulatory and structural reforms, such as the connectivity reform measures. As for telecommunications, the ERP does indicate the need to set up a framework for improvement of this sector and compliance with the EU regulatory framework for electronic communications. In the energy sector, the country's hydropower potential is still largely untapped. A country-wide energy strategy and country-wide infrastructure plans, as well as an energy market with interconnections to the wider regional and EU energy markets, would improve the level of security of energy supply and – along with measures to increase energy efficiency - reduce the wastefully high energy intensity.

The ERP includes a measure on improving communication infrastructure that includes the objective of implementing the country-wide Framework Transport Strategy. However, it contains no information about specific activities, budgets or timelines.

The ERP also refers to the need to draw up a country-wide energy strategy based on the strategies of the country's constituent entities. Such a strategy and adoption of a legal framework in compliance with the Third Energy Package would help Bosnia and Herzegovina meet both its EU and Energy Community obligations. However, while working groups for the establishment of a country-wide energy strategy have been set up, there is no indication of how such obligations are to be met, nor are investment needs clearly specified.

One state level measure is designed to develop the still underdeveloped telecommunications market. The ERP refers to the 2017-2021 Telecommunications Sector Policy (as well as to a Law on Electronic Communications, a Broadband Access Strategy and a continuation of digitalisation of public broadcasting service), but has no clear timeline for adoption or milestones to measure progress, which means potential new entrants' market access continues to be blocked. The opening up to competition between fixed and mobile operators within a proper legal and regulatory framework will require regulatory independence, network operators in the whole country to coordinate and share infrastructure, and specification of conditions for granting aid to ensure an investor-friendly environment for broadband development.

Sector development

Agricultural sector development

Bosnia and Herzegovina faces many obstacles in increasing agricultural productivity and opportunities. These include arable land fragmented into small plots, the large proportion of small farms, low productivity, outdated manufacturing and processing capacities, the small number of farming cooperatives and the unfavourable age structure of the farming community. There is a continued lack of a country-wide agriculture and rural development strategy to develop the sector at country-wide level, although the constituent entities face largely the same obstacles. As rightly noted in the ERP, the absence of consolidated nationwide agricultural data and of a country-wide legal framework for carrying out the agricultural census severely hinders any effective strategy development in this sector. The absence of centralised agriculture and rural development registries, poor access to financing, low overall investment and low administrative capacities are further identified as key obstacles to the development of the sector.

The ERP includes a measure aimed at meeting preconditions for using the IPARD funds, which would help develop and integrate the agricultural market into the European and global ones. However, as indicated in the ERP, this would require several complex institutional, administrative and legislative adjustments. The ERP includes a list of legislative packages designed to meet EU phytosanitary standards; however, there is no further description of the necessary coordination with entities or information on precise timelines, and with no specific budgetary provisions. The lack of progress in agreeing to set up a country-wide IPARD operating structure is blocking further preparations for the set-up of IPARD. More investment in standards certification and agribusiness value chains would help realise the considerable potential for high-quality large scale production of competitive products.

Industry sector development

The industry sector still suffers from the lack of a single economic area. The ERP does not contain a country-wide analysis of the industrial sector, nor does it contain any measures in this field. The industrial sector covers a narrow range of traditional low and medium value-added industries in mining, metal and wood processing, machinery, textiles, tobacco, ammunition and domestic appliances, with little or no innovation. By far most industrial companies are small and medium-sized firms.

Services sector development

Tourism and Information and Communication Technologies (ICT) remain key growth drivers, but the oversized and inefficient public sector impedes further progress. The ERP fails to provide a country-wide analysis of the services sector, nor does it contain any measures in this field. There is an issue of crowding out as the public sector represents a large, inefficient, and dominant part of the services sector. Particular growth sectors are tourism and ICT. While tourism has the potential to increase growth in the country, the sector suffers from the weak business climate and transport system, market fragmentation, lack of coordination between different government levels and lack of direct cooperation between public and private stakeholders. The growing ICT sector has shown dynamic production and export growth, but continues to be held back by factors including the lack of skilled workers and low business research, development and innovation (RDI) uptake. Competition in the ICT sector needs to be enhanced to further reduce costs and improve quality.

Business environment and reduction of the informal economy

Bosnia and Herzegovina's business environment was ranked worse than that of any other European country in the World Bank Doing Business 2017 report. The ERP offers little by way of country-wide analysis other than briefly noting the importance of a good business environment for small and medium-sized businesses and commenting that the education system needs to support entrepreneurship. Though this analysis is not incorrect, there are other immediate and fundamental reasons for the poor performance of the private sector such as a continuing absence of a single economic area linked with political instability, poor access to finance, especially for small and medium-sized enterprises, the weak rule of law and functioning of the judiciary, complex, unclear and sometimes contradictory legal and regulatory frameworks, and the widespread informal economy coupled with corruption. In spite of some improvements concerning market entry and exit, barriers to entering and leaving product markets are still high.

Moreover, the business environment is characterised by an absence of country-wide recognition of business registration, numerous para-fiscal charges, shortcomings in contract enforcement and the implementation of laws. In addition to the key obstacles identified, the business environment lacks quality support measures for start-ups and export-oriented enterprises. The absence of a single coordinating body at country level results in overlapping and weak budgetary planning for major investments in economic development. Online filing of taxes, e-filing of value-added tax (VAT), and other services such as online filing of social security returns and pensions are either limited or impossible.

The measure aiming to introduce electronic signatures is a welcome development and a direct response to the policy guidance. A law on electronic signatures was adopted in 2006 but is still not implemented**.** A new law on e-signature is planned to be adopted to ensure further alignment with the *acquis*. Some progress was made in the establishment of a certification body in the Ministry of Transport and Communications of Bosnia and Herzegovina, which will deal with certificates for e-signatures. Some implementing provisions were adopted and the recruitment procedure for the new department within the ministry has been initiated. At the same time, the ERP mentions the objective of drafting the new law and bylaws in 2017. However, there is no clarity about the specific timeline that would for instance indicate when members of the public or businesses might be able to use an electronic signature to comply with tax and customs obligations throughout the country. Nor is there any discussion of the impact on budget and competitiveness, social outcomes, or risks and possible actions to mitigate them.

Research and innovation

Bosnia and Herzegovina's growth potential through research, development and innovation (RDI) remains low. This is linked to the very low allocation of funds on research and development (R&D) at a marginal 0.30 % of GDP in 2014 and the very low percentage of R&D personnel in the workforce (0.09 %). The country-wide analysis in this area is weak and identifies no shortcomings, but rather lists desired outcomes. Still, the list hints at a number of problems that affect competitiveness, including low expenditure on science and technological development, the insufficient capacity of companies to adopt new solutions, the lack of streamlining of science, research and development projects, the weak capacity of public science and research institutes and the lack of cooperation between universities and industry. Moreover, it hints at the poor state of scientific, research and technological infrastructure (equipment, facilities, systems, laboratories) and poor access to finance for high-tech enterprises. There are only very few innovation policies or strategies at state and entity levels and cooperation between academia and the private sector is either low or non-existent. No measures to address country-wide issues are planned and full support by decision-makers at all levels of government is needed to comprehensively redress the innovation system.

External trade and investment facilitation

The country is one of the least economically integrated in the region, with an export share of 34 % of GDP in 2015, down from 98 % prior to the war. The main areas of concern are a loss of competitiveness due to outdated production facilities, a fragmented domestic market, non-tariff trade barriers such as complex export procedures, the absence of coordinated border controls coupled with weak border infrastructure systems and the absence of a comprehensive approach to meet EU food safety and sanitary and phytosanitary standards. In the latter area, some progress has been achieved but for a limited number of agricultural products only; the veterinary and phytosanitary control framework is still very fragmented and needs to be further aligned with EU standards in order to facilitate export growth. The absence of country-wide strategies for agriculture and rural development, for exports and for quality infrastructure is a further impediment to strengthening the export sector. No country-wide analysis has been included in the ERP.

The measure aimed at accession to World Trade Organisation (WTO) is welcome as it will anchor economic reform and trade liberalisation carried out in the context of Stabilisation and Association Process. However, the necessary legislative changes to comply with WTO requirements are still outstanding. The information provided in the ERP only includes a general state of play without details on specific activities and timelines for finalising the WTO accession process**.** Moreover, no information is provided on budgetary impact, the effects on competitiveness and social outcome, or risks.

Education and skills

Key needs in Bosnia and Herzegovina are to tackle the skills mismatch, to modernise education institutions, and to improve the quality and recognition of qualifications within the country. There is no country-wide analysis in the ERP, partly as a consequence of weak cooperation between responsible bodies. Although employability is a challenge that needs to be tackled, there is no mention of other important issues, such as low levels of participation in preschool education, which is at the bottom among the Western Balkan countries, or the poor quality of pre-university education. Enrolment of students in school programmes with either limited or no labour market demand is a fundamental problem both in secondary and higher education. There is willingness to improve cooperation between education and business, but no systematic effort to institutionalise it. To improve basic education, increase student attainment and boost the overall quality of the education system, the focus needs to be placed on teacher training. Higher priority should be given to offering skills sets that support resilience, adaptability and learning.

While the suggested measure on improving the links between education and the labour market has relevant policy focus, it is unlikely to make a substantial impact. Improved policy monitoring and evaluation, as well as reporting would strengthen the reforms. There is limited information on budgetary and competitiveness impacts, social outcomes and risks and planned mitigating actions. The measure does not envisage any indicators which would enhance its implementation.

Employment and labour markets

The labour market situation in Bosnia and Herzegovina is among the most challenging in the region. Skills mismatch, insufficient job creation, an unsupportive tax wedge as well as weak employment programmes and services are main challenges that result in high and structural unemployment. Young people, women and long-term unemployed are particularly vulnerable. High inactivity and widespread engagement in undeclared work further exacerbate the situation.

Weak implementation capacities prevent substantial impacts from being achieved and reconfirm the need for a serious and rigorous approach to monitoring of the implementation and better coordination between all levels of government. In line with the Reform Agenda, both entities have adopted and implemented new labour legislation. However, it is difficult to establish whether any gains in employment are attributable to increased labour market flexibility.

The ERP measure to improve labour market efficiency includes appropriate activities. Further to the improved targeting of the active labour market policies (ALMPs), reducing the administrative overload of employment offices is a step in the right direction. No strategic action to formalise employment is being put in place. Some actions have been proposed to improve the provision of social assistance, but implementation still has to follow. Increasing incentives to work can be achieved by better linkages between labour market services and social protection systems. There is an agreement that the unsupportive tax wedge should be reduced to improve the business environment and bring about employment, but this should be a result of coordinated actions.

Social inclusion, poverty reduction and equal opportunities

The social protection system is fragmented between the various levels of government. There is inefficiency in both the provision of social assistance and in service provision. The social protection system needs to step up activation, while also helping those most in need. Relatively high social spending is poorly targeted and only has a small redistributive impact. Unequal access to formal education negatively affects employment and social prospects in the future. Poverty and social exclusion particularly affect persons with disabilities, long-term unemployed, women and youth. Women, particularly in rural areas, are in an unfavourable economic and social situation and should be further prioritised, including through employment activation and childcare services. The ERP does not include a country-wide diagnostic of the challenges in the social area.

Improvement of the social situation of the population and of the functioning of the social protection systems will require stronger efforts and coordinated action. There is a recognised need to strengthen eligibility and application of rights, so as to improve targeting of assistance, and to target provision of social services to those who need it most. The key action is to work on the 'mapping' of social benefits. The ERP does not include any country-wide measure to address this need. Efforts are underway to set up a single registry of non-contributory cash benefit users at some levels, but they have not yet progressed significantly. The pace of the reform plans to tackle both sustainability and adequacy of the pension systems has been uneven. If properly implemented, such reform activities may help improve targeting and address the needs of the most vulnerable people through improved data collection, targeting and budgeting.

6.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2016

2016 policy guidance	Summary assessment
PG 1: Improve the quality of public finances: Enhance the growth-friendliness of public spending, among others by increasing public investment, and contain spending for public employment. Improve the targeting of social spending and establish a comprehensive inventory of public sector payment arrears. Furthermore, strengthen the country-wide public debt management capacities, in particular improving cooperation and the flow of information from local data providers to the state level. Set-up of an enforceable rules-based framework to instil discipline at all levels of government	There has been **limited implementation** of PG 1: • The authorities made efforts to contain spending on public sector employment. • Progress has been made on preparing an inventory of public sector payment arrears. However, this was limited to the health sector in the RS. • Limited progress has been made towards improving country-wide debt management capacities • Public investment probably declined in both entities as a percentage of GDP in 2016 (no official data yet). Reason: The authorities had planned to finance investment largely with expected inflows of IMF funds, which were delayed by political disputes between entities. • No significant progress has been made towards better targeting of social spending. • A rules-based framework to instil discipline at all levels of government has been officially established in the RS, but not in other parts of the country.
PG 2: Improve the provision of timely and exhaustive statistics, applying European and international standards, in particular in the area of population statistics, national accounts and government finance statistics. Furthermore, strengthen the provision of data from data providers to producers of official statistics.	There has been **limited implementation** of PG 2: • Results of population and housing census were published on 30 June 2016. According to the final assessment of the International Monitoring Operation (IMO) of October 2016, the census was conducted in compliance with international standards and recommendations. • Limited progress has been made in better aligning national account statistics and government finance statistics. In the area of government finance statistics, one important issue is that the RS does not agree on sector definitions. • The data transmission from data providers to producers of official statistics has not improved significantly.
PG 3: Develop a comprehensive strategy to foster the resolution of non-performing loans by banks, including all relevant stakeholders with a view to reducing risks to financial stability and the real economy. Follow-up on plans to upgrade the legal infrastructure of the financial system and conduct an asset quality review of smaller banking entities. Establish a bank lending and inflation expectations survey in order to better gauge underlying credit and price dynamics.	PG 3 has been **partially implemented.** • No significant progress has been achieved in fostering the resolution of non-performing loans. • Measures have been taken to upgrade the legal infrastructure of the financial system, but no substantial progress has been achieved in conducting asset quality reviews of smaller banking entities. • Concerning the establishment of bank lending and inflation expectations surveys, no

	significant progress has been achieved.
PG 4: Set up a common economic space and systematic coordination mechanisms between all government levels. Adopt a country-wide transport strategy and a country-wide energy strategy in compliance with the country's obligations under the Energy Community Treaty.	There has been **limited implementation** of PG 4: • A coordination mechanism on EU matters was adopted by the Council of Ministers in August 2016. It needs to be properly implemented in order to improve the planning and monitoring of the process of European Integration. • The adoption of a country-wide transport strategy in July 2016 based on related entity strategies is a step forward towards setting up a shared economic area and achieving more systematic coordination between the various levels of government in this sector. • While Working Groups have been established, the country has yet to adopt a country-wide energy sector reform strategy in compliance with the country's obligations under the Energy Community Treaty.
PG 5: Introduce e-payment services on taxation and fully implement the law on electronic signature in order to increase transparency and reduce space for tax evasion, corruption and regulatory complexity.	There has been **limited implementation** of PG 5: • The first steps towards implementing the law on electronic signature were taken. However, apart from the planned elaboration of a new law and bylaws (aligned with EU Regulation no. 910/201) in 2017, information on specific timelines of full implementation of this policy guidance is missing. There is no mention of the impact on the budget and the effect on competitiveness.
PG 6: Reinforce the capacities of the employment services and target active labour market policies in particular to vulnerable youth, women and long-term unemployed. Reduce the unsupportive tax wedge and disincentives for the unemployed and inactive persons to take up formal work. Improve the cooperation between the education system and labour market institutions.	There has been **limited implementation** of PG 6: • Both entities plan to improve the employment offices' intermediary role by relieving them of the administrative burden of dealing with passive measures. However, implementation has not started yet. • Targeting of active labour market policies (ALMPs) per se is good in both entities, but the impacts are low. There is no evaluation of the programmes. More financing is planned for 2017. • Legislative proposals are being drafted in the Federation of Bosnia and Herzegovina to reduce the tax burden on labour. The RS has reduced the tax wedge before and has expressed the intention of further reducing it, pending an agreement between all levels of government. • The Federation of Bosnia and Herzegovina started the procedure of adopting the Law on Single Registry of Non-Contributory Cash Benefit Users to improve better targeting of social contributions. The RS plans to further improve labour inspection. • There has been no substantial progress and further efforts are needed.

6.6. THE 2017 POLICY GUIDANCE

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

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

Brussels, 23 May 2017

[…]

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

1. Enhance the growth-friendliness of public finances; in particular, create fiscal space for public investment by containing spending on public consumption and improving the targeting of social spending. Take steps to reduce public sector payment arrears, including social security contributions.

2. Improve the provision of timely and exhaustive statistics, in particular government finance, national accounts and labour market statistics. Strengthen capacities for consolidated macro-fiscal analysis and planning at country level by enhancing coordination between the various stakeholders and apply the current medium-term fiscal planning instrument in a policy-oriented way. Strengthen the country-wide public debt management capacities at all levels, in particular the cooperation and flow of adequate and full information from all data providers.

3. Follow up on ongoing legislative changes and develop a comprehensive strategy fostering the resolution of NPLs to address the fragilities of bank balance sheets and thus help remove supply-side bottlenecks to credit extension. Strengthen the bank resolution framework by ensuring sufficient coordination among the bodies entrusted with resolution. Establish a bank lending and inflation expectations survey in order to better gauge underlying credit and price dynamics.

4. Adopt a country-wide energy sector reform strategy and a legal framework in compliance with the Energy Community Treaty.

5. Simplify, harmonise and ensure mutual recognition of business registration procedures between entities, including concessions, licensing and allowing branch office registration across entities. Introduce e-payment services on taxation and fully implement the law on electronic signature.

6. Strengthen the employment services to better assist job seekers, in particular youth, women and long-term unemployed. Reduce the tax wedge and reinforce delineation of employment and social policy measures. Increase enrolment in pre-school education. Address skills mismatches by increasing participation in vocational and higher education programmes relevant for labour market needs.

ANNEX: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Economic Reform Programme (ERP) 2017-2019 was adopted by the Council of Ministers of Bosnia and Herzegovina on 25 January 2017 and submitted to the Commission on 31 January 2017. The programme is in line with the government's medium-term fiscal strategy. However, the structural reform section of the ERP does not comply with the programme requirements in that it does not present one coherent country-wide reform programme (diagnostic, measures, public consultation etc.).

Inter-ministerial coordination

The preparation of the ERP was centrally coordinated by the Directorate for Economic Planning (DEP). Two ERP coordinators were appointed from the two entities, the Federation of Bosnia and Herzegovina (FBiH) and the Republika Srpska (RS), and involved the relevant line ministries from each entity. The contributions to the ERP were prepared at entity level, with measures listed by entity, but, like last year, there was no attempt to integrate these into a comprehensive country-wide framework. The ERP input was endorsed by the entity governments. Although coordination efforts within and between entities and with the state and some line ministries at entity and state level did improve and included several coordination meetings, unfortunately this did not result in a single consolidated country-wide ERP text. In particular, section 4 again consists mainly of a combination of the two entities' contributions into one document. Hence, there was no clear national ownership of the exercise and the results of the coordination between the entities and with the state level remained insufficient.

Stakeholder consultation

Unlike last year, a public consultation on the full ERP was held. However, this was done via a website only one week before the deadline for submission to the Commission. This severely limited stakeholders' opportunity to submit comments and effectively made it impossible for the government to take any comments into account. In addition, stakeholder consultations at entity level took place at an earlier stage of the preparation of the programme.

Macroeconomic framework

The programme summarises recent economic developments, but there is still a clear issue of data availability and timeliness. Compared to last year, the macroeconomic scenario is slightly more cautious concerning the country's growth profile. However, the scenario remains optimistic, particularly in terms of its investment projections, given the poor investment climate and the government's reluctance to proceed with investment. The risk analysis is more balanced than last year. The programme only partly complies with the Commission's request to provide an assessment of the medium-term sustainability of the country's external position. The recent macroeconomic performance is adequately described, but does not include the most recent information available at the time of drafting. Overall, the macroeconomic framework is sufficiently comprehensive. However, some key features should have been explained in greater detail. Consistency with other parts of the programme, particularly with the fiscal framework, is still limited.

Fiscal framework

The fiscal framework is still poorly integrated: in particular, the public sector's investment plans are insufficiently linked to the macroeconomic framework, and it remains largely silent on the links between public revenue/spending and structural reform, presented in section 4. The chosen policy approach, i.e. a marked reduction in revenue and spending, may be consistent with the objective of reducing the role of the state in the economy. However, the reasons for this policy choice are not sufficiently explained. Furthermore, there are hardly any references either to any other policy objectives discussed in other parts of the programme or to the Commission assessment in the 2016 Country Report. In addition, the ERP would have greatly benefited from quantifying some of the measures briefly mentioned. The compilation and presentation of fiscal data is not in line with the European System of National Accounts (ESA 2010), and the programme does not present a road map for aligning the country's statistical system with EU standards or for submitting a fiscal notification.

Structural reforms

The section on structural reform priorities does not follow the guidance note in that it does not contain country-wide area diagnostics and reform measures. Instead, the text comprises mainly separate inputs for each entity under the nine area headings. The analysis of key obstacles by entity does not match the guidance note for the Economic Reform Programmes, which clearly states that the section on structural reform priorities is to provide a concise overview of the main structural obstacles to competitiveness and growth at country-wide level (i.e. not at entity level).

In the ERP 2018-2020, the entity contributions should be used as input to the ERP, but the final ERP needs to be presented as one programme for the whole of Bosnia and Herzegovina, with one list of key obstacles and country-wide measures for each area, even if responsibilities for implementation lies at lower levels of government. It is particularly regrettable that the ERP failed to use the Reform Agenda adopted in July 2015 as a good basis for a country-wide diagnostics and strategy to boost growth and competitiveness, nor for reporting on the implementation of the policy guidance. In all, there are 33 reforms, far exceeding the maximum of 20. At the same time, these 33 measures mostly consist of extensive collective sets of measures rather than a single focused or prioritised measure. The page limit of 40 pages for section 4 has been exceeded.

The description of the reform measures is not detailed enough in terms of specific actions and timelines to allow the measures to be easily monitored annually. Some of the measures are covered at this level of detail, but most are not. Tables 10-12 in the Annex have been partly filled in, but each table is subsequently divided in state and entity tables. Table 11 should have contained more detailed timelines and descriptions of activities by year.

7. KOSOVO*

7.1. EXECUTIVE SUMMARY

Kosovo's* economic growth remained strong in 2016 and will likely continue in the upcoming period. The baseline scenario of the economic reform programme (ERP) is broadly realistic, and forecasts an average GDP growth of 3.9% in 2017-2019, in line with the long-term average. Due to low employment and a narrow production base, stronger private consumption growth is expected to be underpinned by the steady growth of diaspora remittances. The ERP's ambitious forecast of investment growth hinges on the execution of planned increases in budget capital spending, and the finalisation of a deal to construct a major new power plant. The growth contribution of public consumption will remain subdued due to Kosovo's limited fiscal capacity following recent increases in categorical benefits. The main downside risks to the outlook arise from possible political shocks and limited capacities to implement projects at the central and local government level.

The 2017 budget projections, made in cooperation with the International Monetary Fund (IMF), are broadly realistic and in line with the baseline ERP scenario. Revenue is expected to increase strongly in 2017 despite some announced tax exceptions. The envisaged large expansion of expenditure is driven by a substantial increase in capital spending while limits have been introduced on current expenditure increases. The overall deficit is projected to be around 4% of GDP throughout the forecasting period; however the adjusted deficit is expected to stay below the 2% threshold when capital projects financed by international financial institutions (IFIs) and the proceeds of privatisation are deducted, according to the exceptions in the fiscal rule, The fiscal risks identified relate to underperformance of revenue and persistent pressure from large interest groups for increases in entitlements and transfers.

The main challenges facing Kosovo include the following:

- **The mechanisms to monitor budget execution and enforce fiscal rules are weak, and the macro-fiscal framework preparation process is exposed to political influences.** With the addition of a new expenditure rule, setting up proper fiscal monitoring and enforcement mechanisms becomes even more important. Attempts to curb the rise in current expenditure have been limited to introducing ceilings for particular spending items. With limited room for further increases, rising pressures from social groups for new transfers, and the rising maintenance costs of newly built infrastructure, Kosovo needs to contain the rise in current expenditure and preserve the share of capital spending. Furthermore, prudent fiscal policy-making is hindered by the lack of capacities in existing institutions in charge of budget planning, macro-fiscal forecasting and fiscal oversight.

- **Given plans to significantly boost public investment, building up capacity for capital project management, planning and public procurement is becoming increasingly necessary.** The capital investment budget has been consistently under-utilised (on average by 15%) both at central and local government level. Capital spending execution is substantially lower for projects funded by the IFIs showing limited government capacity for managing multiple smaller projects and carrying out more detailed and cumbersome procedures. The expected large IFI supported public investment growth will not materialise unless government capacities are increased.

*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.

- **Kosovo's business environment is seriously hampered by the large informal economy**. Registered businesses continue to experience unfair competition from unregistered ones and problems with accessing finance, thus hampering their ability to grow and innovate. Undeclared turnover and work also have negative effects on public revenue collection and workers' rights. The ERP recognises the informal economy as a problem, but the proposed measures fall short of addressing it in a comprehensive manner.
- **An unreliable energy supply is the main constraint to the development of Kosovo's private sector.** The ERP recognises this and proposes a mix of reforms to overcome it, including new investments in power generation (thermal and renewable sources). This should make it possible to close the most outdated and highly polluting thermal power plant. Combined with much-needed energy efficiency reforms, this would help to address the identified problem. However, energy efficiency measures will have only a limited impact if the private and residential sectors are not covered by the reforms and if energy tariffs are not adjusted to reflect costs.
- **Sluggish job creation is not sufficient for the labour market integration of the increasing working age population, and low skills levels resulting from a weak education system are core constraints to raising prosperity levels of the population.** Continued economic growth in Kosovo has so far not resulted in a substantial increase in employment, as more than half of the working age population is inactive. Women are largely absent from the labour market, and very few young people are in work. Reforms in the education system aimed at improving the quality of teaching and adjusting vocational education and training to labour market needs have started. Labour market institutions, in particular the public employment services, are being built up, but have very limited capacity to provide services and active labour market measures. The social protection system is in an early stage of development with focus on implementing a universal health care system.

The policy guidance jointly adopted at the Economic and Financial Dialogue of 25 May 2016 has been partially implemented. Capacity constraints still hinder macroeconomic forecasting and budget planning, while the process of establishing a fiscal council has not yet moved beyond discussions. Some steps have been taken to contain current spending, and the share of capital spending rose slightly in 2016 with further increases due in 2017. Some initial steps to fight the informal economy have been taken. The Strategy implementation reports for 2015 and 2016 have been finalised after a 2-year gap in reporting. On energy, some positive steps were taken towards the liberalisation of the electricity market, including setting deadlines for the deregulation of prices for commercial consumers. However, no significant energy efficiency measures have been adopted for the private sector. The action plan for tackling youth unemployment has not yet been developed, and the implementation of measures to increase labour market participation of women is delayed. The structural reform measures planned in the 2016 ERP were only partially implemented.

In line with priorities identified by the European Commission in its assessment of last year's ERP, the 2017-2019 ERP reiterates the government's commitment to stable public finances and preserving the share of capital spending. However, recently enacted or announced fiscal policy measures are not always aligned with those goals. The structural obstacles to competitiveness and the reform measures identified in the ERP largely match the analysis of the European Commission. It highlights issues related to access to finance, contract enforcement, informal economy, business regulations, the electricity supply, transport, quality of education and skills gap, low labour market participation and employment. More measures are envisaged to be taken in areas with particular weaknesses and/or potential, including energy, agriculture, the business environment, foreign trade and education and skills. However, more focus should have been put on social inclusion, reduction of poverty and creating equal opportunities.

7.2. ECONOMIC OUTLOOK AND RISKS

Economic growth continues to be strong, underpinned by domestic demand, while exports stagnate. Following higher than expected growth in 2015 (4% of GDP), the Kosovo economy continued growing in 2016 at 3.4%, a pace close to its 10-year average of 3.6%. Household consumption remains the largest contributor to GDP growth, driven by strong consumer lending and rising disposable income due to lower energy prices. The strong growth in capital formation was primarily driven by public road investments. Private investments have been held back by a still difficult business climate and by limited, although improving, access to financing for private enterprises. Large infrastructure projects have led to rising imports, especially of heavy machinery and transport equipment. At the same time, exports stagnated as Kosovo's metal exporters struggled to find new export markets and faced low world metal prices. This means that net exports have continued to be a drag on growth.

The continuation of robust GDP growth in 2016 conceals the poor aggregate productivity growth. In 2016 gross value added (GVA) growth was at the lowest level since 2009 (1.6% y-o-y). Productivity stagnation was quite broad-based with only tourism, financial services showing signs of large productivity gains. Productivity in agriculture increased following a large contraction in 2015 but the sector is still underdeveloped due to inadequate investment and ineffective agricultural subsidies. Poorly diversified manufacturing sector recorded declines in productivity due to lower output amid falling demand for metals exports. The difference between the growth of GVA and GDP (1.8 pps) is filled by the net taxes category, reflecting full year effects of VAT and excise increases, and improvements in tax collection.

Table 1:

Macroeconomic developments and forecasts

	2015	2016	2017	2018	2019
Real GDP (% change)	4.0	3.8	4.5	3.3	3.8
Contributions:					
- Final domestic demand	4.9	7.0	6.9	3.9	4.9
- Change in inventories	0.2	0.0	0.1	0.7	0.1
- External balance of goods and services	-1.1	-3.3	-2.5	-1.3	-1.3
Employment (% change)	-8.2	8.0	4.0	4.0	4.0
Unemployment rate (%) LFS	32.9	:	:	:	:
GDP deflator (% change)	-0.3	0.7	1.7	1.4	1.2
CPI inflation (%)	-0.5	0.0	0.9	0.6	0.7
Current account balance (% of GDP)	-8.9	-11.0	-11.6	-11.4	-11.4

Sources: Economic Reform Programme (ERP) 2017

The ERP 2017-2019 projects some moderation of growth compared to the previous years' programme. Following the continued growth in 2016, GDP growth is expected to strengthen again in 2017 to 4.5%, before easing off to around 3.6% in 2018/2019. Private consumption growth is projected to continue, providing the biggest contribution to GDP. It is expected to grow by 3.8% on average over 2017-2019, underpinned by stronger consumer lending and expected improvements in the labour market. Public consumption is set to remain subdued as a result of rules regulating increases in public current expenditure. Investment growth is projected to further accelerate in 2017 (14.9% y-o-y), supported by several new public investment projects financed by the IFIs. Investment growth is expected to taper off later in the forecasting period as fiscal space for new investments is depleted and private investments struggle to gain pace. Owing to Kosovo's narrow export base, the recovery of export growth, which is expected to average 3.5% in 2017-2019, will primarily depend on external demand for metals, despite signs of stronger service exports. Import growth is set to average at 4.7% during this period, reflecting strong investments trend with a substantial import component. On the production side the services sector is projected to grow by 4.3% over 2017-2019, driven by trade, transport and IT. The industry sector is expected to recover (5.6% average growth in 2017-2019) following a contraction in 2016. However, it remains reliant on low-value-added production of metals and constrained by the shortage of high-skilled labour force. The construction sector is largely dependent on large public investment projects and is expected to grow by 4.7% throughout 2017-2019. Expected growth in agriculture (2.6% on average) is not seen as particularly significant, especially following continuation of agricultural subsidies and several announced initiatives for improving the sector's competitiveness.

The ERP's broadly plausible growth scenario is in line with Kosovo's long-term averages, but faces a number of downside risks related to lower investment, energy security, fiscal stability, and political instability. The main downside risk to growth will come from lower than planned execution of capital spending financed under the two exceptions under the fiscal rule. Kosovo's administration has so far struggled to absorb funds from IFIs due to low administrative capacity. The planned amount of new IFI-supported capital spending is several times larger than the overall disbursement by IFIs in 2016 (EUR 10 million). Furthermore the government has often overestimated the funds expected from privatisation and liquidations (EUR 277 million expected in 2017-2019). Lower investment expectations, especially in 2017, are reflected in somewhat less optimistic growth forecasts from the IMF and the World Bank (3.5% and 3.9% respectively). As Kosovo's electricity production capacities are prone to malfunctions, a large production disturbance would raise energy import needs, harming the financial performance of electricity production and distribution companies and would requiring a substantial increase in state energy subsidies (0.7% of GDP increase). Risks of delays and backtracking of reforms and ad hoc increases in current spending also remain significant, especially following the expected end of the IMF Stand-By Arrangement (SBA) in August 2017. Furthermore, political instability could further undermine a business environment already struggling with an inefficient judiciary, weak contract enforcement, a widespread informal economy, and an inefficient and unaccountable public administration. This makes it harder for private sector to become more dynamic and resilient private sector development. The ERP contains a full account of downside risks, but the quantification of their impact on growth and public finances seems overly optimistic, lowering average growth by 1.1 pps with only limited fiscal impact.

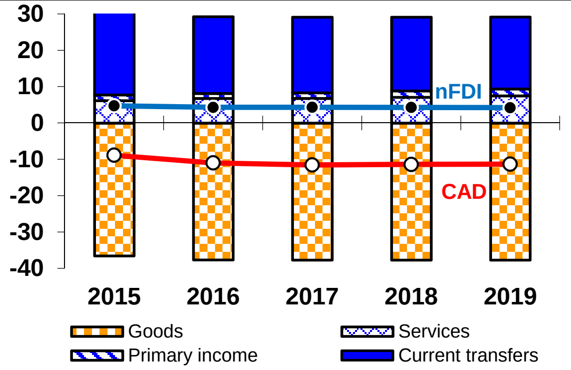
The construction of new electricity production capacities and higher private investment growth are upside risks, although these are less likely to materialise. The new power plant investment project, worth EUR 1 billion (15.6% of GDP) spread over 5 years seems to be in the final stages of preparation and is expected to start in 2018. However, the project was already delayed several times due to disagreements between the government, IFIs and the investor, in particular over the price of electricity and the return on the investment. Another upside risk comes from stronger private investments following the adoption of the second fiscal reform package. However, its impact will likely be marginal given the narrow scope of the measures planned.

Kosovo remains heavily dependent on price developments in its main trading partners, namely the EU. The trend of decreasing price level that started at the end of 2014, seems to be bottoming out as the CPI price level increased slightly in 2016 (0.3% y-o-y). However, food and energy prices were slowly recovering towards the end of the year. Inflation in Kosovo is expected to remain around 1% throughout 2017-2019. This appears slightly underestimated given improving inflation prospects in the main trading partners, the EU and Central European Free Trade Agreement (CEFTA) countries, consumer price inflation (CPI).

Kosovo's weak and unproductive economic base translates into strong import dependence and a significant current account deficit. Kosovo's exports are mostly metals, minerals and low-value added products, heavily dependent on world commodity prices. In 2016 the current account deficit widened to around 9.4% of GDP, mainly as a result of lower income balance and government transfers. Current account balance is expected to deteriorate further throughout the forecasting period to around 11% of GDP due to deterioration of the trade balance. The import component of stronger domestic demand will remain substantial, as development of domestic production capacities is progressing slowly.

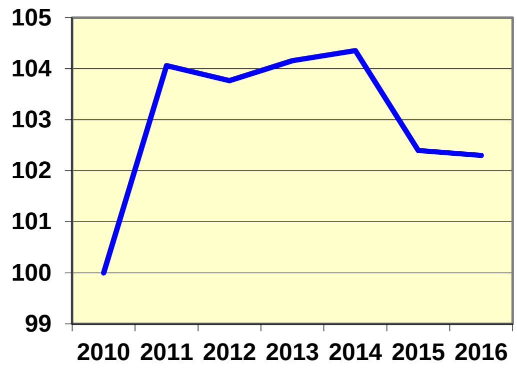
Graph 1: **External competitiveness and the current account**

Change in the current account balance
(% of GDP)



Source: Economic Reform Programme (ERP) 2017
Note: Figures for 2015 and 2016 do not respond to the revised figures by the Kosovo Central Bank which are reported in the text

Real effective exchange rate
(CPI-based, total economy, 2009=100)



Source: ERP 2017-2019

The financing of the current account remains heavily dependent on unrecorded flows and volatile inflows of net foreign direct investment (FDI). In 2016 net FDI inflow decreased to 3.3% of GDP. However, the structure of FDI inflows remained largely the same, with real estate and construction taking up almost 90% of total FDI inflows. Changing this pattern towards greenfield investments in tradable production sectors will require broad-based reforms to strengthen protection of property rights, improve human capital and establish a stable electricity supply. The Stabilisation and Association Agreement (SAA) with the EU, in force since April 2016, should also raise Kosovo's profile among investors.

Despite continued growth, Kosovo's labour market conditions remain a serious concern. In 2015 the sharp drop in employment, despite stronger growth, coincided with a large wave of emigration, but employment likely rebounded in 2016. The ERP optimistically expects employment to continue increasing on average by 4% over the forecasting period. This will not be enough to absorb the large inflow to the labour force (2% annually) and substantially reduce already high unemployment (27.5% in the third quarter of 2016) or increase the abysmally low participation rate (40.2% in the third quarter of 2016). The ERP again does not provide forecasts for unemployment or activity rates; however drastic changes can hardly be expected. The proportion of long-term and unemployed young people is likely to remain high. ,. Due to the poor quality of education and low overall skills level in the labour force, a substantial skills premium for skilled workers is observed across all sectors and professions. Furthermore, the ‘Dutch disease’ effect of the large inflow of remittances increases the wage reservation level and discourages labour force participation. Labour productivity is projected to remain flat (-0.1% growth on average) despite expected low growth of wages.

Table 2:

Financial sector indicators

	2012	2013	2014	2015	2016
Total assets of the banking system, mEUR	2,830	3,059	3,187	3,387	3,637
Credit growth	3.8	2.4	4.2	7.3	10.4
Bank loans to the private sector %	52.6	50.5	44.9	41.5	40.0
Deposit growth	8.3	7.5	3.6	6.5	7.2
Loan to deposit ratio	80.7	78.0	74.9	75.3	78.4
Financial soundness indicators					
- non-performing loans	7.5	8.7	8.3	6.2	4.9
- net capital to risk weighted assets	14.2	16.8	17.8	19.0	17.9
- liquid assets to short-term liabilities	39.1	48.0	43.6	44.9	41.5
- return on equity	*7.1*	*9.4*	*20.2*	*26.4*	*18.5*
- forex loans to total loans	0	0	0	0	0

Sources: National Central Bank, DataInsight

The banking sector remains stable, liquid and profitable, but also heavily under-utilised. Credit growth in 2016 (10.4%) was driven by stronger demand, especially by households. Lower lending standards and decreased interest rates helped increase overall demand for loans. Despite falling revenue (-3%), the banking sector remained profitable (18.5% return on equity) and strengthened its portfolio quality (4.9% non-performing loans). The loans- to-deposit ratio and the bank-loan-to-GDP ratio stood at 76.9% and 37.1%, respectively, indicating ample potential space for further financial intermediation. Unfortunately the ERP scenario does not provide specific numbers on developments in the financial sector in the forecasting period. It can be assumed that stronger credit growth would resume as private consumption and investment are expected to be the main drivers of growth.

7.3. PUBLIC FINANCE

In 2016, public finances benefited from strong revenue performance, while spending composition slightly improved despite hasty introduction of new categorical benefits. The initial 2016 budget was prepared under the IMF stand-by arrangement and thus provided realistic estimates of both revenue and expenditure. It was revised in July 2016 due to the introduction of new spending categories, although with little change to headline figures. Compared to 2015, budget revenue grew by 8.6% in 2016, driven by strong growth in tax revenues, due to the full year effect of the 2015 policy changes to VAT and border excise. Increased economic activity, higher company profits and rising employment also strengthened collection of corporate and personal income taxes while debtors took advantage of incentives derived from the law on debt forgiveness to increase collection of more recent property tax arrears. As expected, customs revenue decreased slightly due to application of the SAA with the EU since April 2016. Overall budget expenditure was 6% higher than in 2015. After 2 years of growth, current expenditure as a share of total spending fell in 2016 to 73.2%, from 74.2% in 2015. The reduction current spending's share came despite the introduction of pensions for war veterans and initial ballooning of the programme's costs. Despite overall reasonable execution of capital spending (88.7%), lower than planned collection of municipal own-source revenues depressed capital spending at local level. The overall deficit stood at only 1.3% of GDP or 0.9% of GDP when calculated according to the fiscal rule, well below the 2% threshold.

Ensuring medium-term sustainability of public finance and strengthening growth friendly capital spending are Kosovo's main public finance objectives in 2017-2019. Kosovo's budget has always been characterised by the large share of capital spending, reflecting its large investment needs. Nevertheless, current expenditure has recently been growing in share, as Kosovo built its institutions and introduced new, not always targeted, social policies. Short sided, ad-hoc rises in public wages, pensions and other transfers to specific interest groups, further squeezed the share of capital spending. To strengthen fiscal stability and preserve capital spending Kosovo has introduced several rules-based mechanisms. The fiscal rule implemented since 2014 limits the deficit to 2% of GDP and the law on public debt sets the long-term public debt level ceiling at 40% of GDP. The amendment to the fiscal rule, known as the "investment clause", was adopted by Assembly to expand fiscal space in the short term. This makes it possible to exclude new donor-financed capital projects from the headline deficit, as long as debt level is below 30% of GDP. Furthermore, capital investment financed by privatisation proceeds was already exempt from the headline deficit provided that the government deposits amount to at least 4.5% of GDP. To limit the rise of current expenditure and align unit labour costs to productivity growth, starting in 2018, a rule governing rises in the budget wage bill will be implemented, limiting its annual growth to that of nominal GDP.

Table 3:

Composition of the budgetary adjustment (% of GDP)

	2015	2016	2017	2018	2019	Change: 2016-19
Revenues	25.5	26.6	26.9	26.7	26.8	0.2
- Taxes and social security contributions	22.6	24.3	24.1	24.2	24.4	0.1
- Other (residual)	2.9	2.4	2.8	2.5	2.4	0.0
Expenditure	27.1	27.7	31.2	30.7	30.6	2.9
- Primary expenditure	26.8	27.4	30.9	30.3	30.2	2.8
of which:						
Gross fixed capital formation	7.0	7.4	11.3	11.2	11.5	4.1
Consumption	12.7	12.4	12.4	12.3	12.1	-0.3
Transfers & subsidies	7.2	7.9	7.4	7.1	7.0	-0.9
Other (residual)	-0.1	-0.2	-0.2	-0.4	-0.4	-0.2
- Interest payments	0.3	0.3	0.4	0.5	0.4	0.1
Budget balance	-1.6	-1.1	-4.3	-4.0	-3.8	-2.7
Budget balance as per fiscal rule	-1.4	0.9	-1.5	-1.4	-1.2	-2.1
Primary balance	-1.3	-0.7	-4.0	-3.6	-3.4	-2.6
Gross debt level	13.0	14.2	17.9	20.4	22.0	7.8

Sources: Economic Reform Programme (ERP) 2017, ECFIN calculations

The revenue projections for 2017 are ambitious but become more realistic in 2018-2019. The 2017 budget, adopted by the assembly in December 2016, aims at a fiscal deficit of EUR 97 million or 1.5% of GDP[2], in line with the fiscal rule. The budget is based on nominal GDP growth of 6.3% in 2017 and CPI inflation of 0.9%. Total revenue is expected to be EUR 1.73 billion, 7.5% higher than in 2016. The increase should result mainly from stronger economic growth, planned changes to tobacco excises and improvements in revenue collection. Although taxes collected at the border currently account for most of the budget revenue, the further implementation of the SAA with the EU will gradually lead to a shift towards domestically collected taxes. The largest contribution to growth of revenue is expected to come from VAT (7.8 growth y-o-y). This is due to rising domestic demand as well as collection of delayed VAT payments for imported lines of production introduced in September 2015. Somewhat puzzling is the

2 This figure refers to the deficit calculated according to the fiscal rule

expected high contribution from the growth of non-tax revenue. The collection of these revenues at both central and local level was poor in 2016 (80.9%), but the 2017 budget still expects an increase in collection of 0.5% of GDP. Revenue forecasts for 2018 and 2019 are set to closely follow nominal GDP growth.

The 2017 budget makes provision for strong fiscal expansion through new capital investment spending. However, full execution of the planned investment spending remains unlikely. Expenditure is forecast at EUR 2 billion in 2016, 20.8% higher than in 2016. Current expenditure is expected to increase by 5.1%, assuming the amount available for war veteran's pensions is limited to 0.7% of GDP and the government keeps to its commitment to limit overall spending on war veterans' benefits to 1.25% of GDP. A substantial increase in goods and services spending (11.5% y/y) is not explained in detail. Kosovo should however, improve its maintenance of existing infrastructure to avoid higher costs in the future. Budget capital spending is ambitiously planned to increase by 62.8% in 2017. The increase is largely due to projects financed by IFIs (1.7% of GDP) and privatisation proceeds (1.4% of GDP). Kosovo has so far constantly underspent its investment budget due to limited administrative capacity, especially when more stringent procurement and multi-year planning procedures are required as in projects financed by IFIs. Moreover, the projects identified for funding under these schemes are in different stages of preparation. Therefore the proposed investment spending plan will likely be spread across a longer period resulting in lower overall growth of expenditure. In 2018 and 2019 overall expenditure growth is expected to remain subdued, growing 3.9% on average.

The risks to the ERP fiscal policy scenario are present in 2017. The IMF programme was delayed in 2016 due to the higher than expected costs of the war veteran pension scheme. The second and third reviews of the programme were merged, delaying disbursement of the associated tranches of the loan. The total amount available for war veterns' benefits was limited to 1.25% in the 2017 budget. Additionally the annual cost of war veteran's pension scheme was limited to 0.7% of GDP, and an independent commission to reviewing the lists of eligible war veterans was set up. Following the fulfilment of the prior actions the IMF board finally approved the second and third review if the SBA in March 2017. To complete the fourth review of the programme the government will need to reform the war disability pension scheme to help limit the overall war veteran related spending to 1.25% of GDP. To help limit overall expenditure on war veteran pensions the government has committed to quickly complete the war veteran reclassification process. If revenue growth is lower than expected, the capital budget will likely be used as a buffer as potential savings on the current expenditure side are limited and substantial cost-cutting reforms are unlikely given the possible early elections. Political risk remains pronounced, especially if there are early elections, during which fiscal stability could be endangered by the propensity of political elites to ingratiate themselves with large interest groups such as public-sector employees, pensioners and war veterans through ad hoc increases of benefits. The absence of a policy anchor after the completion of the IMF programme in August 2017 could result in a period of uncertainty in the second half of 2017 when the 2017 budget revision could come under pressure from groups with a vested interest in increasing wages, before the ‘wage rule’ comes into force in 2018. The preparation of the new law on salaries paid from the budget will need to be monitored closely. The law should be part of a broad reform package prepared, inter alia, to remodel wage policy in Kosovo's public sector using more equitable and efficient principles, but could provide the basis for another major increase in public-sector wages. This would not only undermine the whole reform but also substantially deteriorate public finance stability.

Table 4:

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

	2015	2016	2017	2018	2019
Gross debt ratio [1]	**13.0**	**14.2**	**17.9**	**20.4**	**22.0**
Change in the ratio	2.5	1.5	3.6	2.5	1.6
Contributions [2]:					
1. Primary balance	**1.8**	**1.7**	**1.5**	**1.6**	**1.6**
2. “Snow-ball” effect	**-0.1**	**-0.2**	**-0.5**	**-0.4**	**-0.5**
Of which:					
Interest expenditure	0.3	0.3	0.4	0.5	0.4
Growth effect	-0.4	-0.5	-0.6	-0.6	-0.7
Inflation effect	0.0	-0.1	-0.2	-0.2	-0.2
3. Stock-flow adjustment	**0.8**	**-0.1**	**2.6**	**1.3**	**0.5**

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual

Source: Economic Reform Programme (ERP) 2017; ECFIN calculations

Announced policy changes are few and vaguely presented. As a potential policy change on the revenue side the ERP mentions the adoption of the *second fiscal reform package*. Among other things, the package tries to address the cash flow problems companies' face when importing production inputs or investment goods due to the nature of Kosovo's customs system. The package (i) makes provision for amendments to the list of products subject to a 0% or reduced 8% VAT rate; (ii) expands the list of products exempted from customs duties and excise; (iii) introduces tax holidays for new businesses. While the first fiscal reform package adopted in 2015 was justified as a part of the IMF-supported fiscal consolidation efforts, this package constitutes a clear fiscal easing. Furthermore, proposed measures do not solve the cause of the cash flow problem for companies and would create unequal treatment of businesses in different sectors. The package was not agreed with the IMF and was not incorporated in the 2017 budget revenue projections. The announced merger of the tax administration and customs authorities will not likely happen in 2017. The expected high savings and increases in productivity due to the merger seem unsubstantiated. Nevertheless the merger should be carried out in a transparent way with a clear action plan. The risk of political interference is likely to be significant. A mandatory health insurance system is expected to be introduced in Kosovo in July 2017. Some EUR 17 million was budgeted for 2017. However the full year cost will likely be higher as the budget cost of covering vulnerable categories is not yet known.

The institutional public finance framework is not complete. Kosovo's fiscal policy is characterised by repeated ad hoc decision-making with significant budget impact, such as commitments to large infrastructure projects and across-the-board increases in wages, pensions and other entitlements, especially in pre-election periods. The main purpose of the fiscal framework should be to limit and discourage such practices. Kosovo's fiscal framework consists of a combination of expenditure, deficit and debt rules. The credibility of the framework is questionable as the rules are often amended with new exceptions or supplemented with limits on specific spending categories. Furthermore the framework lacks strong enforcement and monitoring mechanisms. Institutions with some oversight duties over budget preparation and execution lack capacities and resources.

Public debt is low but remains sensitive to refinancing and fiscal shocks. At the end of 2016 public debt and issued guarantees stood at 14.5 % of GDP. This was 1.5 pps higher than in 2015. Around 56% of the debt is domestically issued, in the form of short-maturity treasury bills and bonds, while the rest is mainly held by the IFIs. Due to a large increase in investment spending, which is not counted in the official deficit numbers, the budget's net financing needs will be on average 4.5% over the forecasting period. The debt level is expected to reach 22% of GDP by 2019. The average weighted interest rate (2.6% in 2016) is projected to slightly increase in 2017 to 2.7%, before easing in 2019 to 2.2%. Total financing needs are highest in 2017 (10.8% of GDP) and fall gradually to 7.7% of GDP in 2019. Higher external borrowing in 2017 is due to the disbursement of the final tranches of the IMF programme and the onset of the borrowing from the IFIs on the basis of the 'investment clause'. However low administrative capacity for project preparation and management, and a requirement for the approval of a two thirds majority in the Kosovo Assembly of any external borrowing may delay disbursement from the IFIs planned for 2017. Domestic debt is still dominated by shorter maturity bonds and treasury bills, although the average maturity has been increasing gradually (15 months at end 2016). Kosovo still does not have access to international debt markets due to the lack of internationally credit rating and relatively large fixed costs of issuing debt internationally. To provide an additional financing buffer in case of emergency, the government deposits were replenished towards the level implied by the fiscal rule (4.5% of GDP) following the disbursement of the second and third tranche of the IMF loan. The long-term public debt sustainability analysis presented in the ERP highlights Kosovo's limited room for deviations from the fiscal rule.

7.4. STRUCTURAL REFORMS

There has been a significant improvement in the structural reforms part of the ERP. The ERP properly identifies key obstacles to improving competitiveness, employment and social development and the measures proposed respond to the challenges identified to a large extent. The ERP's analysis is consistent with the Commission's assessment of key competitiveness obstacles, and the findings of the Commission's assessment of the 2016 ERP have been used to draft the measures included in this year's programme.

The 20 reform measures included are spread across the nine different areas reflecting well the overall weak competitiveness of Kosovo's economy. Some areas are given more focus by including more than one measure, including the energy market, agricultural sector, business environment and informal economy (five measures), external trade, and education and skills. This is broadly justified by the severity of problems and/or the sector's potential. There is a good mix of legislative, administrative, grant-based and infrastructure reforms without overemphasising infrastructure but rather looking at genuine structural reforms. Budget contributions are planned for all but one measure, showing strong government commitment to the content of the reforms. Most, but not all, measures are co-financed by IFIs or donors.

Among the main obstacles to competitiveness and growth are an unreliable, and health hazardous energy supply, a very large informal economy (estimated at 39% of GDP) and the low work intensity of the economy due to the lack of jobs and low skills level. The energy sector suffers from outdated production capacity, low energy efficiency, a non-liberalised energy market and a tariff system that does not reflect real costs. The informal economy distorts competition, and reduces public revenue collection and workers' rights. Moreover, unregistered small and medium-sized enterprises (SMEs) do not have the same access to financing as registered ones. The inadequate pace of job creation has led to very high unemployment and an inactive young population. Last year's policy guidance covered these areas specifically, but they have been only partially addressed.

Public finance management (PFM)

Kosovo's public procurement is characterised by low transparency, giving rise to corruption and inhibiting competition. The ERP identifies that the lack of transparency in public procurement excludes SMEs from competition for public contracts and reduces confidence in state institutions. The ERP highlights weak capacity of public procurement bodies, insufficient monitoring and enforcement, and not fully functional remedy system as remaining challenges in this area. The analysis lacks, however, a wider overview of PFM.

The measure aimed to establish an electronic public procurement will help reduce costs and increase transparency. Some advances were made in the legal framework with the adoption of the new public procurement law in 2016. However the weaknesses in the Central Procurement Agency were preventing the swift application of the electronic procurement. Continuing the further development of the electronic procurement, as proposed in the ERP, is consistent with the area diagnostic and Kosovo's PFM reform programme. It links with the goal of improving the capacity of the central procurement agency and public review body (PRB), monitoring the contract and market prices, and publishing all PRB decisions identified in the National Strategy and Action Plan on Public Procurement. It is not clear if all the proposed actions (i.e. IT systems and awareness-raising) will have the necessary budget allocation. Moreover, to have the expected impact, the measure would require awareness-raising, and digital skills capacity building activities for SMEs in Kosovo to fully access and use e-procurement.

Transport, energy and telecommunications markets

Kosovo's competitiveness is severely hampered by the unreliable energy supply and dysfunctional energy market, and the existing transport infrastructure is poorly maintained. Available energy production capacities are highly polluting and prone to malfunctions, while distribution is characterised by large losses due to poor infrastructure. Lack of investments in energy efficiency further increases the cost of energy. The energy market is not functioning on free market principles and existing tariff subsidies cause a fiscal risk. The ERP highlights the inadequacy of roads and railway networks as main weaknesses in the transport sector but does not cover more structural challenges related to the regulation of the network markets. The refocus of this year's ERP away from transport infrastructure measures (which are supported in the context of the EU-led Connectivity agenda), towards more structural obstacles to competitiveness related to the business environment and skills is thus welcome. The ERP points to the unbalanced distribution of information and communications technology (ICT) infrastructure as the main obstacle to the development of the telecommunication market. This is, however, also very much compounded by a lack of ICT skills, and insufficient competition in this area.

The measures on energy are clearly relevant although it is not clear if they are aligned with the reforms included in the Energy Strategy. Progress in 2016 was mainly limited to legislative measures and the introduction of some energy efficiency measures. Foreseen energy efficiency investments still focus exclusively on public buildings, ignoring the residential sector, the largest consumer of energy in Kosovo; this shortcoming of the ERP was highlighted in the 2016 policy guidance. The measure is unlikely to have the expected impact unless the reform also tackles regulatory barriers, municipalities' limited access to credit to adopt energy efficiency measures and the absence of a sustainable energy efficiency financing mechanism in Kosovo.

The measure to further develop energy generation capacity is rolled over from the 2016-2018 ERP and responds to a clear need. However, most of the work planned for 2016 was not done (only the feasibility study for the rehabilitation of Kosovo B thermal power plant has started). The cost estimates of the new planned actions (1 new coal powered thermal power plant, 3 solar, 20 hydropower and 2 wind power plants) are very rough, and without a clear regulatory framework. Moreover, serious risks relating to the process of construction of the different generation plants, and the risks of importing electricity, are underestimated or not mentioned at all.

The measure to extend the ICT network infrastructure is rolled over from the 2016-2018 ERP and is still relevant. Very limited progress was made in the implementation of this reform in 2016 (the timeline was not clear in the previous ERP). The first component of the programme for Kosovo's Digital Economy (KODE) was put on the priority investments list, for which there is a derogation from the fiscal rule. Last year's ERP assessment highlighted the need to complement infrastructure investments with an adequate supply of educated computer engineers, increased competition between operators and independence of the regulator. However, none of these issues have been considered in this year's ERP. Moreover, Kosovo should review the definition of broadband in the KODE (from 512 kbps to e.g. 10-30 Mbps or higher) and specify the targeted penetration rate. To have the intended impact in terms of improvement of access to international markets, development of new business models and increased GDP growth, the measure should target not only ICT businesses but also traditional industries to help them with innovation and competitiveness. This should encompass support for the development of e-skills at different levels, from primary schools to vocational training.

Sector development

Agricultural sector development

Kosovo's agriculture sector suffers from low productivity which contributes to the widespread poverty in rural areas. The ERP's diagnostic highlights the fragmentation of agricultural land, the small size of farms and outdated farm technologies, the absence of modern agricultural skills, the lack of investment in irrigation and the lack of diversification of agricultural products as main obstacles to the sector's competitiveness.

In this context, the measures on investments in agricultural infrastructure and agro-processing and efforts to consolidate land parcels should contribute to increasing productivity in the sector. The infrastructure and agro-processing investment measure is rolled over from the 2016-2018 ERP and some activities seem to have been carried out in 2016 through calls for applications. However, there are no figures for the increase in irrigation coverage, the wholesale agriculture market infrastructure or the number of testing units in laboratories. Some of the targets set for the coming three years are rather ambitious (an annual increase of 13.5% of the area under irrigation; a 20% increase of exports and a 10% fall in import substitution in the products supported; and 15% net added gross value in supported enterprises), but the activities presented to achieve these targets are rather general. It is therefore not clear how realistic they are. Moreover, there are no baseline figures provided to be able to monitor/evaluate them.

The measure to regulate and consolidate agricultural land is also rolled over from last year's ERP and it continues to be fully pertinent. However, the measure basically relies on voluntary consolidation and does not provide any indication of the target to be achieved at the end of the process.

Industry sector development

Kosovo’s industry is characterised by low-value-added and undifferentiated production. The sector is dominated by SMEs with a low level of FDI. The EPR assessment mainly focuses its diagnostic on the weak cooperation between companies and the lack of coordination through industry associations. It leaves out the lack of support services to industries, and other structural problems in the main industries (such as mining or textiles) preventing the development of higher value-added product chains.

The measure to support the development of industrial clusters could help companies to create synergies, learn from each other. It is rolled over from the 2016-2018 ERP; however, it still fails to explain why this is considered the most relevant action in this sector compared to other actions envisaged in Kosovo’s industrial policy and the private sector development strategy. Only limited progress has been made in relation to the activities planned for 2016. The activities planned for 2017-2019 are not ambitious enough to have a real impact on the competitiveness of the Kosovo economy.

Services sector development

The service sector contributes 58,2% of the gross value added and it is the fastest growing export sector. The ERP does not contain a proper analysis of the services sector as a whole and only identifies obstacles in the tourism sector. Other services such as ICT, retail and wholesale, professional services etc. are not mentioned. Moreover, major obstacles to the development of the services sector such as a lack of skills, an incomplete legal framework and an inadequate system of mutual recognition of professional qualifications are also not analysed.

The measure to develop tourism products in Kosovo's tourist regions and increase the economic value of tourism is new and it could have a major impact on the economy. However, the planned actions could be better sequenced: they should start with drafting a sector-wide Action Plan for tourism in Kosovo, involving all relevant stakeholders (notably municipalities and the private sector). This plan could include some of the actions proposed for 2018 and 2019 (e.g. data collection, analysis of potential and evaluation of needs for the different categories of tourism and regions). Specific actions could then be developed in certain regions, as already proposed for 2017.

Business environment and reduction of the informal economy

Informality, poor access to finance, weak rule of law, and low administrative capacities are among the main challenges to private sector development and to competitiveness. The diagnostic recognises these challenges, but leaves out some other pertinent negative characteristics of Kosovo’s investment climate, such as the complex and changing regulatory framework, insufficient consumer protection, a complex market surveillance system, and poor accounting, auditing and financial reporting standards.

The five measures proposed are rolled over from the 2016-2018 ERP. However, in last year's ERP most of them lacked detailed information as to the activities planned in each year, which makes an assessment of implementation in 2016 very difficult.

The measure to strengthen evidence-based policy-making and reduce the administrative burden is relevant. However, the link between the measure proposed and the improvement of the business environment should be made clearer. It is loosely linked to the Regulatory Impact Assessment (RIA) measure of the 2016-2018 ERP, even though the activities planned are different. Last year’s measure was partially implemented through the certification of RIA trainers.

The measure to facilitate property rights recognition and their registration in the cadastre will enable the use of previously inactive assets as lending collateral and thus facilitate the access to finance. The measure was rolled over from the 2016-2018 ERP and was partially implemented in 2016 through the adoption of the National Strategy for Property Rights and the concept paper on public property. The activities envisaged for the next three years, however, are quite ambitious and possibly underestimate the risks associated with the achievement of a unified cadastre and the settlement of disputes.

The measure on reducing the court case backlog should help to improve the judiciary efficiency but will require broad support from all relevant stakeholders, which was not the case so far. It is rolled over from the 2016-2018 ERP and activities planned in 2016 were partially implemented: the legal framework was amended so that the judicial system only handles minor cases if they are contested by the parties. It is worrying that the special team to reduce the backlog of cases was not established due to budgetary constraints and that the project implementation of the Case Management Information System has been delayed. The activities planned in 2017-2019 are important and relevant with a significant potential impact on the business environment.

The measure aimed at the full operationalisation of the Kosovo Credit Guarantee Fund could improve access to finance for businesses. However the projected increase in credit and jobs appears quite unrealistic. The measure was rolled over from the 2016-2018 ERP. In 2016 the regulation on organisational structures was adopted and the Board of Directors was put in place. Agreements were signed with five commercial banks, but the government committed only EUR 2 million to the fund, as opposed to the EUR 3 million initially planned, with the last million planned to be transferred in 2017. If duly implemented, the measure has the potential to bring economic benefits, notably if done in conjunction with other reform measures included in the ERP which also affect access to finance (combating the informal economy, strengthening the property rights system and increasing judicial efficiency).

The measure aimed at merging the Kosovo customs and tax administrations and establishing a single Revenue Collection Agency should be done without any politicisation to achieve the foreseen efficiency gains. It is also rolled over from the 2016-2018 ERP and the activities planned in 2016 were partially implemented through finalising the action plan for the merger. However, the legal base has not been established yet. To have the expected impact in terms of expanding the tax base, efficiency gains in the revenue collection and reducing informalities and the coordination between the main decision making actors must be improved.

Research and innovation

Kosovo's capacity for research, development and innovation (RDI) is very low, which limits the creation of new jobs. The ERP recognises that and points out the lack of a legal and policy framework as well as the low level of political commitment to RDI, which is reflected in the very low public expenditure (0.1 % of GDP). The analysis also adequately signals the lack of incentives for the private sector and academia, although there is no reference to the companies' low absorption capacity and universities' limited capacity for specialised research and lack of results in commercialisation.

The measure to improve the policy and strategic framework is new but the expected impact may not be achieved if the measure is not complemented by more ambitious actions to assist and boost applied research activities in Higher Education, and to substantially improve cooperation between research institutes and businesses.

External trade and investment facilitation

Kosovo is not yet fully integrated in the global economy. Obstacles to increasing trade openness include the high cost of cross-border trading which is linked to procedural, quality, logistical and border obstacles to exports, as well as the certification of Kosovo products and a lack of experience in marketing and sales, which makes it difficult for Kosovo's companies to win contracts in European markets. The ERP recognises these challenges but the critical importance of engaging with the private sector is not sufficiently considered.

The measure to increase the cost efficiency of international transactions (through simplification and standardisation of customs formalities and procedures) is clearly linked to the diagnostic and to the need to eliminate non-tariff barriers to trade. It should thus help to reduce the costlier and more cumbersome procedures that Kosovo suffers to export compered to its regional peers. However, its design would benefit from setting priorities as it includes too many activities. The allocation from Kosovo's budget seems very limited (EUR 10,000) and the activities are expected to be supported by donors (although the level of support and overall cost of the measure is not clear).

The measure on quality infrastructure has become even more relevant in view of the obligations taken on by Kosovo following the signing of the SAA with the EU. It is rolled over from the 2016-2018 ERP, and the activities planned in 2016 were partially implemented. Almost 1400 European and international standards were adopted and awareness raising activities were implemented as planned. However, there was no progress on the completion and establishment of new laboratories, or on increasing the number of conformity assessment programmes. No progress was made in further completing the legislative framework. To have the expected impact, a more holistic approach is needed to the challenges in the three pillars of quality infrastructure (standardisation, metrology and conformity assessment, including certification and accreditation).

Moreover, some challenges to the implementation of this measure, like the weak inter-institutional coordination between relevant ministries and quality infrastructure institutions and the lack of qualified staff, are not identified. The measure also mainly focuses on regulatory work and adoption of legislation while it should also aim at enhancing the support for companies to comply with EU standards (access to expertise/financing) and address the constraints that SMEs face in adapting their production methods and facilities.

Education and skills

The results of the first PISA survey have revealed a considerable gap in education outcomes, placing Kosovo considerably below the Western Balkans region and EU averages. The young population can only become a real asset for economic development if rapid progress is made in stepping up the quality of education at all levels. Education is a strong priority in Kosovo's National Development Strategy, which is reflected to some extent in the ERP. The ERP identifies primarily the low participation in pre-school education as one important factor impeding skills development from early years on; however, it does not present measures for increasing participation.

First steps have been taken for implementing the reform of the teachers' career system. The measure is rolled over from the previous ERP**.** This reform should be pursued without further delay, its initial timeframe 2016-2018 already extended to 2019, and concentrate on the delivery of pre- and in-service teacher training.

A new priority measure foresees adjusting skills supply and demand by developing new occupational standards and reviewing the curricula in vocational education and training accordingly. The lack of skills in demand, such as IT skills, is a key factor hampering business expansion and job creation. The measure is a step in the right direction, provided that it is based on the identification of labour market needs and embedded in a more general review of the current VET provision.

Employment and labour markets

Kosovo is facing a huge challenge stemming from jobless growth and a steady increase in the working age population. The ERP diagnostic based on the official labour market statistics of Kosovo indicates that Kosovo continues to have by far the lowest activity and employment and the highest unemployment rates in the Western Balkans region. Of particular concern is the very low employment rate below 30%, while 40% of male and 80% of female working age population declare to be inactive. Only two cohorts stand out with higher activity rates, men aged 30-50 (80-83%) and women aged 25-35 (28-29%).

Despite positive growth rates over the past years, the private sector economy is still too small to generate larger numbers of new jobs. Although data for the first three quarters of 2016 indicate a net increase in employment, this is only catching up from previous decreases in 2014 and 2015, while the labour force has grown over the same period. Substantial job creation will to a large extent depend on making progress in moving from consumption-led growth relying on remittances to growth through productivity increases and export-oriented goods and services.

The estimated labour force increase of 30.000-45.000 persons per year steadily aggravates in particular the position of young people lacking employment prospects. Out of the 330.000 youth (15-24), 30% are not in employment, education or training. Only 23.3% are active on the labour market, and a mere 10.5% are employed. It is of utmost urgency to start creating opportunities for young people, so that their talents can contribute to developing the country's private sector, in particular in those sectors identified as having a growth potential. Kosovo should without further delay respond to the 2016 policy guidance on developing an action plan for tackling youth unemployment, in cooperation with all relevant domestic and international actors.

Labour market institutions supporting both jobseekers and employers are still in an early stage of development. The reform measure for establishing the Employment Agency into a self-standing institution that could provide client-oriented counselling and mediation services and implement active labour market programmes is rolled over from the previous ERP. First steps have been completed in 2016, mainly focussed on internal administrative issues of the Agency. Active labour market measures are being programmed and implemented, however, with a far too modest scope.

Social inclusion, poverty reduction and equal opportunities

Kosovo is facing multiple social challenges stemming from low employment, while the social protection system is in an early stage of development. The ERP diagnostic points to some key indicators: GDP per capita is around 20% lower than in Albania and Bosnia and Herzegovina, and less than half the level of Montenegro; one third of the population lives in poverty, and around 10% in extreme poverty. The cash benefits systems in place have a limited effect of alleviating poverty.

The socio-economic position of women is particularly weak. Women with lower than secondary education level are fully excluded from the labour market. Only women with tertiary education have higher employment levels (47.7%) than women on average, primarily in the public sector. A lack of childcare facilities and the two-shift school system, combined with low wage levels making part time work unattractive, hamper women's access to employment.

The ERP includes for the first time a reform measure in the area of social policy. The reform includes two distinct components. The building up of the health insurance fund based on contributions, already foreseen by legislation adopted in 2015, is now to start in mid-2017. Budgetary implications are substantial since contributions from public sector employees are covered by the state budget. New budgetary provisions are foreseen for funding social services to citizens at the local level that could support the inclusion of vulnerable and marginalised groups of the population. The government needs to ensure that this reform, which will establish new rights, especially in access to healthcare, is implemented in a sustainable manner and with tangible results for citizens.

7.5. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2016

2016 policy guidance	Summary assessment
PG1: Improve forecast accuracy, enhance technical capacities of the services preparing the macro fiscal framework, strengthen parliamentary oversight capacities in evaluating budget planning and execution as well as fiscal risks and take first steps towards establishing an independent fiscal body.	There has been **limited implementation** of PG1: • The Macroeconomics unit within the Ministry of finance, in charge of policy analysis and forecasting, is still understaffed and struggles with high turnover of personnel. • There have been some discussions between stakeholders on possible modalities for the establishment of the fiscal council/ institution but without any concrete actions.
PG2: Identify offsetting measures for recent increases in categorical benefits while preserving the share of capital spending and address persistent under spending of the capital budget by improving project preparation and management capacities at central and local administration levels.	Kosovo has **partially implemented** PG2: • Annual expenditure for the newly introduced categorical benefits has been limited to 0.7% of GDP. Furthermore the eligibility criteria for the scheme was strengthened and differentiated rates of benefits were introduced, with a view of finding additional savings. The government also committed to review the eligibility of all 48,000 certified war veterans as the original process was marred by transparency and credibility issues. • The share of capital spending was slightly increased in 2016 (26.8% compared to 25.8 in 2015). The 2017 budget foresees the ratio rising to 37.5% by 2019. • Overall 88.7% of the planned capital budget was executed. However this was done primarily due to the payment for the Route 6 highway project. There has not been any improvement in capital spending on the local level. Capacity constraints for public procurement and multi-year planning exist on both central and local levels as is evident from poor execution of planned spending under projects funded by IFIs.
PG 3: Further address the underlying legal and institutional factors responsible for both high cost of credit and difficulties in access to finance so as to increase financial intermediation in the economy, while establishing a reliable measure of private sector inflation expectations so as to better gauge price developments.	Kosovo has **partially implemented** PG 3: • Increased competition in the banking sector, reforms in the justice system and improvements in bank's loan portfolio contributed to credit growth and access to finance. A Credit Guarantee Fund aimed at facilitating access to finance by providing credit guarantees (up to 50%) was established in April 2016. • There has not been any reported progress on development of a reliable measure of private sector inflation
PG 4: Implement the action plan of the strategy for	There has been **limited implementation** of PG 4:

the fight against the informal economy. In particular, speed up the risk assessments focusing on the sectors and branches most vulnerable to informalities in order to identify and apply appropriate corrective measures.	• The Strategy implementation reports for 2015 and 2016 have been finalised and published after a 2-year gap in reporting. The Secretariat for Monitoring the Strategy Implementation has been reactivated and held several meetings. • Sectoral risk analyses have only been developed for the construction sector.
PG 5: Increase energy security by reinforcing the planned energy efficiency measures to include incentives for the private sector and households and by adopting a plan for the gradual adjustment of energy tariffs to reflect actual costs	Kosovo has **partially implemented** PG 5: • Energy efficiency: as of yet there is no mechanism to finance or provide incentives to support energy efficiency investments in the private sector and households. There are no programmes for the renovation of residential buildings. • Regarding the plan for gradual adjustment of energy tariffs: on 18 January 2017 the Board of the Energy Regulatory Office (ERO) adopted Guidelines for the liberalisation of electricity market in Kosovo. For some commercial consumers, the deregulation of prices will start in April 2017, while for the remaining large commercial consumers; the deregulation of prices will start in April 2018. The timelines for deregulation of prices for remaining consumers remains unclear,, although ERO has designed a tariff structure with some incentives for customers who save energy, thus starting to reflect the fact that marginal costs of supply are higher at peak time.
PG 6: Set up an action plan for tackling youth unemployment based on an assessment of the challenges and focussing on improving education outcomes including through improved teacher training and supporting school-to-work transitions. Ensure that the Employment Agency has sufficient capacity. Take measures to increase labour market participation of women.	There has been **limited implementation** of PG 6: • The Action Plan for tackling youth unemployment has not been developed (postponed to 2017). • Teacher training measures have been rolled out. • Internal regulations on the functioning of the Employment Agency have been drafted; however the full operationalisation of the Agency is still depending on the nomination of its Director. • Apart from few active labour market measures with very small number of beneficiaries, no other measures to increase labour market participation of women have been taken so far.

7.6. THE 2017 POLICY GUIDANCE

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

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

Brussels, 23 May 2017

[…]

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

1. Enhance the institutional capacities and ensure appropriate staffing at the Ministry of Finance in order to improve macro-fiscal planning, forecasting and fiscal impact assessments. Prepare an options paper on the establishment of an independent body for fiscal oversight for further consultations with stakeholders, including the EU.

2. Strengthen institutional capacities at central and local government levels for public procurement, multiannual investment planning, and investment project preparation and management in order to improve the execution of capital spending. Take steps towards introducing targeting and means-testing to all war veteran programmes in order to further contain current expenditure.

3. Further address the underlying legal and institutional factors hampering access to finance for corporates to improve banks' incentives to lend to enhance financial intermediation in the economy. Continue improving the central bank's analytical toolkit (including through the establishment of a reliable measure of private sector inflation expectations in order to better gauge underlying price dynamics), and develop a liquidation and bank resolution framework to strengthen the overall resilience of the banking sector.

4. Establish a financing mechanism to support energy efficiency measures and adopt energy efficiency incentives to the private sector and households. Complete the deregulation of energy generation prices, gradually deregulate electricity supply prices and gradually adjust energy tariffs to reflect actual costs.

5. Complete the risk assessments focusing on the sectors and branches most vulnerable to informalities and identify and apply appropriate corrective measures.

6. Adopt an action plan for tackling youth unemployment, based on a sound assessment of the challenges. Finalise the operationalisation of the Employment Agency. Target reforms in vocational education and training and higher education on business sectors with labour demand and job creation potential. Increase enrolment in pre-school education.

ANNEX: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Economic Reform Programme 2017-2019 was adopted by the Government on 27 January 2017 and submitted to the Commission on the same day, ahead of the deadline. It is in line with the previously approved medium-term fiscal strategy and national development strategy. No components of the ERP are missing; however, no written contributions from external stakeholders have been annexed to the programme.

Inter-ministerial coordination

The preparation of the ERP was centrally coordinated by the Ministry of Finance with the support of the Office for Strategic Planning in the Office of the Prime Minister (OPM). The inter-ministerial coordination process improved this year and all relevant line ministries contributed to the drafting of the programme and were fully consulted. The ERP was discussed and endorsed by the Strategic Planning Committee chaired by the Prime Minister on 19 December 2016.

Stakeholder consultation

Section 6 of the ERP provides information on the public consultation of the ERP. A draft ERP was made available to the public on the OPM website in December 2016 and was emailed to a number of external stakeholders. A meeting was also held to discuss the draft, albeit very late in December during the holiday period, which did not facilitate participation. The draft was also presented to the Assembly of Kosovo for information and discussion. However, no written comments from stakeholders were annexed to the ERP.

Macroeconomic Framework

The presented macro-fiscal framework in the 2017 ERP is broadly plausible. External assumptions have been taken from the IMF October 2016 World Economic Outlook and the Commission's autumn 2016 forecast. Credibility of the fiscal framework has been greatly improved on the account of more conservative revenue projections. Both the low and the high growth alternative scenarios are useful to showcase the likely impact of some expected and unexpected developments in Kosovo's economy.

Fiscal Framework

The fiscal framework was prepared in cooperation with the IMF and is in line with the MTEF 2017-2019 and the 2017 budget. It envisages plausible revenue projections due to maintained growth. On the expenditure side the framework foresees a substantial fiscal expansion through higher investments. However, risks of capital under-spending and further ad-hoc increases of current spending remain.

Structural reforms

The structural reforms sections (4, 5 and 6) follow the guidance note. The reporting of the implementation of the policy guidance (sections 1 and 4) and the structural reform measures from the 2016-2018 ERP (table 12 in annex) is both sufficient and up-to-date. The number of reform measures is limited to 20 and the page limit (40) for section 4 is respected. The structure of the reform measures is much improved, in terms of scope and clarity of timeline and budget for activities planned in the three years of the programme. Tables 9-12 of the annex are filled in appropriately.

EUROPEAN ECONOMY INSTITUTIONAL SERIES

European Economy Institutional series can be accessed and downloaded free of charge from the following address:
https://ec.europa.eu/info/publications/economic-and-financial-affairs-publications_en?field_eurovoc_taxonomy_target_id_selective=All&field_core_nal_countries_tid_selective=All&field_core_date_published_value[value][year]=All&field_core_tags_tid_i18n=22621.

Titles published before July 2015 can be accessed and downloaded free of charge from:

- http://ec.europa.eu/economy_finance/publications/european_economy/index_en.htm
  (the main reports, e.g. Economic Forecasts)
- http://ec.europa.eu/economy_finance/publications/occasional_paper/index_en.htm
  (the Occasional Papers)
- http://ec.europa.eu/economy_finance/publications/qr_euro_area/index_en.htm
  (the Quarterly Reports on the Euro Area)

Alternatively, hard copies may be ordered via the "Print-on-demand" service offered by the EU Bookshop: http://bookshop.europa.eu.

HOW TO OBTAIN EU PUBLICATIONS

Free publications:

- one copy:
  via EU Bookshop (http://bookshop.europa.eu);

- more than one copy or posters/maps:
  - from the European Union's representations (http://ec.europa.eu/represent_en.htm);
  - from the delegations in non-EU countries (https://eeas.europa.eu/headquarters/headquarters-homepage/area/geo_en);
  - by contacting the Europe Direct service (http://europa.eu/europedirect/index_en.htm) or calling 00 800 6 7 8 9 10 11 (freephone number from anywhere in the EU) (*).

  (*) The information given is free, as are most calls (though some operators, phone boxes or hotels may charge you).

Priced publications:

- via EU Bookshop (http://bookshop.europa.eu).

KC-BC-17-055-EN-N

Publications Office

ISBN 978-92-79-64694-2